Chapter One

The Economic Outlook

After a strong performance during 1994, the U.S. economy slowed to a crawl during the first half of 1995. Growth of real (inflation-adjusted) gross domestic product (GDP) averaged 4.1 percent during 1994, well above the economy's noninflationary growth potential, which the Congressional Budget Office (CBO) estimates to be 2.4 percent. Hence, some slowing was inevitable if a serious upturn in inflation was to be avoided. Nevertheless, the 1.6 percent rate of growth recorded during the first half of 1995 led some analysts to question whether the pause would be relatively brief or whether it signaled the early stages of a recession.

In CBO's judgment, a recession is unlikely to develop during 1995: aside from some pockets of weakness, the economy appears to be fundamentally sound. Most important, many of the imbalances that typically precede recessions--rising inflation, swollen inventory stocks, and deteriorating balance sheets--are absent from the economic landscape.

The Congressional Budget Office forecasts that the economy will continue to grow slowly for the remainder of the year, averaging 1.3 percent over the four quarters of 1995, and will then grow at a rate of 2.3 percent over 1996 (see Table 1 and Figure 1). CBO's forecast reflects the possibility that a recession will develop, but also incorporates the stronger probability that growth will be close to or even above the noninflationary potential for the economy. With slow growth this year, the unemployment rate is likely to rise slightly--from 5.7 percent in the second quarter to 6 percent in the middle of next year. Inflation is not likely to change much under those conditions, edging only marginally higher by the end of 1996, while interest rates will ease modestly over the same period.

CBO's current forecast is similar to the economic assumptions underlying the budget resolution that the Congress passed in June, which were nearly identical to those CBO published in its winter report.[1] Real growth is somewhat slower in 1995 and slightly faster in 1996 than the winter forecast projected, but the average rate of growth during the whole period from 1995 though 2002 is almost identical to that in the winter forecast. Interest rates are substantially lower than the winter forecast during 1995 and 1996, reflecting weaker growth in the near term, but rise thereafter to the same levels as the winter forecast. CBO's forecast for inflation is almost exactly the same as the winter forecast.

The Federal Reserve's tightening of monetary policy during 1994 slowed the economy sooner than expected, which caused the Federal Reserve to ease rates slightly in July 1995. Between February 1994 and February 1995, the Federal Reserve engineered a succession of interest rate hikes, attempting to cool an economy that was in danger of overheating. By taking steps to slow the economy early, the Federal Reserve hoped to avoid the severe tightening that has often preceded recessions in the past. On this occasion, the tightening of monetary policy affected the economy earlier than most analysts had anticipated. Last winter, CBO estimated that the tightening would begin to slow the economy during the last half of 1995; instead, the effects showed up during the first

1. The sole difference is that the budget resolution forecast included an adjustment for the anticipated revision to the consumer price index beginning in 1998. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1996-2000* (January 1995); and U.S. House of Representatives, *Concurrent Resolution on the Budget for Fiscal Year 1996*, Conference Report 104-159, to accompany H. Con. Res. 67 (June 26, 1995), p. 61.

Table 1.
The CBO Forecast for 1995 and 1996

		Forecast	
	1994[a]	1995	1996
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP			
CBO summer	6.5	3.8	5.1
CBO winter	6.3	5.3	4.7
Real GDP[b]			
CBO summer	4.1	1.3	2.3
CBO winter	3.7	2.5	1.9
Implicit GDP Deflator			
CBO summer	2.2	2.5	2.7
CBO winter	2.5	2.8	2.8
Consumer Price Index[c]			
CBO summer	2.6	3.3	3.4
CBO winter	2.8	3.2	3.4
Calendar Year Average (Percent)			
Real GDP Growth[b]			
CBO summer	4.1	2.6	1.9
CBO winter	4.0	3.1	1.8
Civilian Unemployment Rate			
CBO summer	6.1	5.7	6.0
CBO winter	6.1	5.5	5.7
Three-Month Treasury Bill Rate			
CBO summer	4.2	5.4	5.1
CBO winter	4.2	6.2	5.7
Ten-Year Treasury Note Rate			
CBO summer	7.1	6.5	6.4
CBO winter	7.1	7.7	7.0

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

a. The numbers for 1994 are actual values for CBO's summer forecast but are estimates for the winter forecast.

