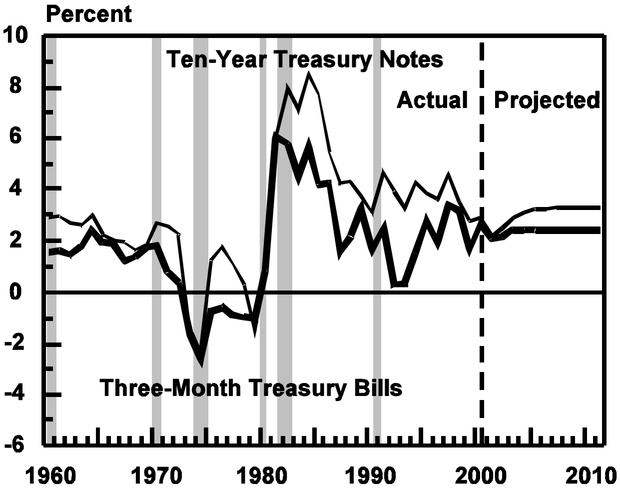
**Figure 2-8.**
**Real Interest Rates**



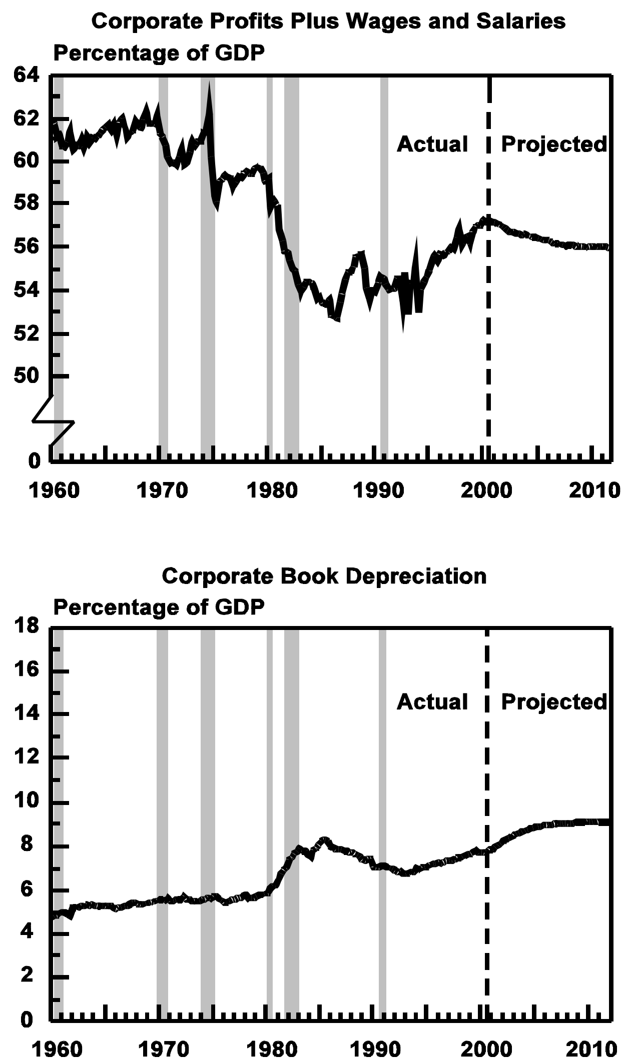

SOURCES: Congressional Budget Office; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

bills averages 2.4 percent during the last years of CBO's projection period, and the real rate on 10-year Treasury notes averages 3.3 percent (see Figure 2-8). The real 10-year rate is about the same as its average of the past four decades; the real three-month rate is slightly higher. Both are also close to their ranges during the stable inflation years of the 1960s but lower than their averages of the early 1980s. Real rates should be lower, on average, for two reasons: because of mounting federal surpluses and because the inflation stability that has occurred since the mid-1980s is likely to have lowered the additional return that investors require for uncertainty in inflation. Combined with projected rates of CPI inflation, those real rates imply nominal interest rates of 4.9 percent for three-month Treasury bills and 5.8 percent for 10-year Treasury notes.

## Taxable Income

CBO's projections for the federal budget are closely connected to its projections of economic activity and components of national income. Because different components are taxed at different rates, and some are not taxed at all, the distribution of income among its components is an important part of CBO's economic projections. Wage and salary disbursements and corporate profits are particularly important because they produce the most tax revenues. As a share of GDP, those two categories combined have risen sharply, from 54.0 percent in 1994 to 57.2 percent in 2000. In CBO's projections, however, their share declines to 56 percent (see Figure 2-9).

**Figure 2-9.**
**Income Shares and Depreciation**




SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: Corporate profits are book profits.

CBO expects the sum of those high-tax categories of income to grow more slowly than GDP during the next 10 years because depreciation will be higher, reflecting the high investment rates of the recent past. The boom in business investment during the past five years has led to a rapid increase in the size of the nation's capital stock. Consequently, firms will be able to deduct growing amounts for depreciation from their taxable earnings. CBO projects that such deductions for depreciation will rise from 7.8 percent of GDP in 2000 to 9.1 percent in 2008 and will remain at that percentage through 2011 (see Figure 2-9).

## Comparison with CBO's July 2000 Projections

The current medium-term economic projections have more favorable implications for the budget outlook than did CBO's previous projections, published last July. The current projections indicate higher federal revenues because the growth of real GDP is significantly higher, the growth of the GDP price index is slightly higher, and the high-tax categories of income together make up a greater share of GDP (see Table 2-4). Other changes, such as a higher projected unemployment rate and lower projected interest rates in the short term, have relatively small effects on the outlook for the budget.

**Growth of Real GDP**. CBO has raised its projections for the growth of both GDP and potential GDP since last July. In the current projections, potential output grows at an average rate of 3.3 percent through 2011, compared with last July's projection of 3.1 percent. As noted earlier, that increase reflects a change in the method that CBO uses to calculate the economy's stock of productive capital, an upward revision to the official data on investment for the past three years, and higher projected levels of investment. Those changes raised the estimated growth of the capital input during the recent past as well as in CBO's projections—where growth of the capital input now averages 5.2 percent through 2011, up from 3.9 percent in last July's projections.

