Chapter One

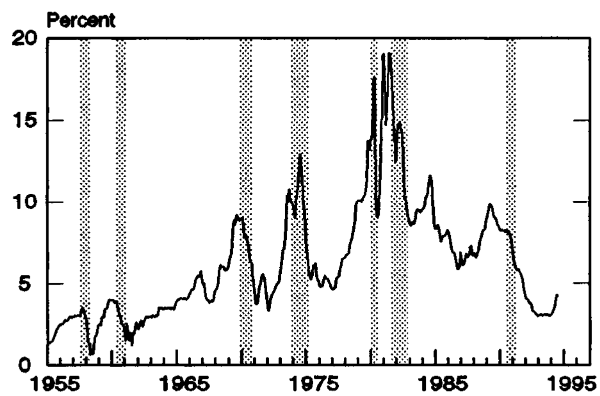
The Economic Outlook

Since the third quarter of 1993, U.S. economic growth has been robust. Although a substantial gap existed in mid-1993 between the economy's output and what it could potentially produce, the strong growth of the last three quarters has whittled away that gap: by mid-1994, both the capacity utilization rate and the unemployment rate reached levels where inflationary pressures normally begin to be a concern. The Congressional Budget Office (CBO) anticipates that the strong growth of real gross domestic product (GDP) will continue during the second half of 1994 and early 1995.

The strength of the economy during the last three quarters was largely unanticipated. Both the *Blue Chip* consensus forecast and the CBO forecast prepared during the last quarter of 1993 indicated about 3 percent growth for the end of 1993 and the first half of this year.[1] Instead, the economy grew at a vigorous 4.4 percent rate. Growth in employment also accelerated. During the first 10 months of 1993, employment grew by an average of 180,000 jobs a month, but between October 1993 and July 1994, 270,000 jobs have been added monthly. Hours worked increased even more rapidly, and the unemployment rate fell from 6.7 percent in January to 6.1 percent in July. Strong growth in investment and consumption of durable goods spurred the pickup in economic activity. Expenditures by businesses for plant and equipment increased by about 14 percent over the three quarters, and consumption of durable goods grew by more than 8 percent. Given such a strong performance of the economy over the previous three quarters, the current CBO forecast points toward higher GDP and interest rates, and slightly more inflation, than last winter's forecast.

The Federal Reserve acted early this year at the first signs of the surprising economic strength reported in January. Between February 4 and May 17, it increased the federal funds rate in four steps--from 3 percent to 4.25 percent. These moves signaled a major turning point in monetary policy, which had slowly lowered short-term interest rates over the previous five years (see Figure 1-1). Other

Figure 1-1.
The Federal Funds Rate Signals a Period of Tighter Money



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Based on monthly data through July 1994.

1. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999* (January 1994); and Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1994).

short-term rates closely followed the hike in the federal funds rate, but long-term rates climbed more than short-term rates. Since January, three-month Treasury bill rates have risen by about 135 basis points, while 10-year Treasury rates have risen by about 150 basis points. Policymakers hoped that financial market participants would interpret the Federal Reserve's actions as prudent measures to head off inflation. Instead, the financial community anticipated further adjustments in the federal funds rate and a rise in inflation. As a result, long-term interest rates rose.

CBO's Updated Economic Forecast for 1994 and 1995

CBO expects the economy to continue to expand in 1994 at an annual rate of about 3.6 percent on a fourth-quarter-to-fourth-quarter basis (see Table 1-1 and Figure 1-2). This forecast for growth in 1994 is almost 1 percentage point higher than the rate of 2.8 percent that was forecast last winter. The primary reason for the increase is that business investment in equipment and spending on consumer durables, which accounted for the bulk of the unexpected growth in demand recently, are likely to continue to spur growth through mid-1995. Strong growth in disposable income, together with some pent-up demand for light vehicles (automobiles, small pickup trucks, sport/utility vehicles, and minivans), will stimulate consumption. Moreover, firms now operating at close to full capacity are likely to continue to expand their industrial base to meet the increased demand for goods and services.

If the U.S. economy continues to grow above potential (the level of output consistent with stable inflation) during the last half of 1994 and early 1995, the Federal Reserve is likely to increase short-term interest rates further in order to stem a rise in inflation. Three-month Treasury bill rates are expected to escalate from their average of 4.0 percent in the second quarter to over 5½ percent during 1995, approximately 1.2 percentage points higher than the CBO forecast last winter. The forecast for long-term rates (measured by the rate on 10-year Treasury notes) has also been adjusted upward since the winter by almost a full percentage point to 6.8 percent in 1994 and 1995.