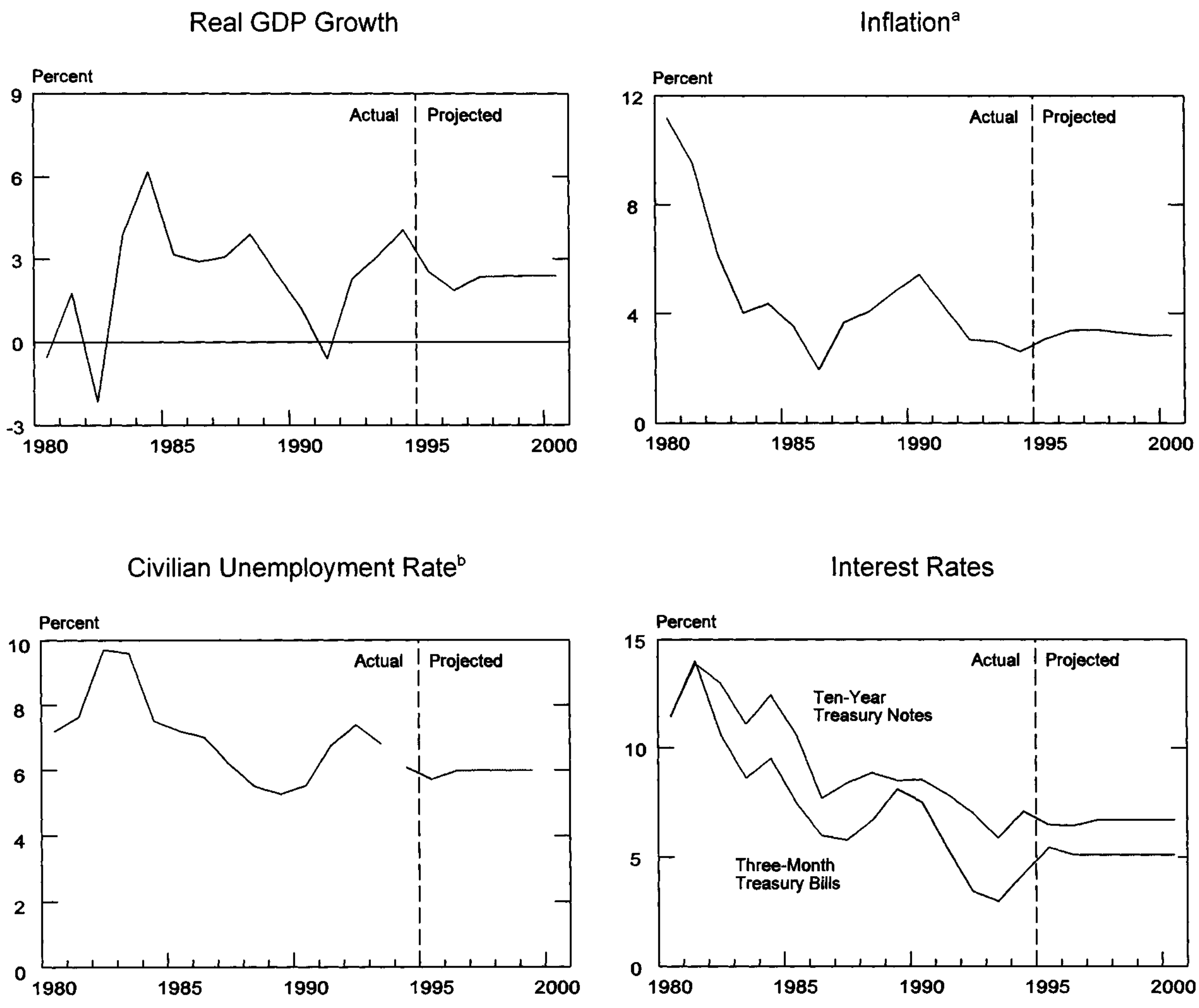
b. Based on constant 1987 dollars.

c. The consumer price index for all urban consumers (CPI-U).

half of the year. The Federal Reserve reacted cautiously to the signs of weakness, trimming the federal funds rate by only 25 basis points (a quarter of a percentage point) in early July.

Although CBO foresees economic growth approaching its potential rate by the middle of 1996, the current outlook holds substantial uncertainties. In particular, CBO's forecast presumes that the weakness some sectors have already experienced will not spread. A worse outcome could follow if producers, worried by weak demand for their goods, cut production further to pare inventory stocks. Reductions in employment and income could then prompt con-

Figure 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. 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.

b. 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.

sumers to postpone purchases further, tipping the economy into recession.

Alternatively, the economy could roar back later this year. Economic growth of 4 percent would be easy to attain if companies continued to invest at their recent pace and if demand for consumer durable goods or housing showed signs of life. The Federal Reserve would then be likely to clamp down, raising interest rates to levels that would risk recession in 1996 or 1997.

