Chapter One

The Economic Outlook

The U.S. economy has settled into a self-sustaining expansion, while many other major economies remain mired in slow growth. The weakness of the world outlook affects the domestic economy in two ways: it holds down the opportunities for U.S. exports, but it also helps to put off the point at which inflation, now well under control, might begin to pick up. The Congressional Budget Office (CBO) expects that domestic demand, especially business investment, will keep the economy growing moderately for the next two years, despite the drag from a mildly restrictive fiscal policy and a drop in net exports. Although restructuring continues among some large corporations, the business sector is behaving much as it usually does at this point in the business cycle, with fixed investment growing at a healthy pace.

Monetary policy has kept short-term interest rates low for a couple of years, but despite the recent good news on inflation, rates are likely to begin to rise soon. In the next few years, the growth of the U.S. economy, together with recovery in economies elsewhere, will begin to increase the pressure on prices. With growth no longer in question, the Federal Reserve will probably head off any possibility of rising inflation by allowing short-term interest rates to rise somewhat.

As is typically the case, several factors make this outlook for moderate growth uncertain: the pace of economic activity among the major trading partners of the United States, the course of monetary policy over the next few years, and the saving behavior of households. In addition, just how much more room the economy has to expand without putting undue pressure on inflation is unclear.

CBO's Economic Forecast for 1994 and 1995

CBO forecasts that real gross domestic product (GDP) will grow at an annual rate of nearly 3 percent during the four quarters of this year and will maintain that rate through 1995 (see Table 1-1 and Figure 1-1). The unemployment rate will fall over the next two years as more jobs are created, but it will fall slowly because more individuals will decide to look actively for work as job opportunities expand.

The mild pace of the expansion will keep inflation and interest rates relatively low, although they will begin to climb slowly as the expansion continues. CBO expects that inflation will hover around 3 percent over the next few years. However, short-term rates are expected to rise throughout 1994 and 1995, with smaller upward movements appearing in long-term rates.

The probable actions of governments, businesses, households, foreign economies, and the Federal Reserve play a key role in determining CBO's forecast. The behavior of federal, state, and local governments will act as a mild restraint on economic growth. Most of this restraint will come from the federal government: the Omnibus Budget Reconciliation Act of 1993 (OBRA-93) imposed higher taxes on high-income individuals and slowed the growth of federal expenditures on top of defense downsizing already in place. The fiscal stance of state and local governments will be approximately neutral, as many of the budgetary pressures of the last few years have eased.

Driven by the need to innovate to increase competitiveness further and helped by a generally good environment for financing new investment, businesses will continue to invest in plant and equipment at a healthy rate. In addition, growing demand for U.S. goods and services increases the likelihood that business will expand and employment will pick up.

After the slow and uncertain first quarter of 1993, households spent more freely during the remainder of the year. As the expansion continues, consumption should grow at a more steady, though not spectacular, rate. Activity in the housing market should be solid, but it is not expected to provide a big boost to national income after the first quarter of 1994.

Slower growth among its trading partners than in the United States signals a significant decrease in net exports. On balance, the foreign appetite for U.S. goods will be less hearty than the American appetite for imports.

As economic growth progressively reduces the amount of excess capacity, the Federal Reserve will probably allow short-term interest rates to rise. Somewhat higher interest rates should not stifle economic activity but merely moderate the momentum of the economy enough to forestall pressures on prices and wages.

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

	Actual	Estimated	Forecast	
	1992	1993	1994	1995
	Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP	6.7	4.9	5.7	5.4
Real GDP[a]	3.9	2.3	2.8	2.7
Implicit GDP Deflator	2.8	2.5	2.8	2.6
Consumer Price Index[b]	3.1	2.7	2.9	3.0
	Calendar Year Averages (Percent)			
Real GDP Growth[a]	2.6	2.8	2.9	2.7
Civilian Unemployment Rate[c]	7.4	6.8	6.4	6.1
Three-Month Treasury Bill Rate	3.4	3.0	3.5	4.3
Ten-Year Treasury Note Rate	7.0	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. Based on constant 1987 dollars.

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

c. Unemployment rate based on 1993 methodology; published rates are likely to be higher (see Box 1-1).

