CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Committee on the Budget
U.S. House of Representatives

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NOTICE

This statement is not available for public release until it is delivered at 9:30 a.m. (EST), Wednesday, January 30, 1991.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, thank you for inviting me to appear before this Committee to discuss the state of the American economy and the federal budget. The Congressional Budget Office (CBO) is today releasing its annual report, *The Economic and Budget Outlook: Fiscal Years 1992-1996*, which describes our current economic forecast and budget projections in considerable detail. The report also contains what we hope is a useful, nontechnical summary of the changes in the budget process that were enacted last year. My prepared statement summarizes our report.

The downturn in the economy and record outlays required to resolve failed banks and savings and loans will push the federal deficit near $300 billion in 1991. Not included in this estimate, but sure to add to it, are the costs of the war in the Persian Gulf. After 1991, as these factors begin to fade and as the savings from last year's budget agreement grow, the budgetary picture should brighten. In fact, by 1995, assuming that the new legal limits on discretionary spending are maintained, CBO projects that the total federal deficit will fall below $100 billion for the first time in 15 years and below 1 percent of gross national product (GNP) for the first time in 20 years.

CBO's budget projections assume that the U.S. economy is now in a brief recession, which will continue into the spring. After that, the prospects for a solid recovery with low inflation are good. Real GNP is projected to be flat in 1991 (on a year-over-year basis) and to grow by about 3 percent a year in 1992 through 1996.

THE BUDGET OUTLOOK

The Omnibus Budget Reconciliation Act of 1990, enacted late last year, included a record of nearly $500 billion in deficit reduction measures over the 1991-1995 period. The Budget Enforcement Act (Title XIII of the reconciliation act) established dollar limits on discretionary spending, a pay-as-you-go provision for most mandatory spending and revenues, and procedures to enforce these requirements. Although the Budget Enforcement Act does not contain fixed deficit targets, as were previously set in Gramm-Rudman-Hollings, the spending cuts and tax increases contained in the reconciliation act should set the deficit on a downward trend after 1991.

Deficit Projections for 1991-1996

The budget baseline has traditionally been used to show what would happen if current budgetary policies were continued without change. For tax revenues and entitlement spending, the baseline generally assumes that laws now on the statute books will continue. For defense, international, and domestic discretionary spending, the projections are based on the most recent appropriations, increased only to keep pace with inflation. Under baseline assumptions, the deficit in 1992 would be the same as in 1991--$298 billion, or about 5 percent of GNP. The projected baseline deficit drops to $128 billion in 1995 but turns up slightly in 1996, when $14 billion in spending reductions and tax increases are scheduled to expire (see Table 1).

TABLE 1. CBO DEFICIT PROJECTIONS (By fiscal year)

	1990	1991	1992	1993	1994	1995	1996
			In Billions of Dollars				
Baseline Total Deficit	220	298	298	239	211	128	135
Assuming Discretionary Spending Limits[a]							
Total deficit	220	298	284	215	160	57	56
Deficit excluding deposit insurance	162	194	186	167	135	103	99
On-budget deficit[b]	277	360	354	294	258	170	185
			As a Percentage of GNP				
Baseline Total Deficit	4.1	5.3	5.0	3.7	3.1	1.8	1.8
Assuming Discretionary Spending Limits[a]							
Total deficit	4.1	5.3	4.7	3.4	2.4	0.8	0.7
Deficit excluding deposit insurance	3.0	3.5	3.1	2.6	2.0	1.4	1.3
On-budget deficit[b]	5.1	6.4	5.9	4.6	3.8	2.3	2.4

SOURCE: Congressional Budget Office.

a. The discretionary spending limits apply only through 1996. The 1996 figures are extrapolations.

