Chapter One

The Economic Outlook

The U.S. economy has settled over the past year to a moderate, sustainable rate of growth. Real output grew by about 2 percent from 1994 to 1995, down from 3.5 percent the previous year, as the effects of tight monetary policy spread through the economy and a two-year boom in business investment began to fade. Despite the slower growth, economic activity was sufficient to keep unemployment at a relatively low average rate of 5.6 percent for the year. Interest rates fell in the wake of the slowdown as fears of higher inflation eased. The fall in rates, together with continued healthy corporate profits, fueled a year-long stock market rally.

This year, the Congressional Budget Office (CBO) is presenting two economic forecasts. One assumes that taxes and mandatory spending follow current law, while discretionary spending grows with inflation after the caps expire in 1998: that forecast implies rising deficits over the next decade. The second forecast assumes that the budget will be balanced by 2002 and held in balance thereafter. Those two forecasts are referred to as the current-policy forecast and the balanced budget forecast, respectively. Both the Congress and the President have voiced their intent to eliminate the deficit by the year 2002. The two sides have not agreed on a plan, however, so the CBO forecast that assumes a balanced budget by 2002 is based on a hypothetical path to budgetary balance. Lacking specifics, moreover, the forecast cannot include any economic effects beyond those of deficit reduction in general. It does not, therefore, incorporate the effects of specific policies, such as a cut in the capital gains tax or reductions in government investment.

In both forecasts, CBO predicts that the economy will grow slightly below its noninflationary potential rate of growth of 2.1 percent over 1996 and 1997. Using current-policy assumptions, CBO forecasts real gross domestic product (GDP) to grow at a rate of 2 percent in 1996 and 1.9 percent in 1997 (see Table 1-1 and Figure 1-1). The current-policy forecast also calls for only slight upswings in the unemployment and inflation rates.

Balancing the budget would add to the potential growth of the economy over the next decade. For the next two years, however, the economic outlook is similar under both the current-policy and balanced budget forecasts. CBO assumes that any policies adopted in the remainder of 1996 would not affect the potential growth of the economy this year. Even in 1997, the impact on potential growth would be small, since the long-term benefits of deficit reduction tend to accrue slowly. Growth in real (inflation-adjusted) GDP would be only slightly affected in 1997 under balanced budget assumptions, and inflation and unemployment would be unchanged. Those calculations assume that, as the budget was being balanced, financial markets and the Federal Reserve would lower interest rates sufficiently to avoid any short-run weakening in the economy.

Readers making comparisons between this forecast and previous CBO forecasts should take their different policy assumptions into account. CBO's

Table 1-1.
The CBO Current-Policy and Balanced Budget Policy Forecasts for 1996 and 1997

	Preliminary[a] 1995	Forecast 1996	Forecast 1997
	Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP			
Current policy	3.8	5.0	4.7
Balanced budget policy	3.8	5.0	4.7
Real GDP[b]			
Current policy	1.4	2.1	1.9
Balanced budget policy	1.4	2.1	1.9
Chain-Type GDP Price Index			
Current policy	2.6	2.8	2.7
Balanced budget policy	2.6	2.8	2.7
CPI-U[c]			
Current policy	2.7	3.1	3.1
Balanced budget policy	2.7	3.1	3.1
	Calendar Year Average (Percent)		
Real GDP Growth[b]			
Current policy	2.1	2.0	1.9
Balanced budget policy	2.1	2.0	2.0
Unemployment Rate			
Current policy	5.6	5.8	6.0
Balanced budget policy	5.6	5.8	6.0
Three-Month Treasury Bill Rate			
Current policy	5.5	4.9	4.8
Balanced budget policy	5.5	4.9	4.8
Ten-Year Treasury Note Rate			
Current policy	6.6	6.1	6.4
Balanced budget policy	6.6	5.7	5.5

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

a. Consistent with the first official estimate for 1995 published on March 4, 1996.

b. Based on chained (1992) dollars.