Because the labor force is expected to grow faster in 1995, CBO forecasts the rate of unemployment to fall only gradually, from an average of 6.2 percent in 1994 to 5.8 percent in 1995. The current forecast is about 0.5 percentage points lower than last winter's forecast.

Stimulated by activity in the household and business sectors, the economy is forecast to grow at a 3½ percent rate through the second half of 1994, even though declining federal expenditures and a deterioration of net exports will restrain growth. In 1995, however, GDP growth will slow as investment and consumption subside, though the foreign sector is likely to stimulate growth by increasing the demand for U.S. exports.

Factors Currently Propelling Growth

Investment and consumption are the primary components of demand propelling growth in 1994. The need to meet the increased growth in final demand will drive expenditures by firms on plant and equipment, while growth in disposable income will stimulate expenditures by households.

Business Investment

Capital investment by businesses--particularly investment in equipment--has been the major source of the economy's strength for more than a year, and it should continue to be so for the rest of this year before slowing down in 1995. A combination of factors has spurred spending on equipment since mid-1992--strong growth in final demand, rising profit margins, declining capital costs, and a continued drive by corporations to strengthen their balance sheets. In addition, investment in construction, though not a strong source of growth, is apt to detract less from growth through the end of next year than it did during the last three years. By 1995, with the economy running at capacity, rising interest rates are likely to temper, though not reverse, the growth in business investment.

Table 1-1.
The CBO Forecast for 1994 and 1995

	1993[a]	Forecast 1994	Forecast 1995
	Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP			
CBO summer	5.4	6.2	5.3
CBO winter	4.9	5.7	5.4
Real GDP[b]			
CBO summer	3.1	3.6	2.7
CBO winter	2.3	2.8	2.7
Implicit GDP Deflator			
CBO summer	2.2	2.5	2.5
CBO winter	2.5	2.8	2.6
Consumer Price Index[c]			
CBO summer	2.7	2.8	3.2
CBO winter	2.7	2.9	3.0
	Calendar Year Averages (Percent)		
Real GDP Growth[b]			
CBO summer	3.0	4.0	3.0
CBO winter	2.8	2.9	2.7
Civilian Unemployment Rate[d]			
CBO summer	*6.8*	6.2	5.8
CBO winter	*6.8*	6.6	6.4
Three-Month Treasury Bill Rate			
CBO summer	3.0	4.1	5.5
CBO winter	3.0	3.5	4.3
Ten-Year Treasury Note Rate			
CBO summer	5.9	6.8	6.8
CBO winter	5.9	5.8	6.0

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

a. The data for 1993 are actual values for the summer forecast but are estimates for the winter forecast.