Since July, CBO has not changed its estimate of the gap between actual and potential GDP in 2000. Consequently, the growth of real GDP between 2000 and 2011, like that of potential GDP, is also higher than in the July projections, averaging 3.0 percent now compared with 2.7 percent then.

**Other Significant Changes**. Two other changes to CBO's economic outlook since last July that have particular importance for the budget projections are increases in the projected growth of the GDP price index and in the high-tax income categories as a share of GDP.

The new projection for the GDP price index raises projected surpluses slightly. The GDP price index is now expected to grow at an average rate of 2.0 percent through 2010, compared with 1.9 percent last July. That change raises revenue projections because it tends to raise the projected level of taxable income. Outlay projections, however, depend primarily on the growth of the CPI, which has changed little from the July projection.

The fact that more highly taxed categories of income make up a greater share of GDP in the current economic outlook than last July also leads to a more favorable budget projection. The combined share of wage and salary disbursements and corporate profits is 56 percent of GDP in 2010 in the current projection compared with 55.1 percent in 2010 last July. Their share is higher in the current projection largely because CBO has lowered its projections of the growth of fringe benefits and businesses' interest payments as a percentage of GDP. (Fringe benefits are expected to grow faster than in the past but slower than projected last July.) Since fringe benefits are not taxed and businesses can deduct their interest payments from earnings when determining corporate tax liability, the reduction in the projections of those categories results in higher taxable income relative to GDP.

## Comparison with the Clinton Administration's Projections

The final economic projections of the Clinton Administration expect stronger growth this year than CBO's current projections do but virtually the same growth for the medium term (see Table 2-5). The Bush Administration is preparing its own economic forecast.

**Table 2-4.**
**Comparison of CBO's Current and Previous Economic Projections for Calendar Years 2001-2010**

| | Estimated 2000 | Forecast 2001 | Forecast 2002 | Projected Annual Average 2003-2006 | Projected Annual Average 2007-2010 |
|---|---|---|---|---|---|
| Nominal GDP (Billions of dollars) | | | | | |
| January 2001 | 9,974 | 10,446 | 11,029 | 13,439[a] | 16,308[b] |
| July 2000 | 9,907 | 10,433 | 10,940 | 13,077[a] | 15,675[b] |
| Nominal GDP (Percentage change) | | | | | |
| January 2001 | 7.3 | 4.7 | 5.6 | 5.1 | 5.0 |
| July 2000 | 7.0 | 5.3 | 4.9 | 4.6 | 4.6 |
| Real GDP (Percentage change) | | | | | |
| January 2001 | 5.1 | 2.4 | 3.4 | 3.1 | 3.0 |
| July 2000 | 4.9 | 3.1 | 2.7 | 2.6 | 2.8 |
| GDP Price Index (Percentage change) | | | | | |
| January 2001 | 2.1 | 2.3 | 2.1 | 1.9 | 1.9 |
| July 2000 | 2.1 | 2.1 | 2.1 | 1.9 | 1.8 |
| Consumer Price Index[c] (Percentage change) | | | | | |
| January 2001 | 3.4 | 2.8 | 2.8 | 2.6 | 2.5 |
| July 2000 | 3.1 | 2.7 | 2.9 | 2.6 | 2.5 |
| Unemployment Rate (Percent) | | | | | |
| January 2001 | 4.0 | 4.4 | 4.5 | 4.7 | 5.1 |
| July 2000 | 3.8 | 3.7 | 4.1 | 4.7 | 5.2 |
| Three-Month Treasury Bill Rate (Percent) | | | | | |
| January 2001 | 5.8 | 4.8 | 4.9 | 4.9 | 4.9 |
| July 2000 | 5.9 | 6.7 | 5.5 | 4.8 | 4.8 |
| Ten-Year Treasury Note Rate (Percent) | | | | | |
| January 2001 | 6.0 | 4.9 | 5.3 | 5.6 | 5.8 |
| July 2000 | 6.5 | 6.8 | 6.3 | 5.7 | 5.7 |
| Tax Bases (Percentage of GDP) | | | | | |
| Corporate profits[d] | | | | | |
| January 2001 | 9.4 | 8.9 | 8.5 | 8.2 | 8.0 |
| July 2000 | 9.2 | 8.4 | 7.7 | 7.3 | 7.0 |
| Wages and salaries | | | | | |
| January 2001 | 47.8 | 48.2 | 48.2 | 48.2 | 48.0 |
| July 2000 | 48.1 | 48.5 | 48.8 | 48.6 | 48.3 |

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

NOTE: Percentage changes are year over year.

a. Level of GDP in 2006.

b. Level of GDP in 2010.

c. The consumer price index for all urban consumers.

d. Corporate profits are book profits.

**Table 2-5.**
**Comparison of CBO's and the Clinton Administration's Economic Projections for Calendar Years 2001-2011**

| | Estimated | Forecast | | Projected Annual Average | |
|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2003-2006 | 2007-2011 |
| Nominal GDP (Billions of dollars) | | | | | |
| CBO | 9,974 | 10,446 | 11,029 | 13,439[a] | 17,132[b] |
| Administration | 9,991 | 10,536 | 11,099 | 13,676[a] | 17,536[b] |
| Nominal GDP (Percentage change) | | | | | |
| CBO | 7.3 | 4.7 | 5.6 | 5.1 | 5.0 |
| Administration | 7.4 | 5.5 | 5.3 | 5.4 | 5.1 |
| Real GDP (Percentage change) | | | | | |
| CBO | 5.1 | 2.4 | 3.4 | 3.1 | 3.1 |
| Administration | 5.2 | 3.3 | 3.2 | 3.2 | 2.9 |
| GDP Price Index (Percentage change) | | | | | |
| CBO | 2.1 | 2.3 | 2.1 | 1.9 | 1.9 |
| Administration | 2.2 | 2.0 | 2.1 | 2.1 | 2.1 |
| Consumer Price Index[c] (Percentage change) | | | | | |
| CBO | 3.4 | 2.8 | 2.8 | 2.6 | 2.5 |
| Administration | 3.4 | 2.7 | 2.6 | 2.7 | 2.7 |
| Unemployment Rate (Percent) | | | | | |
| CBO | 4.0 | 4.4 | 4.5 | 4.7 | 5.2 |
| Administration | 4.0 | 4.1 | 4.4 | 4.8 | 5.1 |
| Three-Month Treasury Bill Rate (Percent) | | | | | |
| CBO | 5.8 | 4.8 | 4.9 | 4.9 | 4.9 |
| Administration | 5.9 | 6.0 | 5.7 | 5.3 | 5.3 |
| Ten-Year Treasury Note Rate (Percent) | | | | | |
| CBO | 6.0 | 4.9 | 5.3 | 5.6 | 5.8 |
| Administration | 6.1 | 5.8 | 5.8 | 5.8 | 5.8 |
| Tax Bases (Percentage of GDP) | | | | | |
| Corporate profits[d] | | | | | |
| CBO | 9.4 | 8.9 | 8.5 | 8.2 | 8.0 |
| Administration | 9.4 | 8.8 | 8.4 | 8.0 | 7.5 |
| Wages and salaries | | | | | |
| CBO | 47.8 | 48.2 | 48.2 | 48.2 | 48.0 |
| Administration | 47.7 | 47.7 | 47.8 | 48.0 | 48.1 |