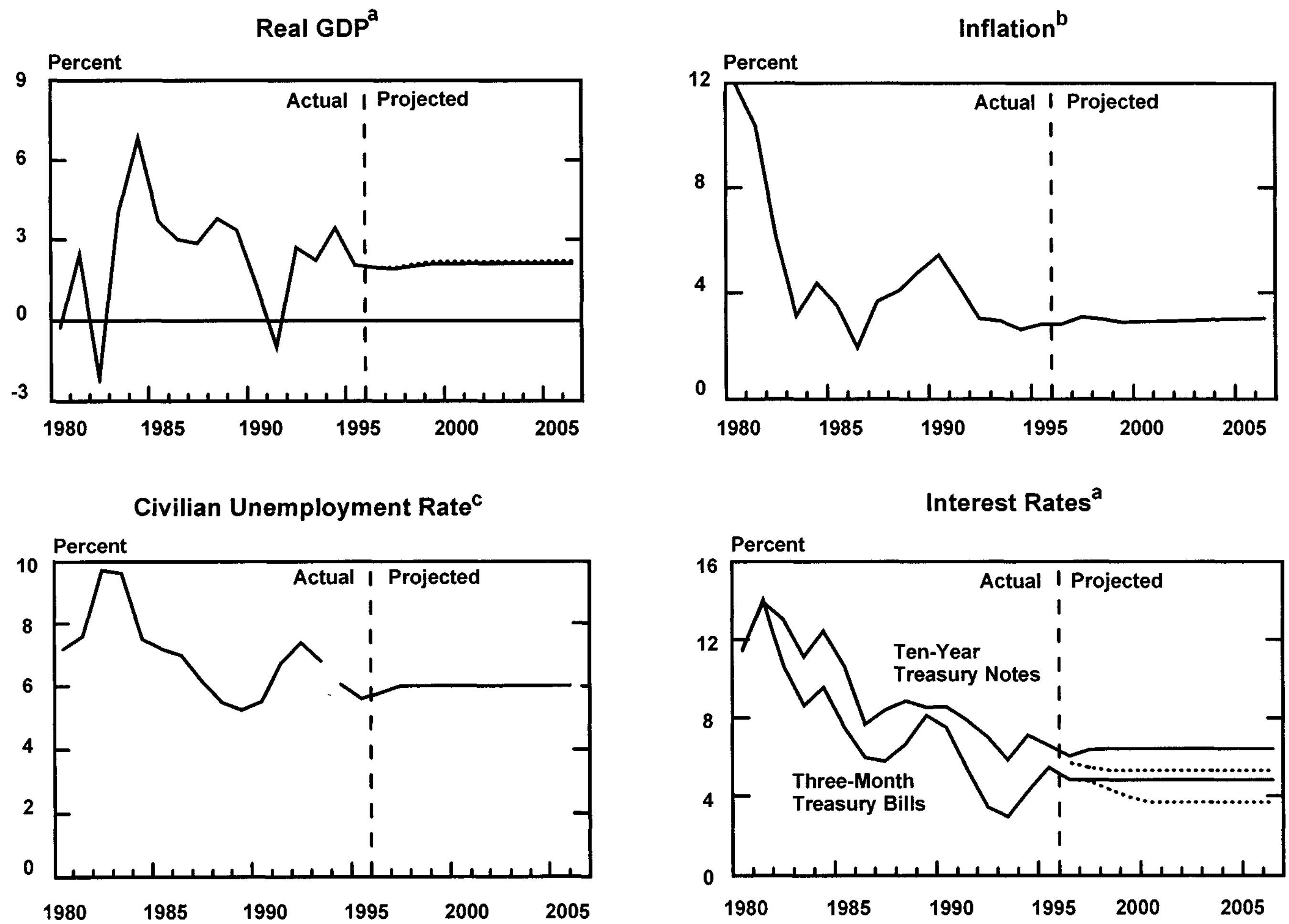
c. CPI-U is the consumer price index for all urban consumers.

August 1995 *Update* gave a current-policy forecast; CBO's December 1995 *Update* presented a forecast assuming a balanced budget. Both updates also included separate calculations of the benefits of balancing the budget. CBO's January 1995 *Economic and Budget Outlook* presented only a current-policy forecast.

The State of the Economy

Growth slowed to a modest 2 percent on a year-to-year basis in 1995, following a robust rate of 3.5 percent in 1994 that had raised concern about inflation.

Figure 1-1.
The Economic Forecast and Projections



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

NOTE: All data are annual values; growth rates are year over year.

a. A dotted line in the projection period assumes a balanced budget policy.

b. Consumer price index for all urban consumers (CPI-U). The treatment of home ownership in the official CPI-U changed in 1983. The inflation series in the figure uses a consistent definition throughout.

c. From 1994 on, the unemployment rate reported by the Bureau of Labor Statistics is not comparable with previous data. The discontinuity reflects an extensive revision of the survey's methodology. The CBO forecast is based on the new methods.

(Those growth measures are based on the new chain-type measure of real GDP; see Box 1). A tightening of monetary policy in 1994 played an important role in bringing down growth during 1995 by raising interest rates and eventually reducing interest-sensitive spending. In addition, a boom in investment spending on equipment and structures dwindled in the last part of 1995, and firms reduced the buildup of their inventories. Consumption spending slackened somewhat, as is typical at this point in an expansion. Though net exports improved over the year, the collapse of the peso and a serious recession in Mexico dampened exports in early 1995. Planned cuts in government spending and two unplanned partial shutdowns of the federal government also slowed the economy slightly in 1995. In addition, two major strikes and severe weather across much of the country lowered output in late 1995 and early 1996.

Labor Markets and Inflation

Despite relatively low unemployment, the underlying rate of inflation held steady in 1995 and early 1996. Through the first quarter of 1996, the unemployment rate hovered around 5.6 percent--a level generally thought to be mildly inflationary. Nevertheless, wage and price growth did not accelerate. Wages grew at about the same rate as in 1994, and the growth of total labor costs (which include both wages and benefits) actually subsided (see Figure 1-2).