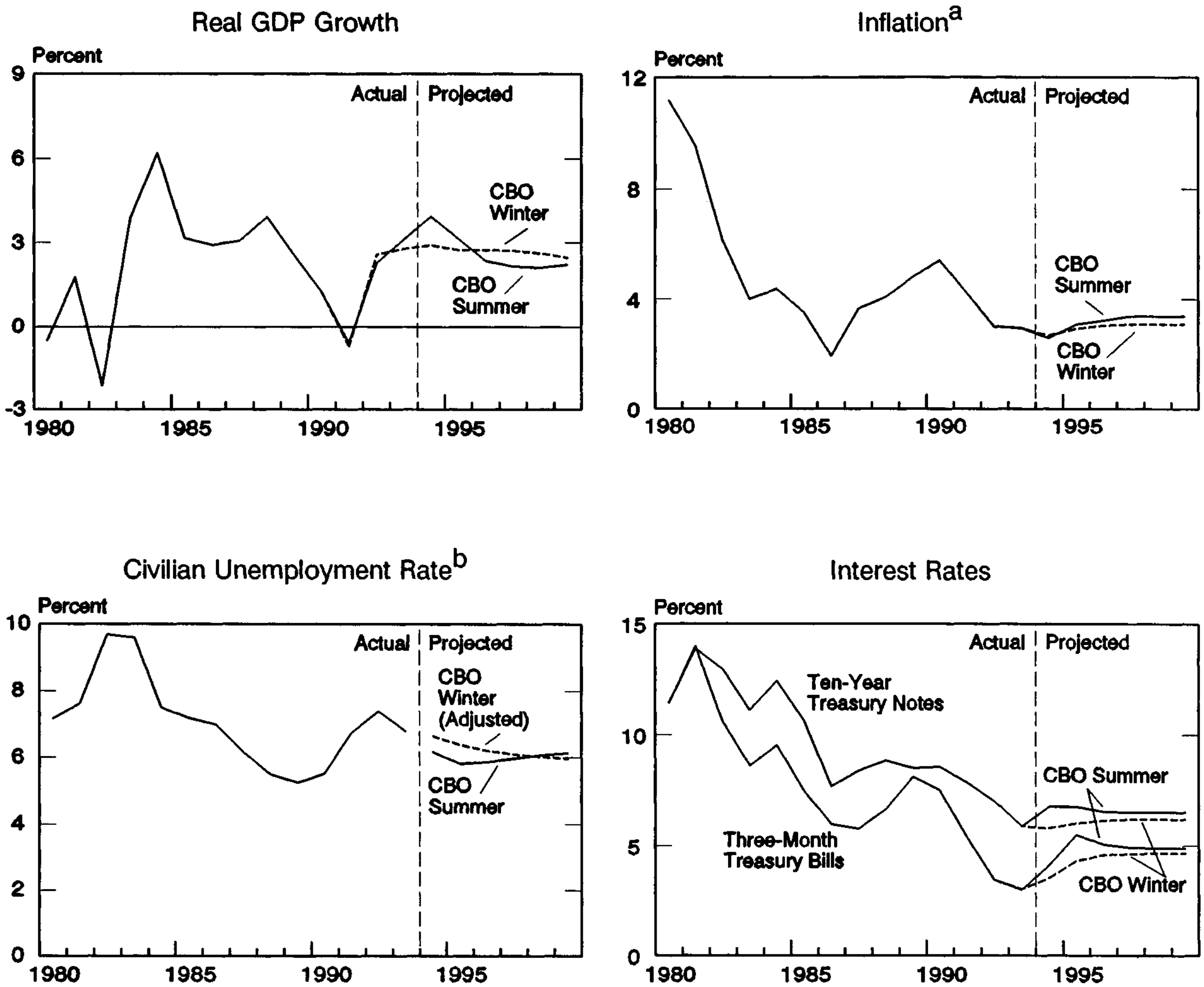
b. Based on constant 1987 dollars.

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

d. The Bureau of Labor Statistics changed the unemployment survey in January 1994. The CBO summer forecast reported in this table uses the new survey methodology. The CBO winter forecast has been adjusted upward by about one-quarter of a percentage point to make the forecast comparable. Data for 1993, shown in italics, use pre-1994 methodology.

Over the last two years, the growth of investment in equipment was spurred primarily by the economic expansion, which raised expectations for both sustained growth in demand and the current and future profitability of corporations. In a continuation of rapid growth that started in early 1992, business fixed investment grew 13 percent over the past four quarters. All of the growth was in equipment spending, with investment in business structures virtually flat over the past two years. Outpacing the growth in real GDP, total spending on equipment grew by 17 percent over the past year,

Figure 1-2.
The Economic Forecast and Projections



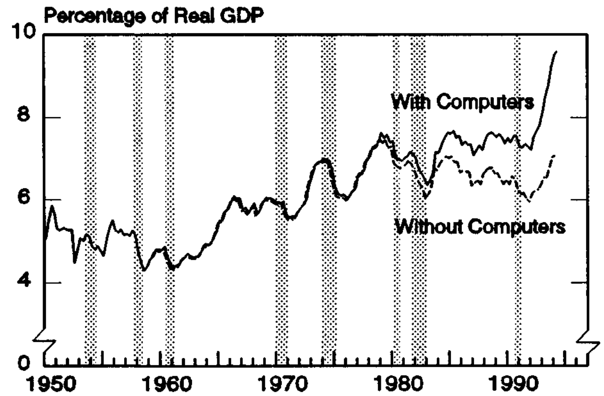
SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

NOTE: All data are presented on an annual basis; growth rates are year-over-year. For 1996 and subsequent years, the projections do not attempt to reflect cyclical patterns.

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 onward, the unemployment rate reported by the Bureau of Labor Statistics is not comparable with prior data. The discontinuity reflects an extensive revision of survey methods. CBO's summer forecast is made on the basis of the new methods. The winter forecast of the unemployment rate, originally reported on the old basis, has been adjusted upward by one-quarter of a percentage point.