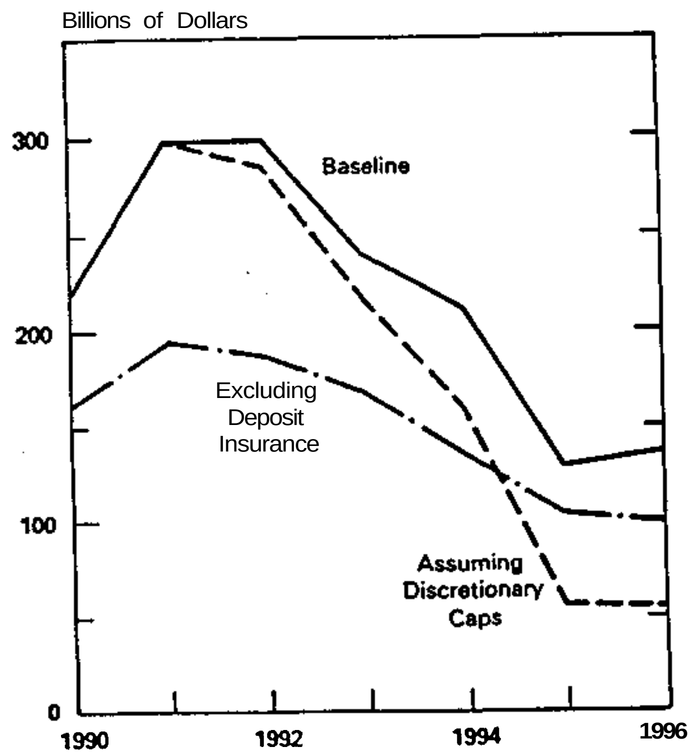
b. Social Security and the Postal Service are outside the budget.

The baseline no longer represents current budgetary policy, however, because the dollar limits for discretionary appropriations are below the levels assumed in the baseline. Adhering to these limits will require holding discretionary outlays below baseline levels by an estimated $13 billion in 1992, $22 billion in 1993, $46 billion in 1994, and $62 billion in 1995. Although the statutory caps do not extend beyond 1995, sticking to the caps through 1995 will also produce discretionary savings in 1996, as well as interest savings in all years. Assuming that discretionary spending is held to the caps, the deficit would be $284 billion in 1992, $57 billion in 1995, and $56 billion in 1996. By 1995, the deficit would fall to 1.8 percent of GNP in the baseline and 0.8 percent of GNP if the discretionary spending caps are effective.

While the total deficit measure discussed above has been the exclusive focus of attention in the past, two other deficit measures are now likely to be considered as well. The first is the deficit excluding deposit insurance spending--the best simple measure of the government's effect on the economy. In both 1991 and 1992, about $100 billion in federal spending will be required to close or subsidize the sale of insolvent savings and loan institutions and banks whose deposits have been insured by the federal government. By 1995 and 1996, however, the federal government's proceeds from selling the assets of failed institutions will cause deposit insurance spending to turn negative.

These large year-to-year swings in deposit insurance spending do not represent changes in the federal government's effect on the economy and have little impact on interest rates. Excluding deposit insurance, the federal deficit is projected to rise from $162 billion in 1990 to $194 billion in 1991 and to decline slowly thereafter, as shown in the figure. In relation to the size of the economy, the deficit

Figure.
Deficit Projections



SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget.

excluding deposit insurance declines from 3.5 percent of GNP in 1991 to 1.3 percent of GNP in 1996.

The second deficit measure that will receive attention is the on-budget deficit, which excludes the receipts and outlays of the Postal Service and the two Social Security trust funds. Assuming adherence to the discretionary caps, this on-budget deficit would be $360 billion in 1991, $354 billion in 1992, and $185 billion in 1996. From the standpoint of economic policy, however, the on-budget deficit is not meaningful.

Changes in the Budget Outlook Since July

While the long-term budget picture has improved since CBO's budget report last July, the short-term outlook is far more pessimistic. The deficit reduction measures contained in the 1990 reconciliation act will be overshadowed for several years by a worsening of the economic outlook, higher deposit insurance spending, and other factors. As indicated in Table 2, CBO estimates that the policies in the 1990 budget agreement will reduce the deficit by $33 billion in 1991, $69 billion in 1992, and $160 billion in 1995, compared with CBO's July baseline. Over the 1991-1995 period, the package saves an estimated $482

billion--$264 billion from spending cuts, $158 billion from tax increases, and $59 billion in resulting savings on debt service.