Box 1-1.
The Change in the Measure of Real Gross Domestic Product

The national income and product accounts (NIPAs), which are the basis of the forecasts prepared by the Congressional Budget Office (CBO) and other forecasters, were revamped earlier this year to change the way that the accounts measure real economic activity. In January, the Department of Commerce's Bureau of Economic Analysis (BEA) released the first version of the NIPAs that featured the "chain-type" measure of real gross domestic product (GDP) and its components. That change to the accounts will better reflect economic activity, but it will not affect nominal GDP, nor should it directly affect the budget outlook. (Other revisions to the accounts raised the level of nominal GDP while only slightly altering its growth rate). CBO used the chain-type version of the NIPA data in preparing its current projections and its December projections (the December projections were based on preliminary chain-weighted data obtained from the BEA).

Nominal GDP is quite straightforward to calculate: it is the sum of spending on all goods and services in the economy during a given year. Computing real, or inflation-adjusted, GDP is more difficult. One must remove the increase in nominal GDP that results solely from higher prices. Several methods are available to perform that task, each with advantages and disadvantages. Until January, the BEA used a fixed-weighted, or constant-dollar, quantity index as its featured measure of real GDP. A fixed-weighted quantity index is computed by valuing each component of GDP at the prices of a base year, such as 1987. The fixed-weighted measure of GDP is easily interpreted: it is the total spending that would have resulted in a given year if every purchase in that year had taken place at 1987 prices.

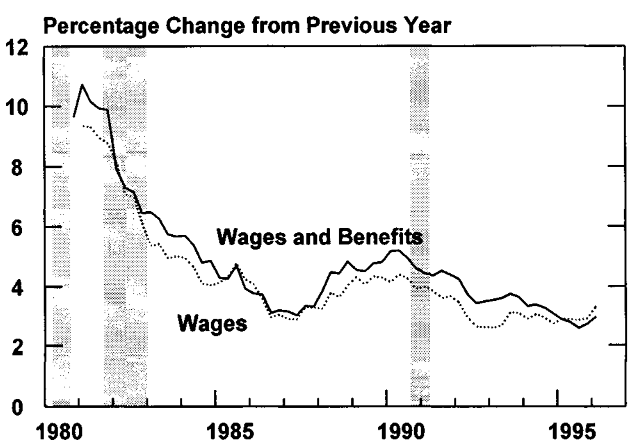
Fixed-weighted GDP provides a satisfactory measure of real economic activity in years close to the base year. However, the series will become increasingly biased if the pattern of prices in the economy drifts away from the pattern in the base year. In particular, a quantity index with fixed weights will overstate the importance of goods with prices that are growing more slowly than average during the period after the base year, thereby biasing the growth of the index upward. That is precisely what happened to the BEA's traditional measure of real GDP as a result of the steep drop in the price of computers. The old fixed-weighted measures of real growth valued spending on computers at 1987's relatively high prices, thus grossly overstating the magnitude of spending for computers in today's economy.

The revised NIPAs have replaced 1987-dollar GDP with a chain-type measure as the featured measure of output. The new chain-type measure does not use any specific base year; instead it calculates each year's real growth using as weights the prices of that year and the preceding year. The chain-type measure substantially reduces reported real rates of growth in the years since 1987 and raises real growth in years before 1987. Between 1990 and 1994, for example, growth measured on the old fixed-weighted basis averaged 2.2 percent; the chain-type measure puts growth during the same period at 1.9 percent.

Labor costs were held down in part by below-trend growth in spending for benefits. Much of that weakening seemed to stem from health insurance, reflecting a switch from traditional fee-for-service plans to some form of managed care. The low growth of labor costs, together with low interest rates, contributed to high profits in 1995.

Even without the falloff in the cost of benefits, the low levels of unemployment in 1995 would not have boosted inflation significantly. Based on historical patterns of unemployment and inflation, CBO estimates that the rate of unemployment below which inflationary pressures start to build (the nonaccelerating inflation rate of unemployment or NAIRU) was 5.8 percent in 1995. One year at 5.6 percent unemployment, which was the average rate for 1995, would raise the rate of inflation by only 0.1 percentage point, an amount difficult to separate from month-to-month fluctuations in prices. Moreover, the effects of low unemployment on inflation are often delayed. For example, in the late 1980s, the last time the country experienced an episode of rising inflation, the unemployment rate had been below the estimated NAIRU for over two years before the underlying rate of inflation picked up noticeably. The small inflationary effects of the low unemployment rate may thus yet appear in 1996 and 1997.

Figure 1-2.
Growth of Labor Compensation



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

Some controversy exists, however, over the precise level of the NAIRU. Based partly on last year's experience, some researchers argue that the true value of the NAIRU is now below 5.8 percent. Analysis by CBO does not, however, indicate a shift in the relationship between unemployment and inflation in the 1990s. CBO therefore believes that although any estimate of the NAIRU should be regarded with a great deal of caution, not enough evidence exists for CBO to revise its own estimate.