Figure 1-3.
Investment in Equipment Is Still Surging



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

NOTE: The figure shows real investment in producers' durable equipment as a percentage of real GDP.

and spending for equipment other than computers grew by 12 percent (see Figure 1-3).[2]

Will the equipment boom continue? For 1994, the prospects for continued strong growth are good. At midyear, new orders for nondefense capital equipment (excluding aircraft and parts) were up nearly 23 percent over mid-1993 levels, considerably above the pace of shipments. Moreover, factories are operating at historically high rates. Since the end of 1993, the Federal Reserve Board's index of capacity utilization in manufacturing has remained above 82 percent, a sign of capacity constraints. By pressing the capacities of current plant and equipment, growth in final demand should keep the pace of investment spending from dropping much this year. Together with the relatively healthy profit margins that currently prevail, the strength in final demand is likely to overwhelm the adverse effects of rising short-term interest rates on investment plans for the remainder of 1994.

2. Computers should be considered separately from other investment in equipment because the rapid growth in real investment in computers stems as much from the decline in the price of computers as it does from increases in nominal spending. Additional investment in computers is probably worth much less to the productive capacity of the economy--and its production requires much less employment and demand for the output of other industries--than its size in the national accounts indicates.

In 1995, however, businesses are likely to purchase capital equipment at a slower rate. By then, the rapid growth of investment in the preceding years will have boosted productive capacity to a level sufficient to meet demand. With the economy growing at its potential rate, the upward climb in interest rates begun in 1994 should temper further growth in spending on equipment by raising the cost of borrowing and pressing profit margins.

Even so, investment in equipment is expected to hold at a fairly high level in 1995. Contributing to this moderate response are the strengthened balance sheets of the nonfinancial corporate sector. Since late 1990, corporations have shifted their liabilities toward equity and long-term debt, which generally imply more predictable financing costs than does short-term debt. Consequently, businesses are now apt to be less vulnerable to short-term increases in interest rates than they were in the 1980s.

Whereas spending on equipment generally follows the business cycle, business expenditures for structures appear to be governed by longer-term cycles. Throughout the boom in equipment investment in 1992 and 1993, spending on construction by businesses was sluggish. Recently, however, some signs of life have appeared. Construction of commercial space such as wholesale and retail outlets has picked up, and industrial building activity grew by more than 10 percent over the past year. Office construction continues to be weak, however. Though much lower than the astronomical peaks in the 1980s, office vacancy rates remain high enough in many areas to continue to cramp the growth of spending on office buildings. Investment in petroleum drilling also continues its secular decline, and both hospital construction and utilities construction have remained flat. Overall, investment in business structures is expected to add little to GDP growth during the forecast period, but at least it will not sap growth, as it did in the 1990-1993 period.

Inventory accumulation since the recession has been lethargic compared with past recoveries and expansions, and, although there was a spurt of inventory investment in the second quarter of this year, CBO does not expect strong inventory accumulation during the forecast. In fact, inventories have slipped relative to sales throughout this business cycle.

Inventories were reported to have jumped in the second quarter, however, prompting some concern that economic activity would slow rapidly in the second half of this year. Analysts feared that the high level of inventories at retail and wholesale outlets would result in the cancellation of orders to manufacturers and manufacturing output would therefore slow. The increase in inventories was indeed large for one quarter, but the ratio of inventory to sales is still quite low. Hence, the increase is probably not a reliable signal of a slowdown in manufacturing, and was largely the result of a temporary weakness in sales of durable goods and apparel. Even a moderate resurgence in sales of these goods will keep inventories in line.

Consumer Spending

The outlook for consumer spending continues to be healthy. Although the growth in consumer spending eased in the second quarter of this year, the slowdown can be tied to special factors that are likely to reverse themselves in the coming months. Continued gains in employment are expected to support growth in disposable personal income and hence consumer spending for the remainder of this year in spite of the recent rise in interest rates and the weakness in the stock market. The pace of consumer spending is likely to slow modestly next year, however, as higher interest rates begin to bite.

The reduction in the growth of consumer spending in the second quarter of this year is not likely to be sustained. The slower growth of spending on consumer services, food, and other nondurable goods came on the heels of strong increases in the first quarter, while the slowdown in spending on apparel may reflect its inherent volatility and problems with the seasonal adjustment of apparel prices. A dip in purchases of motor vehicles stemmed in part from the inability of manufacturers to satisfy the demand for a number of popular light vehicles. However, sales of vehicles are likely to rebound later this year as manufacturers build more vehicles to meet demand.