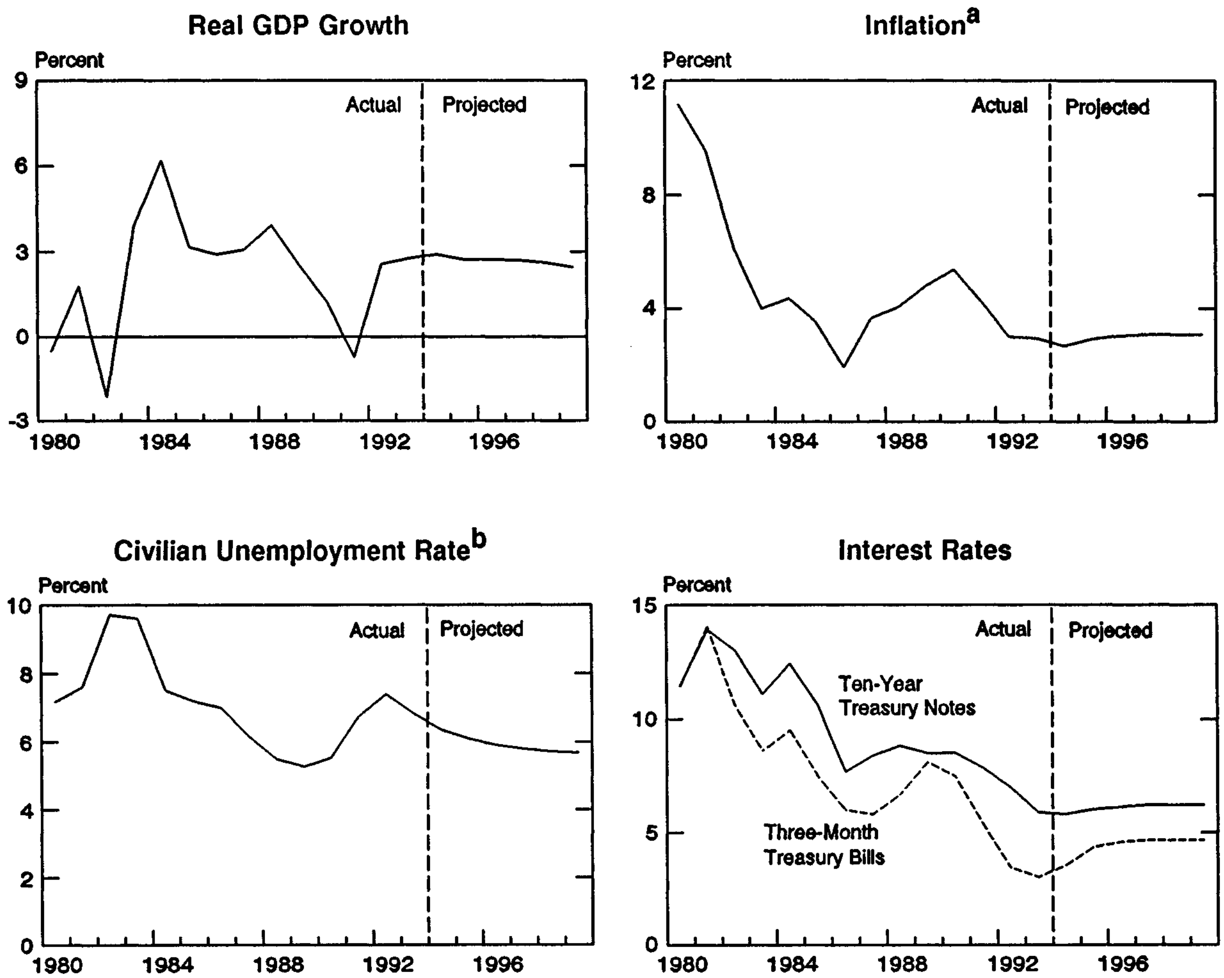
Federal, State, and Local Governments: Fiscal Stance Will Restrain Growth Slightly

Following a neutral stance in 1993, fiscal policy will be moderately restrictive in 1994 and remain so in 1995. This outlook reflects only currently enacted policies and does not incorporate the possible impact of policies, such as health care reform, that the Congress may enact in the future.