For the next several years, however, changes in economic assumptions and other factors overwhelm the policy changes. CBO's new eco-

TABLE 2. CHANGES IN **CBO** DEFICIT PROJECTIONS SINCE JULY
(By fiscal year, in billions of dollars)

	1991	1992	1993	1994	1995	Cumulative **Five-Year Changes**
July **Baseline**	232	238	196	145	138	n.a.
Changes						
Policy **changes**						
Revenues	-18	-33	-32	-37	-39	-158
Entitlements and other mandatory **spending**	-9	-12	-16	-19	-19	-75
Enacted appropriations	-6	-6	-9	-12	-13	-46
Required **reductions** in **discretionary spending**	n.a.	-13	-22	-46	-62	-144
Debt **service** savings	-1	-4	-10	-17	-27	-59
Subtotal	-33	-69	-89	-131	-160	-482
Economic **assumptions**	50	63	63	70	79	n.a.
Technical **reestimates**						
Deposit insurance	23	20	7	32	-44	n.a.
Other	26	30	36	42	43	n.a.
Subtotal	49	50	43	74	-1	n.a.
Credit reform	0	2	3	2	a	n.a.
Total Changes	66	46	19	15	-81	n.a.
Current **Estimate Assuming Discretionary** Spending **Limits**	298	284	215	160	57	n.a.

SOURCE: **Congressional** Budget Office.

NOTES: The projections include Social Security and the **Postal** Service, which are off-budget.

n.a. = not **applicable.**

a. Less than **$500** million.

nomic assumptions have increased the projected deficit by $50 billion in 1991, $63 billion in 1992, and $79 billion in 1995. These figures reflect both the current recession, which is temporary, and what appears to be a reduction in the economy's potential rate of growth.

Changes in CBO's technical estimating assumptions have increased the projected deficits by an average of more than $50 billion per year in 1991 through 1994, but have reduced the deficit slightly in 1995. This pattern mirrors the changes in deposit insurance estimates, which average $20 billion higher in 1991 through 1994, but are $44 billion lower in 1995. In addition to upping the estimated short-run costs of the thrift bailout, CBO has substantially increased estimated spending in 1991 to deal with insolvent banks. CBO also projects faster growth in spending for Medicare and Medicaid. Other technical reestimates affect a wide variety of revenue sources and spending programs and add significantly to the costs of debt service.

THE ECONOMIC OUTLOOK

CBO believes that the U.S. economy has slipped into its ninth recession of the postwar period. Although the economic outlook is extraordinarily uncertain, this recession will probably be milder than the average downturn and will end by midyear. Several factors contribute to the likelihood of a relatively short recession:

- Inventories are relatively low compared with sales, and reductions in orders are therefore less likely than in previous recessions.

- Real exports are expected to remain strong as a result of the dollar's decline and a healthy growth in foreign demand.

- The war in the Persian Gulf is not likely to generate large disruptions in oil supplies.

- Inflation is lower than at the onset of earlier recessions, thereby permitting a further easing of monetary policy.

Forecast for 1991 and 1992

CBO's economic forecast incorporates a decline in economic activity in the fourth quarter of 1990 and the first quarter of 1991. Between the fourth quarters of 1990 and 1991, real GNP is projected to grow by about $1\frac{1}{2}$ percent (see Table 3). Because the recession will expand the gap between actual production and the economy's capacity, higher growth will mark the recovery, as the economy catches up to its potential. For 1992, the growth rate is expected to rise to about 3½ percent.

TABLE 3. COMPARISON OF CBO AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS

	Estimated 1990	Forecast 1991	Forecast 1992
Fourth Quarter to Fourth Quarter (Percentage change)			
Real GNP			
CBO	0.2	1.3	3.4
Blue Chip	0.2	0.9	2.8
Implicit GNP Deflator			
CBO	4.4	4.1	3.6
Blue Chip	4.5	4.0	3.6
Consumer Price Index (CPI-U)[a]			
CBO	6.1	4.0	3.5
Blue Chip	6.2	4.1	4.0
Calendar-Year Averages (Percent)			
Civilian Unemployment Rate			
CBO	5.5	6.8	6.4
Blue Chip	5.5	6.5	6.3
Three-Month Treasury Bill Rate			
CBO	7.5	6.6	7.0
Blue Chip	7.5	6.3	6.5
Ten-Year Treasury Note Rate			
CBO	8.6	7.9	7.7
Blue Chip	8.6	7.8	8.0