Assuming that both of those extremes are avoided, the stage could be set for a renewed period of growth like that which followed the "growth recessions" of 1967 and 1986. In each of those years, the economy experienced a temporary slowdown, largely limited to the manufacturing sector, that relieved inflationary pressures and allowed several more years of economic expansion.

The economic forecast and projections presented in this chapter assume current fiscal policy; that is, they do not reflect the effects of the deficit reductions implied by the budget resolution. Chapter 3 examines the resolution and how implementing the fiscal policy it proposes might affect the economy.

CBO's next *Economic and Budget Outlook*, to be published in January or February of 1996, will incorporate new measures of real GDP. The Bureau of Economic Analysis at the Department of Commerce, the keepers of the national income and product accounts, will switch to a measure that is more sensitive to the changing nature of the economy. For details about the new measure of real GDP, see Appendix B.

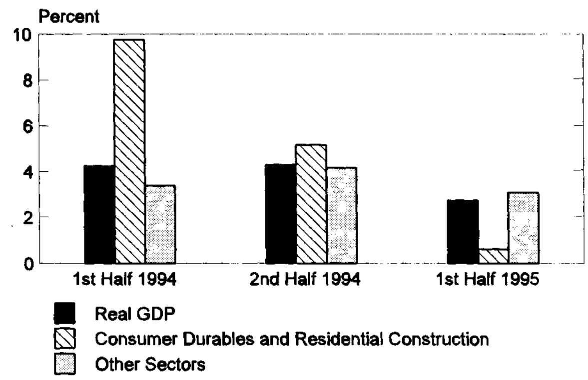
Slowdown in the First Half

The U.S. economy slowed dramatically during the first half of 1995, growing at a 1.6 percent rate since January, down from its brisk pace of 4.1 percent during 1994. During the first two quarters of 1995, the slowing of demand was concentrated in sectors of the economy that are sensitive to changes in interest rates, such as residential construction and consumer durables, especially autos and furniture (see Figure 2). That pattern suggests that the weaker pace of economic activity resulted largely from the Federal Reserve's tightening of monetary policy during 1994 and early 1995. Producers reacted to slower demand by cutting back their investment in inventories--which had been very strong during 1994 and early 1995--to prevent stocks of unfinished goods from mounting.

Some analysts were concerned that the signs of weakening might be signaling the start of a recession. Indicators such as the index of industrial production, housing starts, and vehicle sales all reached peaks and started to decline during the first quarter of 1995. Broader-based measures from the labor market--hours worked, employment, and the unemployment rate--hinted at softer demand for labor during the first half of the year. By midyear, however, many of those indicators showed renewed strength, decreasing the likelihood of a significant unwinding of economic activity.

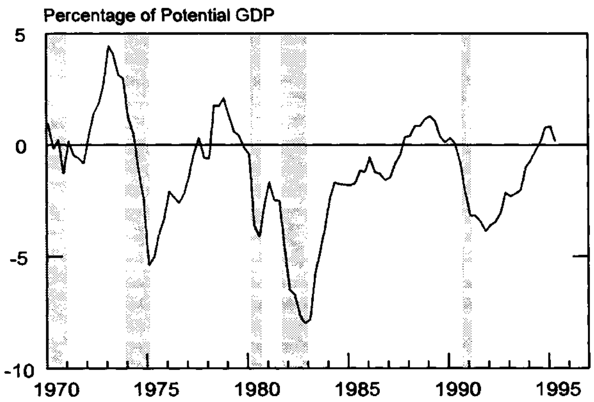
Financial markets responded to the slowing of the economy by driving down interest rates--particularly long-term rates--during the first half of 1995. The rate on 10-year Treasury notes, for example, dropped 160 basis points, retracing nearly four-fifths of its 1994 run-up. The efforts of the Federal Reserve to maintain the federal funds rate at its 6 per-

Figure 2.
Growth Patterns in Selected Sectors
(By half years, at annual rates)



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

Figure 3.
The GDP Gap



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

NOTE: The GDP gap is GDP minus potential GDP expressed as a percentage of potential GDP.

cent target level prevented short-term rates from declining as much. Nevertheless, slower economic growth, combined with the expectation of an easing of monetary policy, forced down yields at shorter maturities, and the three-month Treasury bill rate fell by 30 basis points during the first half of the year.