Deficit Reduction Will Dampen Growth Somewhat in 1994 and 1995

The passage last summer of the Omnibus Budget Reconciliation Act of 1993 significantly changed the course of fiscal policy. Largely as a result of the

Figure 1-1.
The Economic Forecast and Projection



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. Calculated using the 1993 methodology; published rates are likely to be higher (see Box 1-1).

fiscal tightening contained in that act, the deficit excluding deposit insurance will decline from $283 billion in 1993 to $228 billion in 1994 and $182 billion in 1995. After that, it should remain fairly stable through 1998. That deficit will jump to $208 billion in 1999, however, when the current caps on discretionary spending expire. Of course, the possibility of further deficit reduction at some point is very real, since the Congress is well aware of the future jump in the projected deficit.

In the short run, the fiscal restraint of OBRA-93 will tend to depress economic activity and lower the average growth of output somewhat. Over the long run, however, lower deficits will lead to a higher level of GDP than otherwise would have occurred. Smaller deficits will raise the national saving rate, permit more investment, and eventually result in a higher level of output.

CBO measures the stimulus or restraint that the budget provides the economy by the year-to-year changes in the standardized-employment deficit relative to potential GDP. The standardized-employment deficit differs from the actual deficit by removing the outlays for deposit insurance and the cyclical effects of the economy on the budget. Potential GDP is an estimate of the highest level of output that can be produced with available resources of capital and labor without increasing the rate of inflation.

In the CBO forecast, the standardized-employment deficit drops substantially--by 0.7 percent of potential GDP--from 1993 to 1994, followed by a slightly smaller decline of 0.6 percent in 1995 (see Table 1-2 and Figure 1-2). Tax increases embodied in OBRA-93 are responsible for most of the fiscal restraint. Two new income tax brackets of 36 percent and 39.6 percent were imposed on high-income people, effective in January 1993. In addition, individuals will have to pay the Hospital Insurance (HI) tax on all earnings in 1994, rather than only on the first $141,900 of earnings. Some recipients of Social Security will pay income tax on a larger share of their benefits in 1994. Not least, the federal tax on transportation fuels was raised.

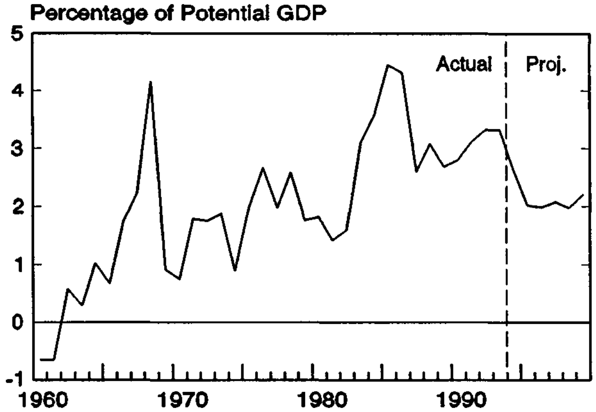
Table 1-2.
The Fiscal Policy Outlook (By fiscal year, on a budget basis)

	1993	1994	1995	1996	1997	1998	1999
			In Billions of Dollars				
Deficit Excluding Deposit Insurance	283	228	182	180	189	184	208
Standardized-employment deficit	215	179	144	149	164	164	191
Cyclical deficit	68	48	38	31	25	20	17
Memorandum:							
Deposit Insurance	-28	-5	-11	-14	-6	-4	-4
			As a Percentage of Potential GDP				
Deficit Excluding Deposit Insurance	4.4	3.4	2.6	2.4	2.4	2.2	2.4
Standardized-employment deficit							
Level	3.3	2.7	2.0	2.0	2.1	2.0	2.2
Change[a]	0	-0.7	-0.6	0	0.1	-0.1	0.2
Cyclical deficit	1.0	0.7	0.5	0.4	0.3	0.2	0.2

SOURCE: Congressional Budget Office.

a. A negative value in this line indicates restraint.

Figure 1-2.
Standardized-Employment Deficit
(By fiscal year)



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

However, this pattern in the standardized-employment deficit may overstate fiscal restraint in 1994 and 1995. One reason is that the increase in income tax rates may partly reduce saving initially rather than spending. If this occurs, short-term effects on economic activity will be smaller, as will the long-term benefits of deficit reduction. Another reason is that some of the fiscal impact of tax increases that were enacted last year took place in 1993, even though most of the tax liabilities incurred in 1993 do not begin to show up as revenues until fiscal year 1994. The biggest tax increase falls on high-income earners who are likely to have reduced consumption in 1993 in response to higher tax rates, even though their payments had not yet risen. Finally, the restraint in 1995 partly reflects approximately \$5 billion in one-time receipts from spectrum auctions that should not depress output or incomes; they reflect investment by the private sector.[1] If these factors are taken into account, the actual amount of fiscal restraint would be at most 0.5 percent in 1994 and 0.4 percent in 1995.