Financial Markets

Swings in expectations of the strength of economic activity, inflation, and the future path of fiscal policy played a pivotal role in shaping movements in interest rates over the past year. The strong economy of 1994 sparked both fears of inflation and tight monetary policy and left short- and long-term interest rates at a relatively high level at the beginning of 1995. But in the first half of 1995, growth ebbed, quieting fears of inflation and contributing to a drop in long-term interest rates. Short-term rates also fell, though more slowly, as the Federal Reserve backed off cautiously from its tightening of 1994. (Monetary policy influences short-term interest rates most directly; long-term rates, though affected by policy, depend to a greater degree on expectations of future interest rates and inflation.)

The prospect of a move toward a balanced budget may also have promoted expectations of lower future short-term interest rates, thereby trimming long-term interest rates and raising stock prices in anticipation. CBO estimates that expectations of deficit reduction accounted for around 30 basis points of the 200 basis-point (2 percentage-point) drop in long-term interest rates during 1995. Lower interest rates, together with high levels of profits, drove up the stock market steeply during the past year. The Standard & Poor's 500 index of stock prices surged by 35 percent in 1995, the largest increase since 1983.

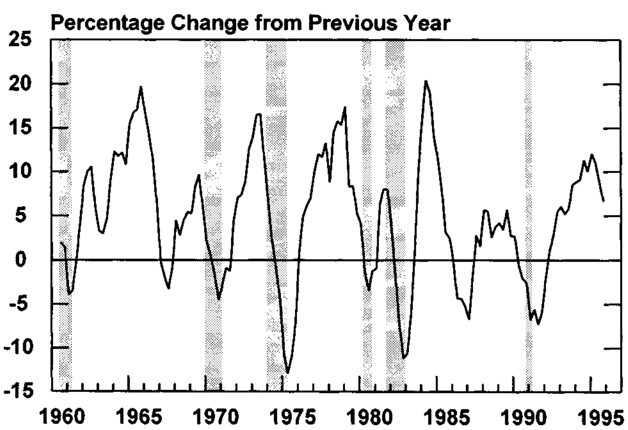
In early 1996, long-term interest rates rebounded sharply, reflecting both economic events and dwindling hopes for achieving a balanced budget. Strong growth in employment in the first quarter of 1996 heightened expectations of growth and inflation. On the budget side, negotiations that had seemed hopeful at the end of 1995 broke down in early 1996.

Investment

Investment spending on plant and equipment, which had been a major source of momentum for the economy, slipped markedly in 1995. Real investment in equipment burgeoned at double-digit rates in 1993 and 1994, and investment in structures also grew much faster than the economy. That investment boom was driven partly by a major wave of restructuring by U.S. businesses and supported by relatively high levels of profits. During the last half of 1995, investment in equipment fell to a 4.3 percent rate of growth, while investment in business structures eased slightly. Residential investment contracted slightly during 1995.

Business investment tends to plummet during a recession and accelerate rapidly in periods of expansion (see Figure 1-3). Following a recession, businesses must make up for the low investment during the downturn and expand capacity to meet rising demand. Investment has adhered to that general pattern during the most recent expansion, increasing at an average rate of 10 percent a year from mid-1993 to mid-1995. At some point, however, firms will have made up for the shortfall in investment during the recession, and investment will return to more moderate growth rates. That point seems to have been reached: the capacity use of firms now suggests decreased demand for investment. In manufacturing, capacity use dropped from 84.7 percent in late 1994 to about 82 percent early this year.

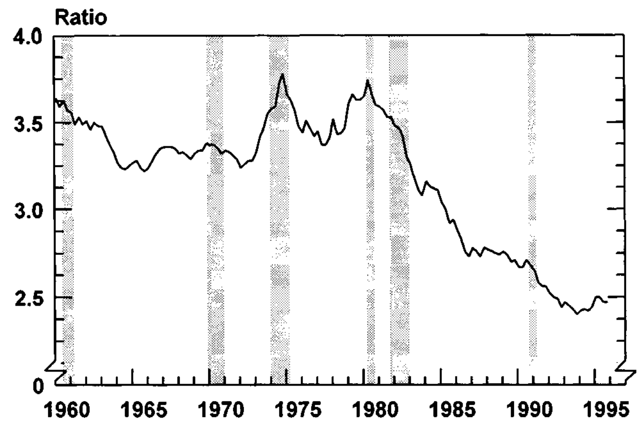
Figure 1-3.
Investment over the Business Cycle



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

NOTE: Business investment in plant and equipment in chained (1992) dollars.

Figure 1-4.
Stock of Inventories Compared with Sales



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

NOTE: Ratio of inventories to sales in current dollars.

The pattern of inventory investment by firms also played a role in the slow growth during 1995. The unexpected decline in demand in early 1995 left unsold goods on the shelves. Firms responded by cutting back on inventory investment to pare back unwanted stocks. Despite the lower rate of accumulation in inventories, however, the inventory-to-sales ratio remains above its levels of two years ago, reversing a long-term downward trend (see Figure 1-4).