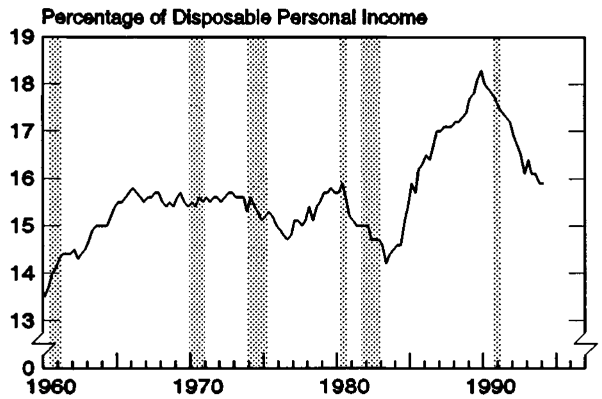
Indeed, the primary factor determining expenditures on consumption--namely, strong growth in disposable income--is expected to continue over the forecast period. In the first seven months of 1994, about 2 million jobs were created. Moreover, the average hours each employee worked per week increased in the first half of 1994, and now exceed the hours worked at the peak of the previous business cycle in 1990. Given the postwar downtrend in hours worked per week, this development is unusual and suggests that hours worked per week will not expand much more. Firms will probably hire additional workers rather than try to increase hours per worker any further. This escalation in demand for labor will bolster the growth of total compensation and wages. In the CBO forecast, real compensation per hour grows at a slightly brisker pace during 1994 and 1995 than it has in recent years.

Strong household balance sheets will also continue to support spending on consumption. Household net worth may have declined slightly in the first seven months of 1994, mainly as a result of a drop in stock and bond values. The Standard and Poor's 500, for example, dipped 3.9 percent between January and July of 1994. But that drop in stock prices is relatively small, and it is not likely to have that much impact on consumer expenditures.

Developments on the liability side of household balance sheets also support consumer spending. The repayment burden has plunged in recent years (see Figure 1-4). In the first quarter of 1994, it has stabilized, reflecting higher interest rates and strong growth in consumer installment credit. In fact, the increase in installment credit suggests that consumers are comfortable with their financial situation and confident about the growth in their future income.

The growth in consumer spending is likely to ebb next year, however. Spending on consumer durables should slow as more of the pent-up demand for durable goods is met. Moreover, strong growth in income should more than offset the effect of rising interest rates in the latter half of 1994. But higher interest rates will begin to take their toll in 1995 as the growth in disposable income flags somewhat. As a result, the increased cost of borrowing as well as interest payments on existing consumer debt will dampen household expenditures on consumption.

Figure 1-4.
The Burden of Household Debt Repayment Is Shrinking



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

NOTE: Debt repayments are shown as a percentage of disposable personal income. The latest data are for the first quarter of 1994.

Factors Currently Restraining Growth

Further fiscal tightening and net exports are expected to restrain growth in 1994. However, in 1995, the government sector should have a neutral impact on growth, while recovering economies in the rest of the world are likely to stimulate growth through an increase in the demand for U.S. exports.

Fiscal Policy

Because of the underlying near-term strength in consumption and investment, the fiscal restraint this year from the Omnibus Budget and Reconciliation Act of 1993 (OBRA-93) has not brought about much loss of output and employment. As it now appears, that restraint has instead helped to check inflationary pressures. Despite continued reductions in real federal purchases, however, fiscal policy will assume a neutral stance in 1995, which will continue throughout the projection period.

CBO estimates that under current tax and spending policies the total budget deficit will decline from $255 billion in fiscal year 1993 to $202 billion in 1994 and to $162 billion by 1995 (see Table 1-2). Thereafter, it escalates throughout the projection period, reaching $231 billion by 1999. Moreover, under current law, much heftier deficits are likely in the next century, despite all of the deficit reduction undertaken in OBRA-93.

To measure the impact of fiscal policy on short-term growth, the total deficit is usually adjusted by removing cyclical fluctuations in receipts and outlays as well as outlays for deposit insurance. A commonly used measure of fiscal policy that incorporates these adjustments is the standardized-employment deficit. It calculates what the budget deficit would be without deposit insurance if the economy were operating at potential GDP. Changes in the standardized-employment deficit from one year to the next indicate the degree of fiscal stimulus or restraint. When this deficit rises, fiscal policy is considered stimulative; when it falls, fiscal policy is restrictive.

Based on the new economic and budget estimates in this report, the standardized-employment deficit will come down from 3.4 percent of potential GDP in fiscal year 1993 to 2.7 percent in 1994 and 2.6 percent in 1995. Thus, moderate restraint in 1994 gives way to an essentially neutral policy stance in 1995. In part, this movement reflects the recent rise in interest rates, which has resulted in higher interest payments on new and refinanced federal debt. But these additional interest payments may have little impact on short-term growth. Instead of spending this additional interest, debtholders may choose to save most of it, especially if the higher interest earnings simply compensate them for expected losses in their wealth as a result of higher inflation. Excluding interest payments, the standardized-employment deficit shows about the same amount of restraint in 1994 but somewhat more in 1995--the first full year of higher interest rates in the CBO forecast.