1. The Federal Communications Commission will auction licenses for commercial use of a portion of the electromagnetic spectrum previously reserved for the government.

During the 1996-1998 period, the overall stance of fiscal policy is essentially neutral. One of the reasons is that OBRA-93 imposes caps on discretionary spending for the 1996-1998 period that will restrain spending. When the caps expire in 1999, the ratio of federal debt to GDP will begin to rise again unless further deficit reduction is enacted.

Uncertainties Surround Health Care Reform

If adopted, the Administration's health care proposal would have far-reaching economic effects and could have significant budgetary effects (discussed in CBO's forthcoming February 1994 analysis). The Administration's health care proposal is not part of CBO's current policy assumptions, but uncertainty surrounding the outcome of this debate could have some adverse effects on short-term economic growth.

The proposal has three major elements: it would provide coverage for people who are currently uninsured while requiring them and their employers to pay for some of their coverage; it would provide federal subsidies to low-income people; and it would change the way most Americans purchase their health insurance. This last change, which has been the subject of intense public interest, attempts to even out the cost of health insurance to different firms and workers and also to reduce its overall cost. These goals are to be achieved through new institutions--regional "health alliances"--that would operate much like heavily regulated purchasing cooperatives for health insurance.

Even now, uncertainties about the Administration's plan and alternative proposals may be affecting employers' behavior. If the plan passes, some employers will find that the cost of the health insurance they provide their employees will go down; for others, it may rise, and those who do not currently offer health insurance will have to start paying for it. Many employers, particularly in smaller firms, are uncertain about how the plan will affect them, and this uncertainty could discourage some of them from increasing the number of their workers, or giving pay raises, until the situation becomes clearer. How much this uncertainty is holding down current increases in employment, however, is impossible to say.

The Fiscal Stance of State and Local Governments Is Likely to Be Neutral

In contrast to recent years, the tax and spending policies of state and local governments are not likely to have a major effect on the growth of overall economic activity. The demand for many of the services state and local governments provide--such as education, health care, public safety, and investment in infrastructure--continues to grow, but real overall spending will expand at about the same rate as GDP. Tax policy will be less restrictive than it has been in recent years. The economic expansion and low interest rates have helped to stabilize the financial situations of most state and local governments. Consequently, few states have planned tax increases for 1994.

Two exceptions to the generally neutral fiscal stance of state and local governments are the states of California and New Jersey. California was hit especially hard by declines in defense spending and civilian aerospace orders together with a collapse in construction. Its general fund may have a deficit of about $1 billion in this fiscal year, and it is projected to have a deficit of $1.3 billion next year. New Jersey faces the possibility of a $1 billion shortfall in its general fund for the fiscal year that begins July 1. The possibility of fiscal tightening in these states, however, does not change the overall outlook.

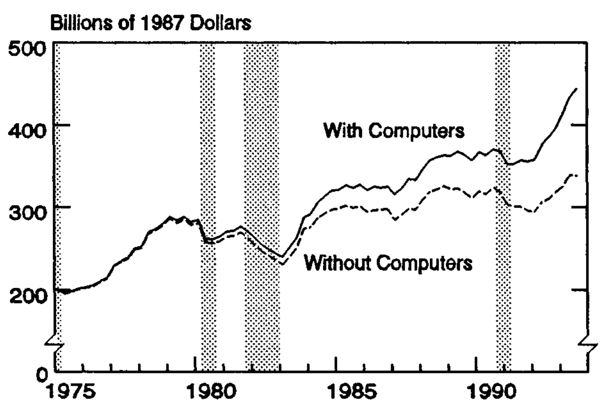
The Business Sector: Investment Will Continue to Be Strong

Even though the pace will be slow relative to that of last year, CBO expects that investment in plant and equipment will be the major engine of growth for the next few years. Investment will be stimulated by continued restructuring, the need to innovate in production, possible pressures on capacity, and easier financing.