Financial markets welcomed the news of slower growth because, by most estimates, the economy is straining its productive capacity. Real GDP surpassed potential output, the level of output that is consistent with a stable rate of inflation, during the third quarter of 1994 and remained above that level through early 1995 (see Figure 3). Other measures of inflationary pressure tell the same story as potential output--the capacity utilization index is close to the level normally associated with a pickup in the growth of prices, and the unemployment rate is below CBO's estimate of the nonaccelerating inflation rate of unemployment (or NAIRU). Slower growth cheers the bond market because it reduces the risk of an increase in inflation and the likelihood of a further tightening of monetary policy.

The pattern of declining interest rates since February, when the Federal Reserve last raised the federal funds rate, has narrowed the spread between long- and short-term interest rates and flattened the yield curve. Such a narrowing typically indicates slower growth ahead, whereas inversions of the yield curve (when short-term rates climb above long rates) are usually followed by recessions. However, the events of 1995 differ from most episodes in which the yield spread has narrowed in that long-term rates dropped but short-term rates fell only slightly. Usually, the yield curve flattens when interest rates are rising and tight monetary policy drives short-term rates above long-term rates. The most likely explanation for this year's events is that slower growth eased fears of inflation among participants in the financial markets and lowered the likelihood of further Federal Reserve tightening. Those forces reduced long-term rates and would have lowered short-term rates sharply had the Federal Reserve not drained reserves from the banking system.

The progress made by the Congress toward deficit reduction may also have contributed to the decline in long-term interest rates. Early in the year, financial market participants seemed skeptical that the Republican majorities could hold together to pass legislation to reduce the deficit substantially. As the budget resolution and other legislation incorporating such reductions progressed through the House and Senate, markets may have changed their views and bid down rates.

The CBO Forecast for 1995 and 1996

The economy is likely to weather the current period of weakness and return to a sustainable path of growth next year. The softening of interest-sensitive sectors caused by tight monetary policy could persist through the end of 1995. It need not, however, cause a dramatic weakening of employment or income and therefore would not spread to other sectors of the economy. CBO foresees a period of slow growth in real GDP this year and a gradual return toward its potential rate of growth during 1996.

Significant slowdowns do not necessarily foreshadow recession. For example, a period of slow growth interrupted the expansion of the 1980s relatively late in the business cycle. During 1986, the growth of real GDP was negative in the second quarter, remained sluggish for the remainder of the year, but then snapped back in 1987. A similar pause occurred in 1967. Those brief pauses probably prolonged the expansions by reducing inflationary pressures, thereby delaying the point at which the Federal Reserve needed to act aggressively to head off inflation. The comparison between the episodes is not perfect--the current slowing can probably be attributed to the Federal Reserve's preemptive strike against inflation during 1994, whereas the slowing in 1986 occurred at a time when the Federal Reserve was easing rates. However, the current slowdown, like those of 1967 and 1986, will probably be mild, relieve pressure on capacity, and help to prevent the economy from overheating.

The Economy Has Enough Fundamental Strength to Avoid Recession

The pockets of weakness that emerged during the first half of 1995 are isolated and are not likely to cause the downward spiral of cuts in production and employment that characterizes recessions. Many fundamental factors support growth: consumer and business balance sheets are healthy; banks do not appear to be overextended; corporate cash flow is strong; inventory stocks do not generally appear to be bloated; the exchange value of the dollar is down; and growth abroad looks solid on average.

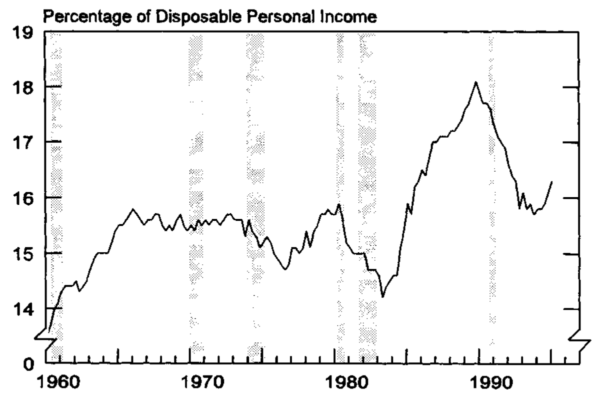
Balanced against those sources of strength is the tightening of monetary policy that occurred during 1994 and early 1995, which clearly began to slow the economy during the first half of 1995 and may yet slow it further. On seven previous occasions since World War II, the federal funds rate rose by at least 180 basis points within four quarters, as it did in 1994 and early 1995. After two of those seven episodes, the economy was in recession within a year, and after another four episodes, the economy was in recession within two years. However, interest rates are still lower now than in past episodes of tightening, perhaps because the Federal Reserve began to tighten earlier in the business cycle than it did many times in the past.