With very little change after 1995 in the standardized-employment deficit relative to potential GDP, fiscal policy would no longer help to raise future living standards by stemming the federal

Table 1-2.
The Fiscal Policy Outlook (By fiscal year on a budget basis)

	1993	1994	1995	1996	1997	1998	1999
	In Billions of Dollars						
Total Budget Deficit	255	202	162	176	193	197	231
Standardized-employment deficit[a]	221	184	183	195	200	196	223
Cyclical deficit[b]	61	22	-3	-7	-2	6	12
Memorandum:							
Deposit Insurance	-28	-5	-17	-12	-5	-5	-4
Net Interest	199	202	226	245	253	264	277
	As a Percentage of Potential GDP						
Total Budget Deficit	3.9	3.0	2.3	2.4	2.5	2.4	2.7
Standardized-employment deficit[a]	3.4	2.7	2.6	2.6	2.6	2.4	2.6
Cyclical deficit[b]	1.0	0.3	0	-0.1	0	0.1	0.1

SOURCE: Congressional Budget Office.

a. Excludes cyclical fluctuations and outlays for deposit insurance.

b. A negative value in this line indicates a surplus.

drain on national saving. Although making further deficit reductions would change this pattern in future years, the longer such decisions are postponed, the more difficult they will be to make. CBO's projection does not explicitly include another recession, but the chance that one will occur before the end of the decade is significant. When it does hit, many policymakers will want to avoid exacerbating an economic downturn, thereby thwarting any attempts to reduce the federal deficit. If only for this reason, it would be much easier to reduce deficits now rather than later.

Pending legislation to reform the health care system will probably have little effect on the size of the federal deficit, although it could significantly alter the composition of receipts and outlays. It is also unlikely to change private saving very much. Most proposals, however, would involve a redistribution of health care costs among different groups of employers and employees, and thus could alter their hiring practices and employment decisions.[3] The extent of these distortions will depend on what specific provisions are ultimately enacted, but uncertainty about this outcome could be affecting employment decisions now.

State and Local Budgets

Although state and local governments are not expected to add much to the overall economy in the next two years, neither are they expected to restrain it, as they have in recent years. Actually, state and local governments are in their best fiscal position since the start of the recession in 1990.

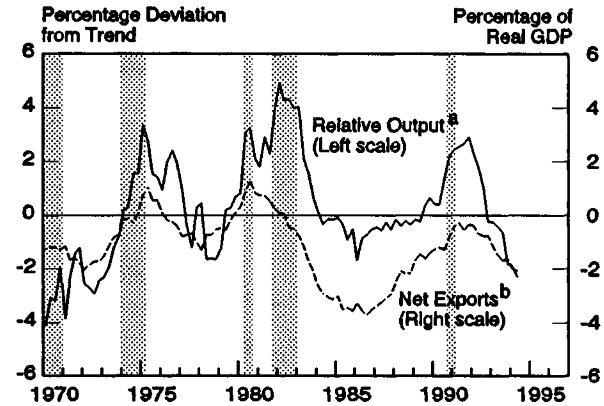
Over the past few years, states have been more conservative in their revenue estimates and have restructured many of their programs to promote efficiency. As a result, 1994 revenue collections matched or exceeded projections in almost all of the states, and fewer states are having to make midyear

3. See Congressional Budget Office, *An Analysis of the Administration's Health Proposal* (February 1994), and *An Analysis of the Managed Competition Act* (April 1994).

budget adjustments. Many states are actually considering reducing taxes, especially for lower-income families. Taxes targeted for reduction include the sales tax, personal income tax, and corporate income tax in an effort to attract businesses. However, taxes on cigarettes, motor fuels, and alcohol are still climbing.

Although that picture offers a rosier outlook than states have had for the past several years, it is not without potential pitfalls. Increasing costs of grants-in-aid programs such as Medicaid, federal mandates such as the Safe Drinking Water Act, and the uncertain future of health care reform have the potential to darken this outlook. In addition, the modest overall growth in state expenditures masks the shifts that are occurring within state budgets. All major state functions except Medicaid and criminal justice declined as a percentage of state budgets from 1987 to 1993. Although the rate of growth of Medicaid spending slowed recently, the growth in Medicaid costs is still exceeding the rate of inflation. Spending on corrections is also growing, in part because many states are under court orders to relieve overcrowding and improve prison conditions.