Spending on equipment will rise rapidly over the next few years. This spending grew 14 percent in real terms in the past year, and even if it slows somewhat, it will still be the fastest-growing component of output (see Figure 1-3). Its importance to the growth of the rest of the economy is, however, somewhat less than this rate of increase indicates. In recent years, the huge growth in computer purchases has dominated real spending on equipment, the reason being that the price of computers has declined at an astonishing pace while nominal spending has changed much less. 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 appears to indicate. But the recent growth of spending on plant and equipment goes beyond what occurred in the computer sector: noncomputer spending also grew strongly (8 percent) over the past year and is set to continue at a healthy pace in the coming year.

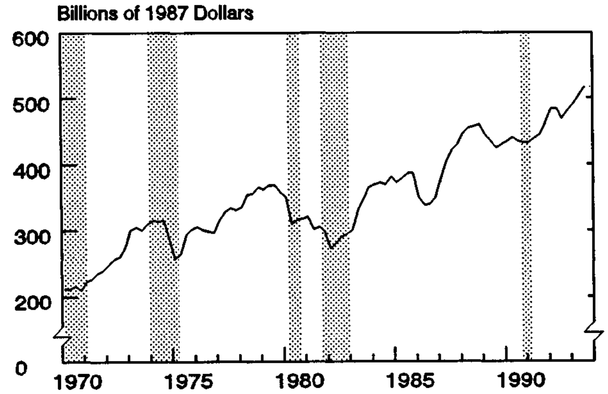
Many businesspeople have cited continued restructuring together with competitive pressures as a cause of strong investment in 1993 and 1994. Firms are reorganizing and trying to make their production methods more innovative to maintain or regain their competitive edge against foreign as well as domestic producers. As evidenced by the auto sector, such measures often pay off in increased profits and market share.

Figure 1-3.
Investment in Producers' Durable Equipment



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

Figure 1-4.
Real Net Corporate Cash Flow



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

NOTE: Real net corporate cash flow is net corporate cash flow divided by the implicit deflator for nonresidential fixed investment.

Commercial vacancy rates remain high enough in many areas to restrain the growth of spending on nonresidential structures. Nevertheless, the huge drop in recent years in commercial construction--a major part of nonresidential construction--has halted, and a slow recovery may be under way. Between 1988 and 1992, the real value of commercial construction dropped over 40 percent--from $69 billion to $41 billion. Construction then remained steady through the fall of last year and currently shows some signs of picking up.

Pressures on the capacity of current plant and equipment could encourage investment in the industrial sector. Capacity utilization rose to about 83 percent in the last quarter of 1993, its highest level since the summer of 1990. If capacity utilization continues to rise, additional investment in industrial structures as well as equipment will occur.

A generally good environment for financing and carrying out investment will also support business fixed investment over the next few years. Low rates of interest in recent years have brought down the nominal cost of borrowing, and strong stock markets have lowered the cost of capital raised in the stock market. In addition, banks are more willing to lend. Banks are generally in a good position to provide credit to business. They have rebuilt their capital bases, and the yields on Treasury securities--an alternative to business loans--are so low as to be less appealing than they have been recently. Further, many firms now find themselves with substantial profits and retained earnings and can finance investments through their cash flows rather than by borrowing (see Figure 1-4). As a result of all these factors, firms will find that financing investments is easier in 1994 and 1995 than has been the case over the past several years.

Households: Expenditures Should Be Buoyant

After a shaky start at the beginning of the recovery, spending by households is now more solid. Consumer outlays rose about 4 percent during the last half of 1993, after adjustment for inflation, with much of the strength coming in durable goods. Renewed strength in housing has led to increased sales of goods ranging from building materials to furniture and home appliances. A surge in spending for home computers and for services such as movies has occurred as well.

The strengthening financial position of households is likely to bolster consumption spending over the next few years, but growth in the housing sector will weaken nonetheless. Consumption will be buoyed by continued growth in real disposable income, low interest rates, and little change in saving propensities in the near term. However, further substantial gains in housing are unlikely, given the slow rate of household formation.

Real Disposable Income Will Increase Further

Despite large layoffs from corporate restructuring, the economy created about 2 million jobs on net during 1993. CBO expects that slightly more will be created during 1994. The hours each employee worked increased last year, and by the last quarter, the average number of hours worked per week was equal to the level at the peak of the last business cycle in early 1990. Given the postwar downtrend in hours worked per week, this is an unusual development and suggests that output will not be expanded much more by this means. Consequently, firms are likely to hire additional workers during 1994 instead of further boosting the length of the workweek. These job gains will help to bring down the rate of unemployment. (See Box 1-1 for a discussion of revisions in measuring the rate of unemployment.)