Consumers Will Not Retrench. Consumer spending grew at a 2.0 percent annual rate during the first half of 1995, slipping from its 3.3 percent pace during the previous two years. Thus far, the weakness in consumption has been concentrated in areas that are sensitive to changes in interest rates, including durable goods such as autos and furniture. In CBO's view, the weakness in spending for durable goods will continue into 1996, but will not spread to demand for nondurables--such as food and clothing--or to demand for services.

The outlook for growth in personal income, though not as strong as its robust pace during the latter half of 1994, is favorable enough to support continued growth in consumer spending. CBO expects disposable personal income, adjusted for inflation, to grow at an average rate of 1.7 percent through the end of 1996. Unfettered by a heavy burden of debt repayment, consumers should react to such growth in income by increasing their consumption spending at a similar rate (see Figure 4). The surge in stock and bond prices during the first half of 1995 will also support consumer spending, though only modestly.

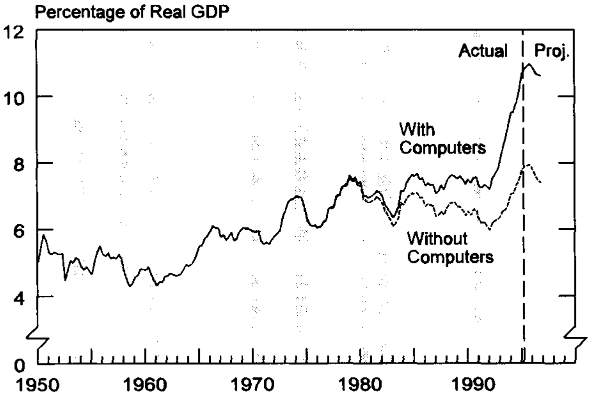
Business Investment Cools. Growth of business investment, which has advanced at a 10 percent rate since the beginning of 1994, is expected to slow dramatically during the remainder of the year and into 1996. Spending for capital equipment, which has been an important engine of growth during the current business cycle, is expected to lead the slow-

Figure 4.
Household Payments on Debt



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

Figure 5.
Investment in Producers' Durable Equipment



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

down (see Figure 5). Although CBO expects that companies will respond to the slower pace of sales by trimming their capital-spending plans, several factors argue against a collapse in business investment: factory operating rates continue to be high, thus putting pressure on companies to expand capacity; corporate cash flows and profits are strong; business balance sheets are not loaded down with debt; and financing costs are falling as interest rates sag and the stock market surges.

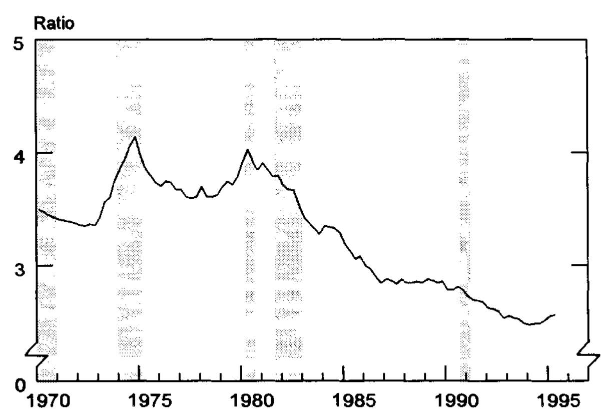
One source of concern is the rapid pace of inventory accumulation during 1994 and the first quarter of 1995. Investment in inventories accounted for a significant share of the growth of real GDP during those quarters--0.6 percentage points of an overall growth rate of 3.8 percent. That pace of accumulation did not concern analysts during 1994, when the growth of demand was brisk. However, inventory stocks mounted when sales slowed during the first half of 1995, especially in the housing and auto sectors, in which the shortfall in demand was concentrated. When production fell off during the second quarter in response to a growing stock of unsold goods, analysts became concerned about the possibility that large inventories could induce recession.

CBO does not forecast such a cycle because the inventory buildup--with the exception of a few sectors--is not especially large compared with the recent level of sales. Indeed, the overall inventory-to-sales ratio showed a very mild increase during the first half of 1995 (see Figure 6). In addition, manufacturers have already begun to align their inventories with sales by slowing production during the second quarter. CBO projects that the investment in inventories will remain slow during the second half of the year and that inventories will be in line with sales by early 1996.

Investment in nonresidential structures is expected to provide a mild boost to the economy through the end of 1996. After three years in the doldrums, that sector perked up in 1994 and posted a 17 percent rate of growth during the first half of 1995. Growth in nonresidential construction was surprisingly broad-based during the first six months of 1995, encompassing industrial buildings (including factories and warehouses), commercial real estate (including retail and wholesale space, hotels and motels, and even office buildings), mining, and construction by utilities. Spending for structures depends less on the ups and downs of the business cycle than other investment and therefore may continue its modest growth even if investment in equipment slows.