Figure 1-5.
Net Exports Move According to World and U.S. Output



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

NOTE: U.S. real net exports rise when the rest of the world's real GDP rises relative to U.S. real GDP.

a. Relative output is the ratio of the rest of the world's real GDP, measured by a 28-country trade-weighted index, to real U.S. GDP. Data are shown with a nonlinear trend removed.

b. Real net exports as a percentage of real GDP.

Net Exports

The U.S. trade deficit is expected to widen through 1994, but then begin to improve in early 1995. That change in trade performance reflects the different patterns of economic recovery in the major industrial countries. The U.S. economy, which was one of the first to experience recession, recovered earlier and is now growing more quickly than most of its major trading partners. This faster growth in the United States has produced correspondingly strong growth in spending on imports by U.S. businesses and consumers. Consequently, the growth in imports has exceeded that of exports, so it is not surprising that the trade balance has deteriorated since the U.S. recovery began (see Figure 1-5).

As the recoveries in the major trading partners of the United States take hold in 1995 and the developing countries continue to expand, the growth in U.S. exports is expected to outpace that of imports. In the CBO forecast, the world GDP index of 28 countries, in which the GDPs are weighted by each country's share of U.S. nonagricultural exports, is expected to grow more slowly than GDP in the United States in 1994, but to overtake it in 1995.

Two of the United States' major trading partners, Germany and Japan, have endured painfully slow recoveries but are now showing signs of improvement. In Germany, the first major drop in unemployment since late 1991 was posted in June of this year. Although the recent rise in long-term interest rates, slow wage growth, and a restrictive fiscal policy are expected to weaken domestic demand in 1994, personal spending on consumption is likely to revive as the labor market stabilizes. As a result, the saving rate could fall. According to a survey of private forecasters, growth in output is expected to register about 1.8 percent in 1994 (compared with a decline of 1.2 percent in 1993) and 2.6 percent in 1995.[4]

4. See Consensus Economics, Inc., *Consensus Forecasts* (July 11, 1994).

Although the Japanese economy remains weak, signs of recovery were evident in the first half of 1994. In Japan's private sector, consumer spending has recently revived, and some gains in industrial production were reported in the first half of 1994. Excess capacity and falling prices, however, still plague the Japanese economy. Consequently, according to the survey of forecasters, growth in output will slightly improve from 0.1 percent in 1993 to 0.7 percent in 1994. In 1995, spending on consumption and an upturn in corporate investment are expected to increase GDP growth to 1.9 percent.

Canada, Latin America, and the newly industrialized countries of Asia, which together accounted for approximately 50 percent of U.S. export demand last year, should enjoy slightly faster growth in 1994 and 1995, and strengthen export growth in the United States. According to the survey of forecasters, the Latin American countries are expected to grow at an average of 3.2 percent over the forecast period, while the newly industrialized countries of Hong Kong, South Korea, Singapore, and Taiwan will continue to expand rapidly at nearly 7 percent over 1994 and 1995. At the same time Canada, the United States' major trading partner, is expected to grow at an average of 3.6 percent in 1994 and 1995.

A Neutral Factor: Residential Construction

Residential construction bolstered growth in demand over the last four quarters, but it is likely to wane during the second half of this year and remain pallid during 1995. The weak underlying demographics of housing demand during the 1990s, which tend to put a ceiling on housing starts, and the rise in mortgage rates are the main reasons to expect slower growth. The CBO forecast assumes that housing starts will be about the same on average over the next year and a half as last quarter's rate of 1.44 million units.

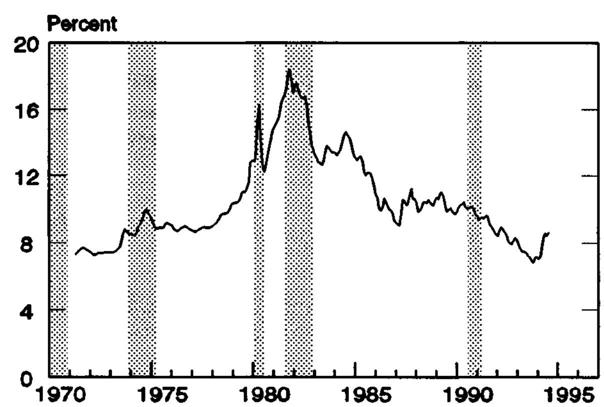
Although many analysts believe that the growth of residential construction will ebb, some forecasters have argued that residential investment will continue to contribute to GDP growth. These analysts argue that demographic projections are highly uncertain and may not form a good basis for forecasts of housing. They also note that the decline in home ownership rates over the 1980s for many groups may imply a pent-up demand for nonrental units.