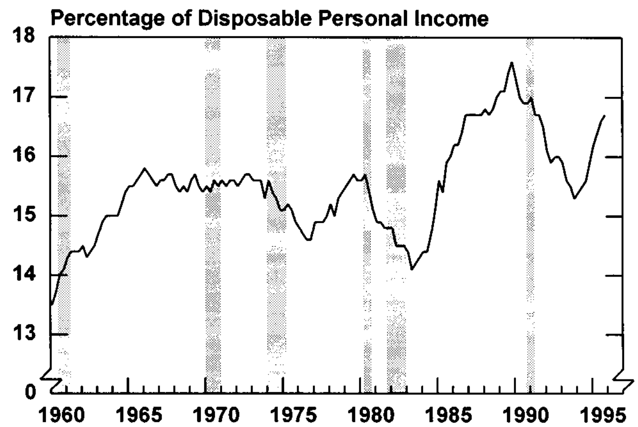
The rise in mortgage interest rates during 1994 hit residential investment hard in the first half of 1995. As interest rates flagged during 1995, the picture brightened somewhat and housing starts rebounded. The upturn in interest rates in the past few months, however, is likely to depress residential investment in the near future.

Consumption

The growth of consumption, like that of investment, slowed slightly in 1995 (see Figure 1-5). That slowdown was in part prompted by the rise in interest rates during 1994, which put a damper on the consumption of durable goods--particularly motor vehicle sales--in early 1995. Moreover, consumers may have largely rebuilt their stocks of durable goods since the last recession. Consumers often put off purchasing such goods during the hard times of a recession, leaving a backlog of demand when the economy recovers. During the subsequent expansion, however, the pent-up demand is reduced, and the growth rate of consumption slowly eases off. That pattern held over the past year: while income growth remained steady, the personal saving rate edged up as consumption subsided.

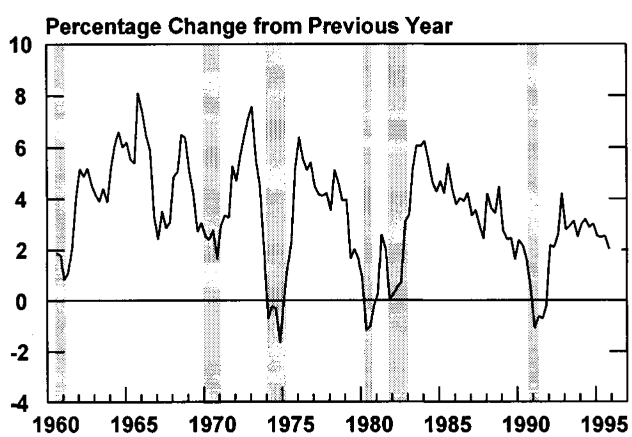
Although the saving rate increased, household debt burdens grew heavier over the year. Delinquencies on consumer debt climbed, and debt-service payments accelerated relative to income (see Figure 1-6). However, the financial situation of households does not seem bad enough to signal an imminent contraction in spending. Debt service as a share of income is no higher than it was in the mid-1980s, and consumption did not weaken at that time. Moreover, the value of assets held by consumers has surged along with the stock market, leaving them on average with higher net wealth. With greater wealth, consumers may see less need for saving and consume a greater portion of their incomes. Nevertheless, high levels of debt could make consumers vulnerable to a slowdown in income growth or a drop in asset values, especially if interest rates continue to rise.

Figure 1-6.
Household Payments on Debt



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

Figure 1-5.
Expenditures for Personal Consumption



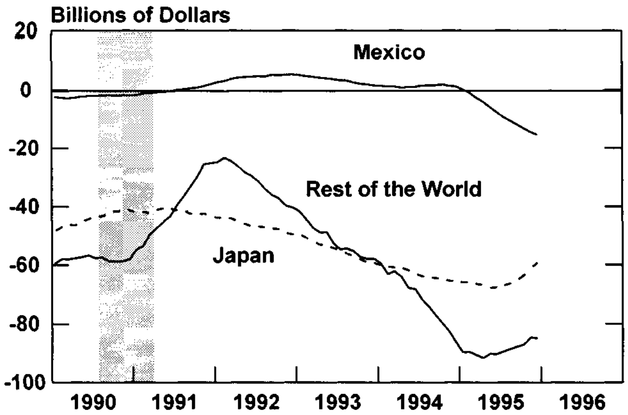
SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: Personal consumption expenditures in chained (1992) dollars.

International Trade

The real trade deficit increased early in 1995 and fell during the second half, but the recent improvement does not promise continued gains in the near future. The trade deficit deteriorated rapidly from an annual rate of $110 billion in the second half of 1994 to an annual rate of $123 billion in the first half of 1995. The deterioriation reflected both high demand for imports in the United States and the economic crisis in Mexico, which sent the bilateral balance of trade sharply into deficit (see Figure 1-7 on page 8). The overall trade deficit improved over the second half of the year, however, narrowing to $105 billion at an annual rate. Exports continued their strong growth, led by sales to rapidly growing Asian developing countries and--somewhat surprisingly--by increased sales to a sluggish Japanese economy. By contrast, growth of imports slowed, absorbing a substantial part of the slowdown in domestic final sales and of the lackluster pace of inventory growth.