Baseline Fiscal Policy Is Not a Factor. CBO's economic assumptions normally reflect the federal fiscal policies--that is, tax policies and spending plans--that have already been passed into law. The current-law forecast embodies a fiscal policy that scarcely re-

Figure 6.
Stock of Inventories Compared with Sales



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

strains economic activity in 1995 and 1996. Actual fiscal policy is likely to be more restrictive than current law, however, since both the Congress and the Administration have indicated a desire to reduce the deficit for 1996 and beyond on the way to budgetary balance (see Chapter 3).

CBO gauges the stance of fiscal policy using the standardized-employment deficit, which removes outlays for deposit insurance and the effects of the business cycle from the budget deficit. Deposit insurance is removed because those outlays are generally considered to be exchanges of existing assets and have little effect on output and employment. The cyclical component of the deficit is removed because it is not the result of policy changes. Fiscal policy is stimulative in a given year if the standardized-employment deficit rises relative to potential GDP in

Table 2.
The Fiscal Policy Outlook (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
	In Billions of Dollars						
	With Discretionary Inflation After 1998						
Total Budget Deficit	203	161	189	218	229	261	288
Standardized-employment deficit[a]	194	189	188	211	221	251	277
Cyclical deficit	16	-11[b]	9	12	13	13	14
	Without Discretionary Inflation After 1998						
Total Budget Deficit	203	161	189	218	229	243	250
Standardized-employment deficit[a]	194	189	188	211	221	233	239
Cyclical deficit	16	-11[b]	9	12	13	13	14
Memorandum:							
Deposit Insurance	-8	-16	-8	-4	-5	-3	-2
	As a Percentage of Potential GDP						
	With Discretionary Inflation After 1998						
Total Budget Deficit	3.0	2.3	2.6	2.8	2.8	3.1	3.2
Standardized-employment deficit[a]	2.9	2.7	2.6	2.7	2.7	2.9	3.1
Cyclical deficit	0.2	-0.2[b]	0.1	0.2	0.2	0.2	0.2
	Without Discretionary Inflation After 1998						
Total Budget Deficit	3.0	2.3	2.6	2.8	2.8	2.8	2.8
Standardized-employment deficit[a]	2.9	2.7	2.6	2.7	2.7	2.7	2.7
Cyclical deficit	0.2	-0.2[b]	0.1	0.2	0.2	0.2	0.2

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 cap.

a. Excludes cyclical fluctuations and outlays for deposit insurance.

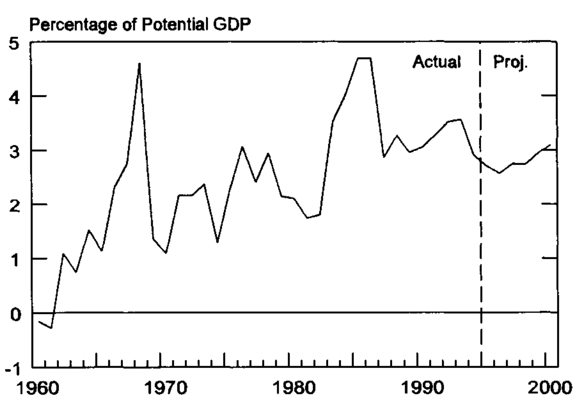
b. Surplus.

that year and restrictive if it falls relative to potential GDP. Otherwise fiscal policy is said to be neutral if the ratio remains constant.

Under current law, the standardized-employment deficit will remain roughly constant as a share of potential GDP between 1995 and 1998 (see Table 2 and Figure 7). Its course thereafter depends on whether discretionary spending grows with inflation or remains constant after the current caps on such spending expire. If discretionary spending was allowed to grow with inflation, the standardized-employment deficit would also grow as a share of potential GDP between 1998 and 2000. After 2000, rising spending for health programs would drive up the deficit even more. If discretionary spending was held constant at its 1998 dollar level, the standardized-employment deficit would be a roughly constant share of potential GDP between 1998 and 2000. From a longer-run point of view, however, baseline fiscal policy would be a source of concern because federal borrowing would continue to crowd out private investment.

Net Exports Show Modest Improvement Through the End of 1996. The U.S. trade balance, which deteriorated as a result of a sharp decline in exports to Mexico during the first half of 1995, should improve in the remainder of 1995 and into 1996. Faster growth abroad combined with slower growth at home is largely responsible for improving the trade balance. In addition, the exchange value of the dollar plunged sharply during the first quarter of 1995, providing a further reason to expect improvement in the trade picture.