SOURCES: Congressional Budget Office; Office of Management and Budget; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

NOTE: Percentage changes are year over year.

a. Level of GDP in 2006.

b. Level of GDP in 2011.

c. The consumer price index for all urban consumers.

d. Corporate profits are book profits.

The Clinton Administration anticipated a more favorable economic outlook than CBO for 2001 primarily because it completed its forecast in November, before the recent spate of data indicated a sudden weakening in growth. Real GDP growth and interest rates for this year are significantly higher in the Administration's forecast than in CBO's, and the unemployment rate is much lower.

For the entire 2001-2011 period, the Administration's projection of real GDP growth averages only slightly more than CBO's projection. The difference stems from higher assumed growth of the labor force, not of labor productivity. Short-term interest rates are higher as well in the Administration's medium-term projections, but all other aspects of the economic outlook are similar to CBO's projections.

## Recent Economic Developments

In the last five years of the 1990s, the economy grew much more rapidly than CBO's estimate of its potential growth. But during the second half of 2000, economic activity appears to have shifted from above-trend growth to below-trend growth. (That shift was especially pronounced in the manufacturing sector; see Box 2-2 for details.) After an extraordinarily rapid increase—6.1 percent—during the previous four quarters, real GDP slowed to 2.2 percent annual growth in the third quarter of 2000 and appears to have remained at a subdued pace in the final quarter.

Slower growth in spending by consumers and businesses accounts for much of the slowdown in overall growth. That sudden deceleration has raised the chances that the economy could slip into a recession this year—although in CBO's view, that possibility is not as likely as the mild slowdown that CBO has forecast for the short term. In any event, such a slowdown has few lasting effects and thus has little impact on the medium-term projections.

The recent slowing in economic activity followed restrictive monetary actions by the Federal Reserve and probably a shift in consumers' and businesses' confidence about future economic activity. The Federal Reserve responded to the earlier rapid growth in aggregate demand by tightening conditions in credit markets, raising its target for the federal funds rate from 4.75 percent in early June 1999 to 6.5 percent by May 2000. In the second half of 2000, credit markets grew more cautious as losses on business loans and bonds mounted, and they raised lending standards and interest rates, particularly for high-risk borrowers. Stock prices fell with investors' diminished expectations about the future growth of profits, which in turn lowered consumers' wealth and raised businesses' cost of capital.

The Federal Reserve made no further changes to its target for the federal funds rate in the second half of 2000 as growth began decelerating and the rate of inflation eased from its pace in the first half of the year. However, at the end of 2000, the Federal Reserve indicated that the balance of risks in the economy had shifted from rising inflation to economic weakness. In a surprise move, it lowered its target for the federal funds rate by 0.5 percentage points in the first week of January.

### Consumer Spending and Residential Investment

The Federal Reserve's move reflected in part a sharp slowdown in consumer spending toward the end of last year. After growing at an average annual rate of 5.4 percent from the second quarter of 1999 through the second quarter of 2000, real consumer spending slowed to a still-strong annual growth rate of 4.5 percent in the third quarter of 2000. However, available data on spending confirmed news reports of disappointing holiday sales and indicate that consumer spending on goods slowed further in the fourth quarter.

Some of that slowdown was probably inevitable because spending had grown very rapidly at the end of 1999 and beginning of 2000. Sales of cars and light trucks, for example, rose from an average rate of about 15 million units a year during the 1994-1998 period to an annual rate of 17 million in the second half of 1999 and 18.2 million in the first quarter of 2000—the strongest quarter on record. Sales of those vehicles fell back to an annual rate of 15.3 million by December 2000. Domestic manufacturers have