Figure 1-7.
Net Exports of Goods from the United States



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

NOTE: Net exports equal exports minus imports of goods, based on Bureau of the Census data.

The deteriorating bilateral trade balance with Mexico was a significant feature of U.S. trade developments during 1995. Net exports to Mexico plummeted in the aftermath of the peso devaluation of December 1994, which lowered the cost of Mexican goods to U.S. purchasers and raised the cost of domestic goods to Mexicans. Mexico's crisis plunged it into a deep recession, further eroding Mexican buying power. The dollar value of exports of goods to Mexico dipped some 10 percent, while the dollar value of imports of goods from Mexico shot up by 25 percent.

Transitory Factors

Recent economic activity was dampened by factors whose effects on growth are largely temporary. The federal government went through two partial shutdowns that directly reduced hours worked and measured output in late 1995 and early 1996. Other federal purchases were delayed because of the budget impasse, and workers affected by the shutdowns may have postponed some of their purchases. In addition, major strikes cut production at Boeing in the last quarter of 1995 and at General Motors in March 1996. Finally, in early 1996, much of the United States was hit by a spate of harsh weather, which tends to reduce spending and output.

Fiscal Policy

Fiscal year 1996 began with no appropriation bills signed (appropriation bills provide funding for the federal government's discretionary spending--that is, spending other than for entitlement programs and interest payments on the federal debt). In its budget resolution, the Congress had proposed an ambitious path of budget balancing combined with reforms of the fast-growing Medicare and Medicaid entitlement programs and various tax cuts. The President disagreed with many of those proposals. The resulting impasse in the budget talks produced considerable uncertainty about both short- and long-run fiscal policy. Presidential vetoes of Congressional budget plans led to two government shutdowns of unprecedented duration and extent.

The first government shutdown, in mid-November, followed disagreements between the President and the Congress over three bills: a bill to raise the limit on the government's authority to issue debt; the Congress's reconciliation bill that would have provided a long-term budget plan; and the Congress's proposal for a second continuing resolution that would have provided temporary funding for the current year for those parts of the government without an appropriation for fiscal year 1996. The President refused to sign the debt-limit bill because it also contained a provision requiring budgetary balance in seven years using CBO's assumptions--an agreement that the President was not at the time ready to make. The reconciliation bill was the vehicle for the Congress's overhaul of Medicare and Medicaid, changes in farm programs and student loans, and $245 billion of tax cuts. The President also disagreed with that plan, particularly with the size and distribution of its tax cuts. Finally, the veto of the second continuing resolution reflected disagreement over its provisions increasing Medicare premiums for doctors' visits and its targeting of some programs for immediate cuts. At that time, only four of the appropriation bills for fiscal year 1996 had been signed, so the agencies without appropriations largely shut down. Exceptions were made for limited "emergency" personnel, including those preparing Social Security checks. A total of 800,000 government employees were sent home for six days.

The first shutdown ended on November 19 with the signing of the second continuing resolution, which reopened the government for one day while negotiations between the Administration and the Congress continued. The third continuing resolution, signed on November 20, incorporated an agreement that budget proposals would aim to produce a balanced budget by 2002 based on CBO estimates. Despite some temporary disagreement over the assumptions that would be used in meeting that test, the agreement in principle to balance the budget has held up over the succeeding months and is not currently a source of contention.

Shortly after the agreement was signed, however, it became clear that there was no meeting of minds about how budgetary balance was to be achieved. Fundamental differences remained over Medicaid, which the Congress wished to turn over to the states in the form of block grants, and over proposals for the earned income tax credit, Medicare, and tax cuts. The Congress and the Administration were unable to reconcile their differences. That impasse led to a second and longer shutdown from December 16 to January 6.

As time passed, it became obvious that the Administration and the Congress were not going to reach agreement on tax cuts or major reforms of entitlement programs, and the budget deliberations turned to focus on discretionary spending. Even within that more limited area of debate, disagreements about expenditures for education, job training, and environmental protection stalled the passage of a budget. Agencies for which appropriation bills had not been passed were kept open with a succession of continuing resolutions. Finally, after the 13th continuing resolution, an agreement on the 1996 budget was signed on April 26.

Fiscal Policy in 1995 and 1996

After all is said and done, fiscal policy for 1996 has been restrictive. CBO now estimates that the budget deficit for fiscal year 1996 will total $144 billion, down from $164 billion in 1995, despite the fact that no major changes were made to entitlement programs or taxes (see Table 1-2). Fiscal restraint this year amounts to 0.7 percent of potential GDP, as measured by the decline in the standardized-employment deficit, which is the deficit adjusted to eliminate the effects of the business cycle (see Appendix A). That measure of the deficit has dropped from 3.5 percent of potential GDP in 1993 to an estimated 2 percent in 1996.

The appropriations enacted through regular bills and continuing resolutions reduced discretionary spending for 1996 to levels in line with the targets of the budget resolution passed last summer. The budget impasse and government shutdowns temporarily magnified that reduction in the first part of the fiscal year. The closing of the government temporarily delayed outlays for wages and salaries (although workers were later paid for the time they did not work), while the shutdowns and associated uncertainties also caused some contracts and other purchases to be postponed. Most of that delayed discretionary spending for 1996 will be undertaken before the end of the fiscal year.