Figure 7.
Standardized-Employment Deficit
(By fiscal year)

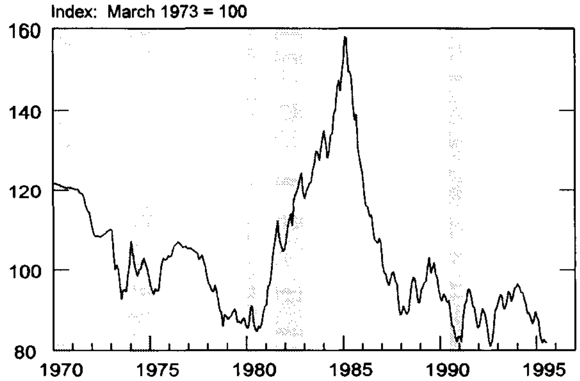


SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Growth in world output should outpace growth in the United States during the rest of 1995 and 1996, averaging 3 percent in both years. Economic recovery is firmly established in Canada, Germany, and the United Kingdom--three of the top five trading partners of the United States--though slower growth in the United States seems to have dampened prospects in Canada. Growth in the newly industrialized countries of Asia, though moderating from its remarkable 7.6 percent rate in 1994, is projected to remain much faster than the growth of the U.S. economy during 1995 and 1996.

The notable exceptions to that rosy picture are Japan and Mexico--the second and third largest trading partners of the United States--which are currently experiencing low or negative growth in output. The economic recovery in Japan, which has been limping along for the last two years, was further battered by the Kobe earthquake in January and an appreciation of the yen during the first half of 1995. Economic activity in Japan during this business cycle has been hampered from the start by sluggish lending by banks, which are struggling to crawl out from under a mountain of bad loans caused by the collapse of prices in real estate and financial assets. One of the actions undertaken by banks (and insurers) is the sale of marketable assets, which forces the prices of equities and property down further. Although the economy seems to have recovered quickly from the effects of the earthquake (rebuilding work could be stimulating growth at this point), the effects of the yen's appreciation make it less likely that foreign demand will boost the economy in the near term. In addition to decreasing the competitiveness of Japan's exporters in foreign markets, the yen's appreciation has spurred cost-cutting measures by firms that have slowed--and will continue to slow--the growth in employment, wages, and consequently consumer demand. Some analysts are worried that Japan will slip back into recession, but a consensus forecast envi-

Figure 8.
The Dollar Exchange Rate



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Trade-weighted index relative to the currencies of 10 countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the United Kingdom.

sions Japan's output growing at about 0.5 percent in 1995 and 1.2 percent in 1996.[2]

Mexico's currency crisis subsided in March after a package of international aid and loan guarantees, combined with the Mexican government's austerity program, restored confidence in the peso. By mid-July, Mexico's first debt offering since the crisis was greeted by strong demand in the private capital market; $1 billion of new two-year notes was sold, twice the targeted amount. However, the crisis itself, which cut off the flow of international investment, and the actions taken by President Zedillo to address the crisis--holding down wage growth, reducing government spending, and selling government enterprises--will depress growth in the near term. The Mexican economy is expected to contract by nearly 3.5 percent in 1995 but is expected to bounce back in 1996, when the impact of the austerity program has passed its peak.

Bolstering the effect of relative growth rates on the trade picture is the depreciation of the dollar, which declined 8 percent during the first half of 1995 when measured against a 10-country, trade-weighted basket of currencies (see Figure 8). The weaker dollar will improve the U.S. real trade balance by making foreign goods more expensive for U.S. residents and domestic goods cheaper abroad. Analysts have generally attributed the fall in the exchange value of the dollar to the expectation by currency traders of slower growth (and lower interest rates) in the United States. Lower interest rates make investments in dollar-denominated assets less attractive to foreigners.

Residential Construction Will Stabilize. Construction of residential housing was decidedly weak during early 1995, after a surge in the last quarter of 1994. Although most analysts expected that sector to soften during 1995, the degree of weakness was a surprise. The decline in long-term interest rates that occurred during the first half of the year will help this sector, but only with a lag. CBO expects that residential construction will decline further during the remainder of 1995 and early 1996, before turning around midway through next year.