## Box 2-2.
## The Recent Slowdown in Manufacturing

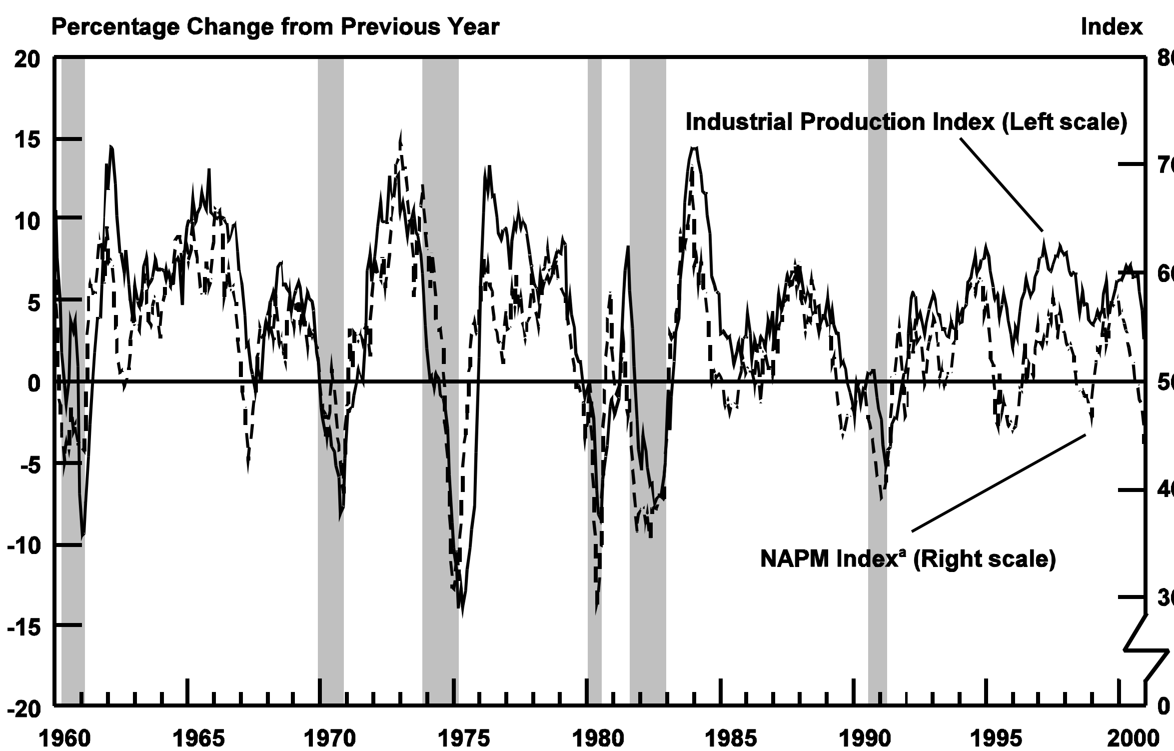
Output from the manufacturing sector has grown much more slowly in recent months, and some monthly indicators point toward further slowing and a significant risk of a recession in that sector. The Congressional Budget Office does not consider the recent weakness to be a strong signal of an overall recession, however. The slowdown may be temporary, and even if the weakness in manufacturing persists, the overall economy may continue to grow.

One measure that indicates further slowing in manufacturing is the National Association of Purchasing Managers' (NAPM) index, which dropped sharply in 2000 (see the figure below). Until recent years, the growth of the Federal Reserve's industrial production (IP) index for manufacturing—a measure of manufacturing output adjusted for inflation—would turn negative or be very weak soon after the NAPM index fell below a value of 50. That relationship changed during the second half of the 1990s. IP growth remained above 3 percent even when the NAPM index fell well below 50. The change resulted from the growth in the manufacturing sector's output of information technology, particularly semiconductors. In spite of that change in the relationship between the two indicators, the recent drop in the NAPM index is a strong signal of further slowing in the growth of manufacturing output.

A moderate recession in manufacturing would not necessarily imply a recession for the economy as a whole, however. The IP index was flat or fell over a number of four- or five-month periods during the 1980s and 1990s (in 1986, 1993, 1995, and 1998) when the economy was not in recession. Moreover, the output of the manufacturing sector accounts for only about 16 percent of gross domestic product, so continued strength in the output of services can offset weakness in manufacturing.

Furthermore, any recession in manufacturing could be brief. Since firms have developed better inventory information and control systems over the years, manufacturers may be able to realign output with demand quickly. In addition, manufacturing output could pick up soon because the recent easing of interest rates by the Federal Reserve may spur demand for and production of manufactured goods.

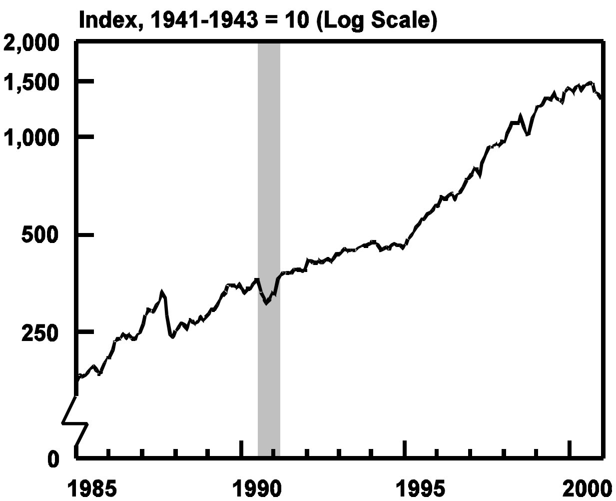
### Indicators of Change in Total Manufacturing




SOURCES: Congressional Budget Office; Federal Reserve Board; National Association of Purchasing Managers.

a. The National Association of Purchasing Managers' (NAPM) index is a composite measure of the seasonally adjusted diffusion indexes for five indicators that reflect current activity. Diffusion indexes indicate what percentage of people surveyed said that current business conditions were favorable, unfavorable, or unchanged. A reading above 50 indicates that the manufacturing sector is generally expanding; below 50, that it is generally contracting.

**Figure 2-10.**
**The S&P 500 Index of Stock Prices**




SOURCES: Congressional Budget Office; Standard & Poor's.

scaled back their production plans to reduce inventories of unsold vehicles.

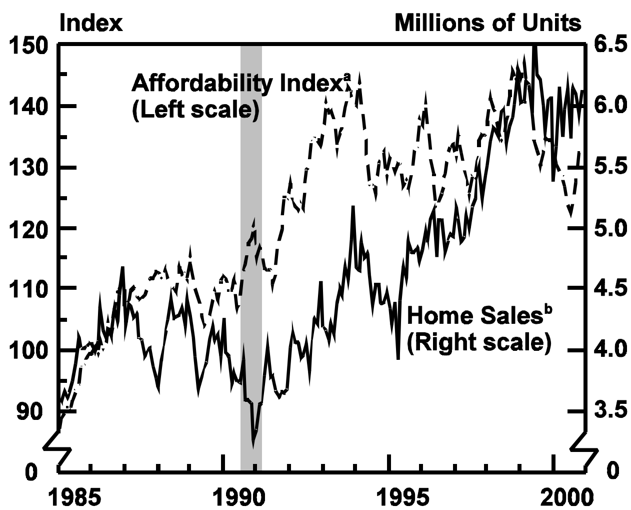
The slowdown in consumer spending also reflected a weakening in some fundamental factors that determine such spending, including consumers' expectations about future business conditions. Before 2000, a significant share of the strength in consumer spending reflected a rise in consumers' wealth, much of which resulted from sharp increases in stock prices (see Figure 2-10). Correspondingly, the decline in stock prices in 2000 reduced consumers' wealth. In addition, the growth of employment slowed in 2000, which may have moderated consumers' expectations about their income growth. Higher interest rates on consumer loans may also have dampened spending slightly. Rising energy prices may have been another factor, as well as the early arrival of winter in several parts of the country (see Box 2-3). Those two factors ran up consumers' heating bills and kept some shoppers from stores during the crucial holiday season.