Alternative Assumptions About Future Fiscal Policy

Considerable uncertainty surrounds the outlook for fiscal policy beyond this year. The stated policy goal of both the Congress and the Administration is to balance the budget by 2002. However, because of disagreements over how to cut spending and reduce taxes, legislation to carry out that policy goal--called for in the third continuing resolution--has not yet been enacted. Thus, current policy does not reflect intended policy changes to balance the budget, although it incorporates the lower levels of discretionary spending consistent with enacted appropriations for 1996.

Usually, CBO's economic outlook has assumed the fiscal policy implied by the budget baseline--that is, current policy. If proposed but not yet enacted changes in fiscal policy are small, that procedure risks making only minor errors. But the changes in fiscal policy now proposed--balancing the budget by

2002--would have a large and beneficial impact on the economy in the long run. To recognize fully the economic changes that balancing the budget would produce, CBO has constructed two economic forecasts: the first one (the current-policy forecast) assumes the baseline or current-policy fiscal policy; the other (the balanced budget forecast) assumes that the budget is brought into balance over the 1996-2002 period and stays balanced thereafter.

Gauging the likely path of the economy under any given fiscal policy requires some assumptions about how individuals and markets regard the credibility of that policy. The extensive legislative and negotiating efforts to bring about a balanced budget probably led consumers and financial markets to believe that a balanced budget plan might be enacted. CBO now assumes, however, that despite the agreement in principle to balance the budget, financial

Table 1-2.
Measures of Fiscal Policy Under Current-Policy Assumptions (By fiscal year)

	1992[a]	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
							In Billions of Dollars								
Standardized-Employment Deficit[a]	224	233	192	192	154	177	183	205	230	243	267	291	321	354	380
Primary standardized deficit[a]	24	34	-11	-41	-86	-69	-74	-66	-53	-54	-45	-37	-25	-11	-6
Net interest payments	199	199	203	232	240	246	257	271	283	296	311	328	346	365	385
Cyclical Deficit	69	50	19	-2	5	10	15	16	17	18	19	21	22	23	24
Deposit Insurance	3	-28	-8	-18	-10	-5	-2	-2	-2	-2	-1	-1	-1	-1	-1
Spectrum Auctions	0	0	0	-8	-5	-12	-3	0	0	0	0	0	0	0	0
Total Budget Deficit[a]	290	255	203	164	144	171	194	219	244	259	285	311	342	376	403
Debt Held by the Public	2,999	3,247	3,432	3,603	3,770	3,967	4,181	4,422	4,687	4,966	5,268	5,593	5,947	6,333	6,746
							As a Percentage of Potential GDP								
Standarized-Employment Deficit[a]	3.5	3.5	2.8	2.7	2.0	2.2	2.2	2.4	2.5	2.5	2.7	2.8	2.9	3.1	3.1
Primary standardized deficit[a]	0.4	0.5	-0.2	-0.6	-1.1	-0.9	-0.9	-0.8	-0.6	-0.6	-0.4	-0.3	-0.2	-0.1	0
Net interest payments	3.1	3.0	3.0	3.2	3.2	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.2	3.2
Cyclical Deficit	1.1	0.8	0.3	0	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Deposit Insurance	0	-0.4	-0.1	-0.2	-0.1	-0.1	0	0	0	0	0	0	0	0	0
Spectrum Auctions	0	0	0	-0.1	-0.1	-0.1	0	0	0	0	0	0	0	0	0
Total Budget Deficit[a]	4.6	3.9	3.0	2.3	1.9	2.2	2.3	2.5	2.7	2.7	2.9	3.0	3.1	3.3	3.3
Debt Held by the Public	47.3	49.2	49.9	50.2	50.2	50.3	50.6	51.0	51.5	52.1	52.7	53.3	54.0	54.9	55.7
Memorandum:															
Potential GDP (Billions of dollars)	6,341	6,604	6,872	7,182	7,514	7,880	8,266	8,670	9,094	9,538	10,004	10,493	11,005	11,543	12,106

SOURCE: Congressional Budget Office.

NOTE: See Chapter 2 for details of current-policy budget assumptions.

a. These numbers exclude outlays for deposit insurance, offsetting receipts from spectrum auctions, and--in 1992--$4.9 billion of allied contributions for Operation Desert Storm.

markets are currently focusing on the fundamental policy disagreements that would have to be resolved in order to put a plan into place. As a result, the 30 basis-point decline in rates has been reversed, accounting for part of the much larger increase in long-term rates during the last few months. In the balanced budget forecast, CBO assumes that a balanced budget plan, once passed, would gradually become fully credible. In other words, as plans firm up, markets will come to believe that budgetary balance will occur on schedule and that the plan will not be abandoned in midcourse.