Interest Rates and Affordability

The rise in interest rates during the first half of this year will dampen residential investment, but the higher rates are unlikely to reduce activity severely. Conventional mortgage interest rates have climbed from 7.1 percent in January to 8.6 percent for July, bringing rates back to mid-1992 levels. They are still, however, below those of the 1980s, and about equal to the average for the mid-1970s (see Figure 1-6). In addition, the availability of adjustable-rate mortgages provides home buyers with an opportunity to soften the effects of the increase in fixed-rate mortgages. The wide disparity between short-term adjustable-rate mortgages and long-term mortgages has recently encouraged a resurgence of adjustable-rate financing.

Housing affordability declined recently, reflecting the increase in interest rates, but it still remains high (see Figure 1-7). The affordability index compares median family income with the income re-

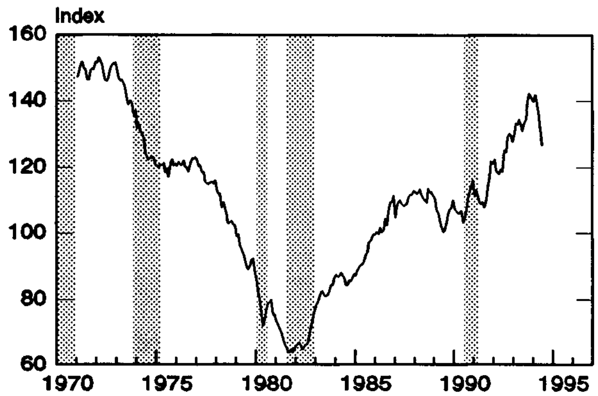
Figure 1-6.
Mortgage Rates Have Turned Up



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Contract interest rates on commitments for fixed-rate mortgages. Based on monthly data through July 1994.

Figure 1-7.
Housing Is Still Affordable



SOURCES: Congressional Budget Office; National Association of Realtors.

NOTE: Monthly data are shown through June 1994. The index equals 100 when median family income is just sufficient to qualify a family to purchase a median-priced home.

quired to purchase a home of median price. Affordability jumped sharply in the years since the 1990 recession, and, although the recent drop is significant, affordability is still at high levels relative to the last 15 years. Currently, according to the index, the median family income is about 30 percent higher than necessary to qualify for the purchase of a typical home.

Expectations of future changes in housing prices, one of the important factors influencing the decision to buy a home, are not reflected in the affordability index. If potential buyers anticipate rapid appreciation in home values, they are more willing to buy, even when mortgage rates are high. This inclination was an important stimulant to demand in the late 1970s when housing prices were appreciating rapidly. Since inflation in housing prices has been much more moderate recently, buyers are currently unlikely to see generous increases in housing values. Therefore, even though affordability is better now than in the late 1970s, the financial incentives to buy a house may not be as positive as the affordability index indicates.

Demographics

The underlying demographics imply general weakness in housing throughout the 1990s. Generally slower growth in household formation and the changes in the age distribution of the population indicate that the demographic impetus to housing construction that was so strong in the 1970s and 1980s will progressively weaken through this decade. The number of households, rather than population, is the main factor determining the need for housing units. The Census Bureau reports that population growth for the 1990s is likely to be about the same as it was between 1965 and 1985, but net household formation will probably be much slower.

The changing age distribution of households implies that the recent weakness in rental markets and first-time home buying will continue. The number of households headed by a person age 25 to 34 is declining, and this group constitutes the rental and "starter" home market. Some of the weakness in rental markets may be offset by the rapid growth in households headed by a person over 45 years old, but the net effect of these demographic shifts on rental markets is likely to be negative.

These demographic trends may, however, understate future demand for housing. Unpredictable changes in household formation, changes in employment and income growth that affect the decision to rent or buy, and a possible pent-up demand for owner-occupied housing may offset the general demographic pressures. The dip in home ownership rates between 1980 and 1992 raises the possibility of pent-up demand for owner-occupied housing. Although the decline in the overall home ownership rate was not large--it fell from 65.6 percent in 1980 to 64.1 percent in 1992--households in which the head of household was 44 years old or younger (particularly those that have children) experienced much sharper declines in home ownership rates, about 8 percentage points. The current relatively high level of affordability of single-family housing may permit home ownership rates for these groups to increase.