Investment in housing also slowed in the second half of last year. After growing at an average annual rate of 2.2 percent in the first half of 2000, real residential investment fell by 10.6 percent in the third quarter of 2000 and appears to have remained weak through the end of the year. That drop probably reflected many of the same factors that slowed consumer spending; it also resulted from a decline in the affordability of housing in the first half of 2000 that occurred because of rapidly rising housing prices and higher mortgage rates (see Figure 2-11).

## Business Fixed Investment

Like consumer spending, spending by businesses on structures, equipment, and software—known as business fixed investment (BFI)—weakened in the second half of 2000 after a strong showing in the first half. The growth of real BFI slowed to an annual rate of 7.7 percent in the third quarter of 2000 after averaging 17.7 percent in the first half of the year. Spending on equipment and software accounted for all of that slowdown in the third quarter, and data on shipments suggest that equipment spending remained subdued in the fourth quarter. Spending on nonresidential construction, however, was strong last year, buoyed in part by a sharp rise in exploration for petroleum and natural gas in response to higher energy prices.

**Figure 2-11.**
**Home Sales and Affordability**




SOURCES: Congressional Budget Office; Department of Commerce, Bureau of the Census; National Association of Realtors.

a. A value of 100 for the affordability index indicates that a family with the median income can afford to buy the median-priced home, given prevailing mortgage rates.

b. Sales of new and existing single-family homes.

Some of the slowdown in BFI in the second half of last year may have been a rebound from the unusually fast growth of equipment spending in the first half of 2000. But part of the slowdown may prove more lasting if it reflects weaker business confidence and a higher cost of capital. The growth of corporate profits slowed in the second half of last year, and credit and equity markets tempered their willingness to assume risk. An important source of uncertainty in CBO's short-term forecast is the degree to which financial markets will reduce their lending and further weaken investment by businesses.

**Box 2-3.**
**Recent Developments in Energy Markets**

Prices for crude oil, petroleum products, and natural gas shot up in 2000. The markets for different energy products—especially crude oil and petroleum products—influence one another, but each market is affected by special and independent circumstances. The recent price increases probably will not continue beyond this winter. Developments in oil markets, in fact, point strongly to the prospect of lower prices this year.

**Crude Oil**

Ironically, the broad swings in oil prices seen in recent years stem largely from efforts by the Organization of Petroleum Exporting Countries (OPEC) to keep prices within a narrow range. The Asian financial crisis of 1997 and 1998 caused a severe drop in demand for oil in that region and a collapse of oil prices—to less than $15 per barrel in mid-1998. The drop in demand prompted OPEC producers to curtail their output, and the prospect of falling prices led oil companies to pare down their petroleum inventories. In 1999, however, rebounding Asian demand, solid economic growth in the United States and Europe, and some extreme summer weather combined to push demand for oil beyond OPEC's expectations. With low stocks of oil and growing demand, prices rebounded in 1999 and 2000. They reached 10-year highs in the second half of 2000 before OPEC made its first efforts to increase production.

As of January, oil production once again appears to exceed demand, and the easing of oil prices that occurred in the last quarter of 2000 looks likely to continue. However, events such as production cutbacks by OPEC, a cold winter, or adverse political developments in the Middle East could keep prices from falling much farther in the near term.

**Petroleum Products**

Although prices for refined petroleum products in the United States have largely followed the cycle of world oil prices, special circumstances pushed up heating oil prices last fall by even more than the increase in crude oil prices. Heating oil is produced in conjunction with gasoline, so the low levels of gasoline production last year—coupled with a late-winter surge in demand for heating oil in early 2000—made it difficult to rebuild heating oil stocks for the current winter. Demand for heating oil to rebuild U.S. stocks and meet needs in Europe (which experienced early cold weather) contributed to the jump in prices for heating oil that occurred in September 2000.

Below-average levels of petroleum stocks in the United States and worldwide—and very low stocks of U.S. heating oil—point to the possibility of further large increases in prices should demand this winter prove extreme. Through early January, this winter had been colder in the United States than the past three winters. If such cold weather continues, prices may remain high for a few more months. A further concern is that uncertainty about the use of the government's new Northeast Petroleum Reserve could complicate oil companies' decisions about inventories and exacerbate pressures on heating oil prices.

**Natural Gas**

Because it is difficult in the short run to substitute between natural gas and petroleum products, the market for natural gas is largely independent of the world market for crude oil. Nevertheless, natural gas prices also rose sharply in 2000. The producer price index for residential natural gas has soared by 30 percent since the spring of 2000 (see the figure at right). The forces that caused that increase had been building for many

## Financial Markets and Monetary Policy

Financial markets retrenched in the second half of 2000, as expectations about the future growth of corporate earnings declined and concerns about the quality of credit rose. The Standard and Poor's (S&P) 500 stock price index, which summarizes the stock market values of major U.S. corporations, fell at an annual rate of 17 percent between June and December of last year, after growing at an annual rate of almost 15 percent in 1999 and the first half of 2000.