Fiscal Policy Under Current-Policy Assumptions. The current-policy fiscal path implies that the standardized-employment deficit as a percentage of GDP would climb significantly by 2006, partially reversing substantial reductions over the past three years. In the long run, that increase would curb economic growth. Moreover, it would provide little short-run stimulus to the economy because the increase would be very gradual.

Between 1996 and 2006, the standardized-employment deficit would rise from 2 percent to 3.1 percent of potential GDP under current-policy assumptions. Because the higher deficits soak up savings that would otherwise flow to productive investments, they would result in a lower level of economic activity in the long run.

Table 1-3.
Measures of Fiscal Policy Under Alternative Budget Assumptions (By fiscal year)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
					In Billions of Dollars						
Standardized-Employment Deficit[a]											
Current policy[b]	154	177	183	205	230	243	267	291	321	354	380
Balanced budget	154	166	116	83	58	18	-21	-19	-21	-22	-23
					As a Percentage of Potential GDP						
Standardized-Employment Deficit[a]											
Current policy[b]	2.0	2.2	2.2	2.4	2.5	2.5	2.7	2.8	2.9	3.1	3.1
Balanced budget	2.0	2.1	1.4	1.0	0.6	0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Memorandum:											
Potential GDP (Billions of dollars)											
Current policy[b]	7,514	7,880	8,266	8,670	9,094	9,538	10,004	10,493	11,005	11,543	12,106
Balanced budget	7,514	7,882	8,274	8,684	9,114	9,565	10,039	10,536	11,058	11,605	12,180

SOURCE: Congressional Budget Office.

a. These numbers exclude outlays for deposit insurance and offsetting receipts from spectrum auctions.

b. Current policy assuming discretionary spending is adjusted for inflation up to the statutory caps that are in effect through 1998. All discretionary spending other than spending from the Violent Crime Reduction Trust Fund is assumed to equal the caps in 1998 and to grow from that level at the rate of inflation in later years. See Chapter 2 for details.

Fiscal Policy Under Balanced Budget Assumptions. The balanced budget economic forecast assumes a fiscal policy that would eliminate the deficit by 2002 via an illustrative path, which would imply a small surplus in the standardized-employment budget from 2002 onward (see Table 1-3 on page 11). Between 1996 and 2002, the illustrative path in broad terms is similar to the one that the Congress proposed in the Balanced Budget Act of 1995. That policy path exerts significant restraint on short-term growth in some years, which CBO assumes would be roughly offset by changes in monetary policy and in financial markets that would lower interest rates. The balanced budget path also slims the federal debt relative to GDP, and that, too, would lower interest rates as well as raise the level of potential output.

Without an agreement between the Congress and the Administration on how to balance the budget, the details of the budget between now and 2002 remain elusive. But because of the beneficial economic effects of balancing the budget, policy actions alone would not have to do all of the work. The higher growth and lower interest rates resulting from the move to a balanced budget would help considerably in achieving that goal by raising revenue and reducing debt service.[1]

The Outlook Under Current-Policy Assumptions

Business cycles dominate short-term fluctuations in economic growth, whereas productivity, growth in the labor force, and average levels of investment govern long-term trends. CBO incorporates business-cycle influences only over the first two years of its forecast. Because of the uncertainty of economic estimates, that process involves weighing different possible outcomes (weaker or stronger growth, for example) by their estimated probabilities.

1. For more about the economic and indirect budgetary effects of balancing the budget, see Congressional Budget Office, *The Economic and Budget Outlook: December 1995 Update*, CBO Memorandum (December 1995), and the updated estimates presented later in this report.

By contrast, CBO's medium-term projections for 1998 through 2006 do not reflect any attempt to estimate either cyclical movements of the economy or the effects of fiscal policy on the year-to-year changes in economic activity. Instead, the projections are designed to approximate the level of economic activity on average, including the possibility of above- or below-average rates of growth, inflation, and interest. CBO uses historical relationships to identify trends in fundamental factors underlying the economy, including growth of the labor force, the rate of national saving, and growth of productivity. The projections of variables such as real GDP, inflation, and real interest rates are then based on their historical norms.

CBO's Current-Policy Forecast for 1996 and 1997

The economy appears poised for moderate growth in 1996 and 1997. Although some areas of concern exist, the economy appears to be well balanced overall. Inflation and interest rates are relatively low, inventories are at a manageable level, and the stock market is high. On the gloomier side, capital spending is slowing, consumer debt is relatively high, and fiscal policy is contractionary for this year. Those factors reduce the chances of robust growth over the next two years.

CBO forecasts that the underlying rate of inflation will creep up slightly from current levels in 1996 and 1997 because of the delayed effects of the low unemployment rate of the past year and a half. Inflation will be aggravated as labor compensation, driven by increased benefit or wage growth, revives from last year's subpar growth rates. Recent jumps in oil prices are likely to prove ephemeral. A rise in grain prices, resulting from low levels of stocks combined with anticipation of a poor wheat harvest, may put some upward pressure on food prices, but that trend is also not likely to persist. The anticipated slight slowing of real economic activity is expected to lead to modest increases in the unemployment rate, thus moderating the expected increase in compensation and quelling any fears of a major bout of inflation.