The level of interest rates is the most important short-term influence on housing construction, and the run-up in rates during 1994 certainly contributed to the falloff in housing construction earlier this year. The average interest rate on 30-year fixed-rate mortgages climbed 2 percentage points during 1994, peaking at over 9 percent in December. The increase in fixed rates precipitated a shift toward adjustable-rate mortgages, but rates on those mortgages climbed too, rising from 5.6 percent in early 1994 to 7.0 percent in mid-1995. Increases in mortgage rates make a home more expensive to finance, and indeed measures of housing affordability fell as rates increased (see Figure 9). However, the 120 basis-point decline in the interest rate on fixed-rate mortgages during 1995 had the opposite effect, arresting the decline in the index of housing affordability. Although it will operate with a lag, the decline in rates will serve to stimulate housing construction--or at least temper its fall.

The longer-term outlook is for modest growth at best in the housing sector. The most important influence on residential construction over the longer term is the number of new households formed, particularly those in which the head of the household is between the ages of 25 and 34. The dearth of births during the "baby-bust" generation of the late 1960s and 1970s is

2. Consensus Economics, Inc., *Consensus Forecasts* (July 10, 1995).

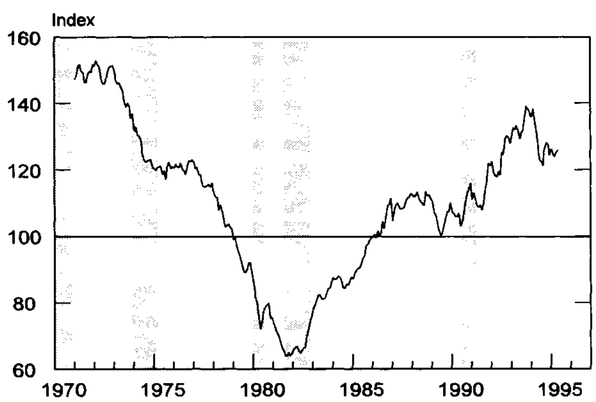
now showing up as a slowdown in the formation of households by that age group--a trend that is expected to continue through the end of the decade. Spending on renovations has supported spending for residential construction during recent years, however, and that spending could accelerate if baby boomers decide to renovate their houses rather than try to sell them to a smaller pool of first-time buyers.

Pressure on Wages and Prices Eases During 1995 and 1996

Despite weakness this year, the economy is operating at high levels of resource use, creating upward pressure on wages and prices. CBO expects that the underlying rate of inflation--measured using the consumer price index for all urban consumers (CPI-U) excluding food, energy, and used cars--will average 3.3 percent between the fourth quarters of 1994 and 1995, slightly above the rate in 1994, and will inch up to 3.5 percent in 1996.

Without any shocks--for example, to oil prices--the primary force that influences the rate of inflation is the growth of labor costs, the largest component of most companies' total expenses. The growth rate of employee compensation, as measured by the employment cost index, is no longer falling and is expected to step up slightly during 1996. That pattern reflects the normal lag between the time that excess demand appears in labor markets--late in 1994--and the time that costs begin to accelerate. The rate of capacity utilization has fallen over the last six months, but it is still near the level at which the rate of inflation for manufactured goods would climb. However, the expected uptick in prices of manufactured goods has not yet been observed. The tumble in the exchange value of the dollar will also tend to pump up inflation through import prices, but the effect on the CPI is likely to be small.

Figure 9.
Housing Affordability Index



SOURCES: Congressional Budget Office; National Association of Realtors.

NOTE: The index equals 100 when median family income is just sufficient to qualify the family to purchase a median-priced home.

Some analysts have argued that the Federal Reserve's focus on fighting inflation has been overdone because the underlying rate of inflation did not increase during the first half of 1995. Those analysts suggest that conventional measures of capacity are no longer relevant in today's economic environment of relentless corporate cost-cutting, heavy investment in computers, and increasing global competition. It is too soon to tell whether that argument is valid because the forces that spur inflation operate with a long lag--anywhere from six months to two years. Since the unemployment rate only breached the level of the NAIRU--CBO's preferred measure of capacity in the labor market--during the fourth quarter of 1994, it is not surprising that inflation in consumer prices has yet to tick up. However, some evidence of price rises exists, and clearly the growth of wages and prices is no longer slipping as it had been since 1990.

Monetary Policy Is Expected to Ease Further

The Federal Reserve progressively tightened monetary policy during 1994 and early 1995 but is now cautiously loosening the degree of restraint. Citing the easing of inflationary pressure, the Federal Reserve cut the target federal funds rate by 25 basis points, from 6 percent to 5¾ percent, in early July. Despite that cut, monetary policy is still relatively tight, and CBO expects that the Federal Reserve will ease policy even further during the second half of 1995 to achieve its goal of sustainable growth with low inflation.