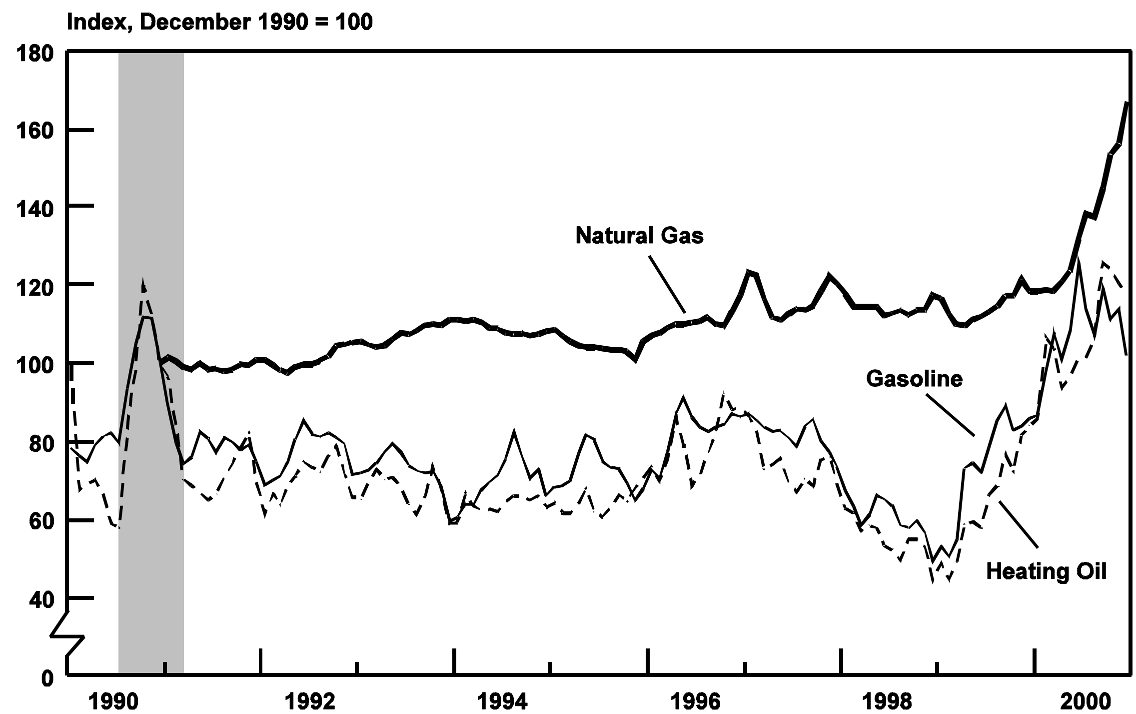
years, including low levels of exploration for natural gas and growing demand for gas by electric utilities and homes—both a response to 15 years of low prices. During the summer of 2000, record high temperatures and demand for cooling across the central southern states and problems with electricity restructuring in California added to the demand for natural gas and impeded efforts to build underground gas reserves. (Electricity producers burn gas in turbines to generate power to meet peak-period demand.)

In response to the high prices, however, natural gas exploration and development have risen sharply. Thus, some additional supplies should be reaching the market soon. That extra supply should help limit further price increases in the near future and perhaps—as futures markets for natural gas expect—cause prices to decline.

**Implications for the Economy**

So far, developments in energy markets appear unlikely to dampen U.S. economic growth significantly, though they will have some effect. In general, consumers and businesses have been able to shift to lower-cost sources of energy or conserve enough that basic economic activity has not been curtailed, except in isolated cases. However, because half of the petroleum consumed in the United States is imported, the increase in oil prices will depress economic activity slightly. The value of net petroleum imports last year was nearly twice as high as in 1999. That increase was similar to a $60 billion excise tax and will dampen real consumption.

**Producer Price Indexes for Energy Products (By calendar year)**




SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Moreover, the share prices of many high-technology firms collapsed. On average, the businesses listed by the Nasdaq stock market, which include many well-known high-technology companies, lost about half of their market value between March 2000 and the end of the year. High-technology start-ups lost much of their attractiveness to investors and faced greater difficulty raising funds in capital markets.

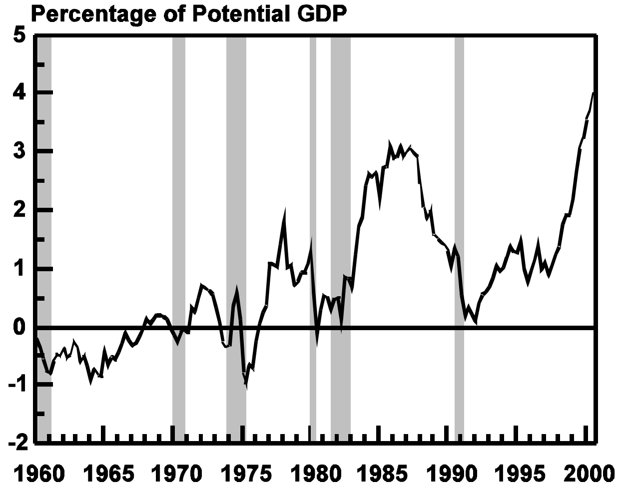
Credit markets have also become more cautious in their lending. Commercial banks tightened their standards and terms of lending to businesses last year in the face of rising delinquencies and losses on business loans. As a consequence, the growth of business loans slowed, although to a pace still consistent with continued economic expansion. The spread between the interest rates on top-quality corporate bonds and lower-quality bonds increased last year, indicating that lenders' perception of the risk of default increased. The corporate bond market also pulled back from new issues of risky debt such as high-yield (or junk) bonds in the face of greater defaults; the amount of funds raised in the high-yield market was sharply lower in 2000 than in 1999. Although some of the pullback by banks and the bond market may reflect a better assessment of risk that will enhance the productivity of business investment in the long run, there is always a danger that lenders will overreact and sharply curtail funding to low-risk firms.

Against that backdrop of tighter supply in credit and capital markets and a slowdown in economic activity, the Federal Reserve eased monetary policy early this year. On January 3, it cut the target for the federal funds rate from 6.5 percent to 6 percent. The size and timing of that move surprised financial markets. In contrast to its usual practice, the Federal Reserve had not signaled its intentions to the markets ahead of time. Before the cut, the futures market for federal funds had expected the Federal Reserve to drop its target gradually to 6 percent by the end of March and to 5.5 percent by midyear. After the January cut, the futures market lowered its expectation for the federal funds rate to 5 percent by midyear.

## Net Exports

The trade deficit continued to grow in the third quarter of 2000, widening to a record $389.5 billion, or 3.9 percent of GDP (see Figure 2-12). Preliminary data indicate that it remained large in the fourth quarter.