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1991); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

a. CPI-U is the consumer price index for all urban consumers.

b. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

The pain of a recession, however, will produce the traditional benefits of reduced inflation and lower long-term interest rates. The inflation rate is likely to remain between 3 percent and 4 percent on a sustained basis--significantly lower than it was during most of the 1980s. The interest rate on 10-year Treasury notes, which averaged 8.6 percent in 1990, is expected to fall to 7.9 percent in 1991 and remain low. Short-term interest rates should remain relatively low in the near term as the Federal Reserve continues to relax monetary policy, but will rebound as the economy recovers.

Projections for 1993-1996

CBO does not try to forecast short-term fluctuations in the economy more than two years into the future. Instead, for the 1993-1996 period, CBO makes projections based on trends in variables such as labor supply, productivity, and saving rates. CBO projects that potential GNP will grow on average by about $2\frac{1}{4}$ percent a year. This projection, which is slightly lower than CBO's estimates of last summer, reflects the July revisions to the national income and product accounts, which suggest that productivity has been growing more slowly in recent years than earlier reports had indicated. The projection of potential output also takes account of the expected slowing in the growth of the labor force, as well as the increase in the capital stock that will stem from reductions in the federal deficit. Real GNP is projected to grow at an average rate of 2.8 percent over the 1993-1996 period to close the gap between actual and potential GNP opened up by the recession (see Table 4).

TABLE 4. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1993 THROUGH 1996

	Estimated	Forecast		Projected			
	1990	1991	1992	1993	1994	1995	1996
Nominal GNP (Billions of dollars)	5,467	5,700	6,107	6,505	6,919	7,358	7,824
Nominal GNP (Percentage change)	5.1	4.3	7.1	6.5	6.4	6.3	6.3
Real GNP (Percentage change)	0.9	0.0	3.3	2.9	2.8	2.7	2.7
Implicit GNP Deflator (Percentage change)	4.2	4.3	3.7	3.5	3.5	3.5	3.5
Fixed-Weighted GNP Price Index (Percentage change)	4.6	4.6	3.8	3.8	3.8	3.8	3.8
CPI-U (Percentage change)	5.4	4.9	3.5	3.6	3.6	3.6	3.6
Unemployment Rate (Percent)	5.5	6.8	6.4	6.2	6.0	5.8	5.6
Three-Month Treasury Bill Rate (Percent)	7.5	6.6	7.0	6.7	6.3	5.9	5.7
Ten-Year Treasury Note Rate (Percent)	8.6	7.9	7.7	7.6	7.4	7.3	7.2

SOURCE: Congressional Budget Office.

NOTE: CPI-U is the consumer price index for all urban consumers.

CBO's long-run projections of interest rates are based on the historical pattern of interest rates and increases in national wealth. The reduction in the federal deficit will increase saving and capital formation, but increased European capital demands will offset the resulting downward pressure on interest rates. As a result, CBO projects real short-term interest rates in the mid-1990s of about 2 percent, and real long-term rates about $1\frac{1}{2}$ percentage points higher.

CONCLUSION

CBO's economic forecast is slightly more optimistic than the current *Blue Chip* average, as Table 3 shows. The 50 or so individual forecasts that make up the average, however, are more widely dispersed than normal, reflecting the unusual uncertainty prevailing today. Military and political analysts cannot foretell the course of the war or the shape of the postwar Middle East. Similarly, economists are notoriously poor at predicting the path of the economy near turning points in the business cycle. In addition, there is a good deal of uncertainty about whether banks and other financial institutions are in a position to extend sufficient credit to the rest of the U.S. economy.

Fortunately, the Budget Enforcement Act has partly insulated the budget process from these unpredictable factors. It adjusts the deficit targets for economic and technical changes and no longer promises to balance the budget by a certain date. It exempts deposit insurance spending from the requirement that increases in mandatory spending be offset by other spending cuts or tax increases. And it exempts emergency spending--such as the cost of operations in the Persian Gulf--from the discretionary spending limits and pay-as-you-go requirements. If fiscal policy is kept on its current course, the deficit should shrink significantly in a few years, even if it suffers further reverses in the meantime.