**Figure 2-12.**
**Nominal Trade Deficit**




SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

The uninterrupted rise in the trade deficit since 1997 has resulted mainly from the gap between economic growth rates in the United States and abroad as well as from the persistent strength of the U.S. dollar. The deceleration in U.S. growth in the second half of last year did not help reduce that deficit because trade adjusts relatively slowly to changes in growth and because foreign economic growth also slowed. For example, economic recovery in Japan and other Asian countries, which showed some promise in the first half of 2000, faltered again in the second half under the weight of higher oil prices and slower U.S. demand for Asian goods. The growth of European economies also slowed in the second half of last year for similar reasons as well as because of higher interest rates.

The fragility of foreign recoveries and a relatively more favorable investment environment in the United States kept the dollar strong last year, despite the persistence of the trade deficit and a consequent rise in U.S. external indebtedness. The strength of the dollar has continued to keep the prices of U.S. exports high relative to those of imports, constraining U.S. exports and stimulating imports.

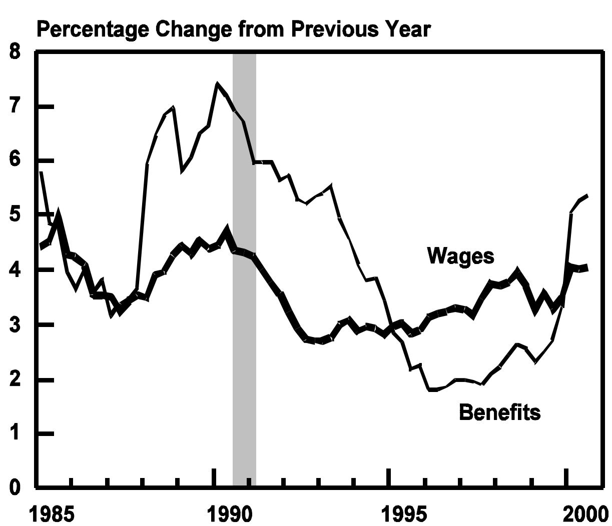
## Government Spending

Direct government spending for goods and services —by both the federal government and state and local governments—has supported strong growth over the past year. Real federal government spending for goods and services surged back during the past two years after a prolonged contraction between 1990 and 1998, and state and local spending, although easing somewhat in recent quarters, has been strong for more than four years.

## Labor Markets and Wage and Price Inflation

Labor markets continued to be extremely tight in the second half of 2000 despite the slowdown in growth of GDP; the unemployment rate remained at a remarkably low 4.0 percent. In line with tight labor markets, labor compensation—including benefits as well as wages and salaries—grew faster in 2000 than the year before (see Figure 2-13). An important reason for the spurt in benefit costs has been an acceleration in the cost of medical benefits, which analysts expect to continue this year.

**Figure 2-13.**
**Employment Cost Indexes for Wages and Benefits**




SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

The growth of the broad price indexes used to measure inflation generally showed little change in the second half of 2000. The core rate of inflation (the growth rate of the consumer price index excluding food and energy) inched up slightly, but the growth rate of the overall CPI did not. The difference in behavior between the two rates reflects a deceleration in the average growth of the energy component of the CPI. Although economic activity has slowed, the economy's continued high level of resource use may put more pressure on prices in the near future.

# CBO's Short-Term Forecast

Those various recent economic developments suggest that the slowdown that many forecasters expected has arrived. CBO anticipates that in 2001 and 2002, real GDP will grow well below the 4.6 percent rate of the past two years and below the estimated potential growth rate of GDP discussed earlier. CPI inflation is expected to fall from 3.4 percent in 2000 to 2.7 percent in 2001, reflecting CBO's belief that energy prices will remain lower than last autumn's levels (see Table 2-6). In addition, slower growth of economic activity than in recent years will probably contribute to lower interest rates. A major risk to CBO's short-term forecast is that consumers and businesses will curtail their spending much more than CBO assumes, leading to a recession this year. Alternatively, the growth of consumption and investment could pick up again from its modest rates of late last year, producing faster economic activity than CBO anticipates.

The current CBO forecast for growth and inflation in the next two years is about the same as that of the *Blue Chip* consensus, an average of approximately 50 private-sector forecasts (see Table 2-7). Compared with the *Blue Chip* consensus, CBO's forecast for growth of real GDP is slightly lower for 2001 and about the same for 2002, and its forecasts for inflation are slightly higher for both years. CBO's forecasts for interest rates are noticably lower than those of the *Blue Chip* consensus, but that is probably because the latter did not fully reflect the Federal Reserve's surprise interest rate cut of early January.

CBO's current forecast for 2001 is weaker than its previous forecast, published last July (see Table 2-4 on page 39). The growth rate of real GDP is substantially lower, the unemployment rate is significantly higher, and interest rates are much lower. The forecast for CPI inflation is virtually unchanged, whereas the forecast for inflation in the GDP price index is slightly higher.

## Growth of Real GDP

CBO's forecast for the growth of real GDP over the next two years reflects the view that the factors stimulating overall demand during the second half of 1999 and the first half of 2000 have waned. Investors' expectations of the growth of corporate profits, which boosted stock prices and encouraged greater lending for business investment, provided much of that stimulus. Higher stock prices in turn spurred consumer spending. Favorable rates of return in U.S. capital markets also encouraged foreigners to invest in the United States, which further lowered the cost of investment for U.S. businesses.

Investors' expectations were deflated in the second half of last year, when slower profit growth and rising defaults on business loans and high-yield bonds began to appear. A less bullish stock market will continue to limit the growth of consumers' wealth and thus their spending. A higher cost of equity capital, plus stricter lending standards by banks and bond investors, will dampen investment by keeping the cost of funds higher and their availability less than in recent years. Moreover, because the economic outlook abroad has sagged, the trade deficit is unlikely to improve noticeably over the next two years despite moderate growth in the United States.

A major risk to that forecast is that the growth of spending may slow more than CBO assumes. Consumers may retrench drastically in response to the drop in their stock market wealth and to lower expectations about their future income. Businesses

**Table 2-6.**
**CBO's Forecast for 2001 and 2002**

| | Estimated 2000 | Forecast 2001 | Forecast 2002 |
|---|---|---|---|
| **Fourth Quarter to Fourth Quarter (Percentage change)** | | | |
| Nominal GDP | 6.1 | 5.0 | 5.6 |
| Real GDP | 3.7 | 2.6 | 3.4 |
| GDP Price Index | 2.4 | 2.3 | 2.1 |
| Consumer Price Index[a] | | | |
| Overall | 3.4 | 2.7 | 2.8 |
| Excluding food and energy | 2.6 | 2.8 | 2.8 |
| **Calendar Year Average** | | | |
| Real GDP (Percentage change) | 5.1 | 2.4 | 3.4 |
| Unemployment Rate (Percent) | 4.0 | 4.4 | 4.5 |
| Three-Month Treasury Bill Rate (Percent) | 5.8 | 4.8 | 4.9 |
| Ten-Year Treasury Note Rate (Percent) | 6.0 | 4.9 | 5.3 |

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

a. The consumer price index for all urban consumers.

**Table 2-7.**
**Comparison of CBO and *Blue Chip* Forecasts for Calendar Years 2001 and 2002**

| | Estimated 2000[a] | Forecast 2001 | 2002 |
|---|---|---|---|
| Nominal GDP (Percentage change) | | | |
| *Blue Chip* high 10 | | 5.5 | 6.1 |
| *Blue Chip* consensus | | 4.8 | 5.4 |
| CBO | 7.3 | 4.7 | 5.6 |
| *Blue Chip* low 10 | | 3.9 | 4.8 |
| Real GDP (Percentage change) | | | |
| *Blue Chip* high 10 | | 3.1 | 4.0 |
| *Blue Chip* consensus | | 2.6 | 3.4 |
| CBO | 5.1 | 2.4 | 3.4 |
| *Blue Chip* low 10 | | 2.0 | 2.8 |
| GDP Price Index (Percentage change) | | | |
| *Blue Chip* high 10 | | 2.5 | 2.4 |
| *Blue Chip* consensus | | 2.1 | 2.0 |
| CBO | 2.1 | 2.3 | 2.1 |
| *Blue Chip* low 10 | | 1.7 | 1.4 |
| Consumer Price Index[b] (Percentage change) | | | |
| *Blue Chip* high 10 | | 3.1 | 3.0 |
| *Blue Chip* consensus | | 2.6 | 2.5 |
| CBO | 3.4 | 2.8 | 2.8 |
| *Blue Chip* low 10 | | 2.2 | 1.9 |
| Unemployment Rate (Percent) | | | |
| *Blue Chip* high 10 | | 4.6 | 4.9 |
| *Blue Chip* consensus | | 4.4 | 4.5 |
| CBO | 4.0 | 4.4 | 4.5 |
| *Blue Chip* low 10 | | 4.2 | 4.2 |
| Three-Month Treasury Bill Rate (Percent) | | | |
| *Blue Chip* high 10 | | 5.8 | 5.9 |
| *Blue Chip* consensus | | 5.4 | 5.4 |
| CBO | 5.8 | 4.8 | 4.9 |
| *Blue Chip* low 10 | | 4.9 | 4.9 |
| Ten-Year Treasury Note Rate (Percent) | | | |
| *Blue Chip* high 10 | | 5.9 | 6.2 |
| *Blue Chip* consensus | | 5.3 | 5.6 |
| CBO | 6.0 | 4.9 | 5.3 |
| *Blue Chip* low 10 | | 4.9 | 5.1 |

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Aspen Publishers, Inc., *Blue Chip Economic Indicators* (January 10, 2001).

NOTE: The *Blue Chip* high 10 is the average of the 10 highest *Blue Chip* forecasts; the *Blue Chip* consensus is the average of all 50 *Blue Chip* forecasts; and the *Blue Chip* low 10 is the average of the 10 lowest *Blue Chip* forecasts.

a. CBO's estimate for 2000.

b. The consumer price index for all urban consumers.

may slash their investment plans if they grow more wary or may be forced to cancel those plans if a shortage of capital and credit occurs. Foreign investors may become disenchanted with the U.S. economy, perhaps because of its growing trade deficit, and move their capital to other countries, thus raising interest rates and further curtailing spending in the United States. A greater slowdown in the U.S. economy would also be felt in the rest of the world as the United States imported fewer goods.

Alternatively, since unemployment is low and real wage growth has remained strong, consumption may rebound. If so, manufacturers could quickly sell off excess inventories, employment and investment growth could bounce back, and overall economic growth would be faster than CBO anticipates.

## Inflation and Unemployment

CBO expects that a drop in energy prices will slow the rate of consumer price inflation this year to 2.7 percent from 3.4 percent last year (see Table 2-6). However, core CPI inflation will edge upward to 2.8 percent from 2.6 percent last year because the high level of resource use will continue to put upward pressure on the core rate of inflation. The unemployment rate is projected to rise over the next two years, reflecting CBO's view that the growth of GDP will be less than CBO's estimate of the growth of potential GDP.

If the growth of labor productivity slows dramatically from its rapid pace of recent years, inflation may increase by more than CBO anticipates. That recent rapid growth has held down inflation and costs per unit of labor in the face of strong demand for labor and output. A sudden drop in the growth of productivity could increase businesses' costs and the prices of their products. In those circumstances, the Federal Reserve would probably feel compelled to raise interest rates to preempt an increase in inflation, thus slowing the economy even more.

A sudden drop in the exchange value of the U.S. dollar would also lead to higher inflation than CBO expects. The large U.S. current-account deficit and international indebtedness indicate that the dollar eventually needs to fall to help lower that deficit. Although the dollar declined at the end of 2000, it is still strong relative to its average of the 1990s. The fragility of economic recoveries in many countries, however, suggests that the dollar may remain strong for a while longer despite weaker economic activity in the United States.

## Interest Rates

CBO believes that interest rates in 2001 and 2002 will, on average, be lower than last year's levels. Slower growth of aggregate demand is likely to continue to contribute to lower interest rates this year. Indeed, financial markets have reduced their expectations of the federal funds rate for the first part of 2001, indicating that they believe that the Federal Reserve will relax monetary policy further this year. However, if inflation picks up more than the markets expect, interest rates will be higher than they anticipate.