In addition to expected job growth, rising wages will continue to boost income in the current economic expansion. Total compensation adjusted for inflation grew about 2 percent in both 1992 and 1993, or about 5 percent in nominal terms, and CBO expects slightly larger gains over the next two years. Wages and salaries, excluding contributions for pensions, health insurance, Social Security, and the like, increased almost 4 percent in 1993 but should grow almost 7 percent in 1994. Contrary to popular perception, hourly earnings have grown in real terms in recent years, though at a slower rate than in the 1950s and 1960s (see Appendix F).

Higher Taxes May Reduce Consumption Slightly. OBRA-93 contained several provisions that raise taxes for particular groups of consumers--high-income people face higher marginal income tax rates plus the HI tax on all earnings, and some recipients of Social Security will pay taxes on a higher percentage of their benefits. These higher taxes will reduce the disposable income of some individuals and will result in less consumption, less saving, or both. Although people with high incomes are generally thought to be forward-looking and therefore may have already planned ahead for higher marginal tax rates on income and for the HI tax to be imposed on all earnings in 1994, other groups of consumers may find that they must cut back on consumption in order to make ends meet. Some recipients of Social Security with more modest incomes may cut their spending as well to cover the increased tax bite out of Social Security benefits.

The Recent Decline in Interest Rates Will Support a Modest Increase in Consumption. The recent decline in interest rates has affected consumer spending in two ways. First, lower interest rates imply a decline in the cost of borrowing on new purchases. The kick from the lower cost of borrowing is unlikely to be large, however, for two reasons. Research shows that the link between borrowing costs and purchases of durable goods is not strong. And the real interest rate on borrowing for consumer durables, after adjustment for tax deductibility, is not low now compared with that of the 1980s, in part because interest on consumer debt is no longer tax-deductible.

Second, lower interest rates reduce the required interest payments on existing debts. Lower interest rates together with reduced indebtedness have decreased household interest payments by roughly 2 percent of disposable income during the past two years. This extra cash should encourage consumer spending.

Although household interest income also falls with interest rates, largely offsetting the decline in debt-service payments, lower interest rates probably do increase consumer spending a little. Households that borrow money and benefit from lower interest rates tend to spend a higher proportion of their extra disposable income than do households that lend money and are hurt by lower interest rates.

The Personal Saving Rate Will Stay Low in the Near Term but Is Likely to Rise Slowly over Time. The personal saving rate dipped to 3.7 percent in the third quarter of 1993, and this rate will probably stay low in 1994 before turning up. Part of the recent decline can be attributed to pent-up demand for durable goods, particularly autos, which has caused spending to rise faster than income. Gains in stocks and bonds over the past few years may explain some of the decline in the saving rate as well. Of course, considerable uncertainty surrounds recent estimates of the personal saving rate, and revisions to the data often result in raising the rate. The saving rate has been revised upward in 11 of the past 15 years, by an average of 1.2 percentage points, though many of the revisions in recent years have been downward.

A couple of fundamental factors point to a gradual rise in the saving rate over the next few years. These fundamentals include the ratio of wealth to income, which is relatively low, and the demographic makeup of the population. As the baby boomers approach the age when adults typically begin to save for the college expenses of their

Box 1-1.
Revisions in the Measure of Unemployment

On February 4 of this year, the Bureau of Labor Statistics (BLS) will report new and more accurate measures of unemployment and other labor market indicators from the redesigned Current Population Survey (CPS). The reported unemployment rate will probably be higher under the new procedures than it would have been under the old, perhaps by nearly half a percentage point. The redesign of the CPS will affect estimates of many other labor market measures, including duration of unemployment, reasons for unemployment, part-time work for economic reasons, weekly earnings, hours of work, size of the labor force, and number of "discouraged" workers. During the early part of 1994, estimates from the household survey will be less reliable indicators of trends in labor markets. BLS suggests that analysts should focus more attention on other measures, such as payroll employment, for comparisons between 1993 and 1994.

This CBO forecast, prepared in late 1993, does not incorporate the new measures. Instead, CBO uses the relationships and trends revealed in past data to predict the unemployment rate according to the old measure. In future reports, the new measure of unemployment will be used.

The primary aim of redesigning the CPS is to improve the accuracy and quality of the data, given that large changes have occurred in society and the economy since the last major revision in 1967. The wording, ordering, and number of questions have been altered to improve the respondent's understanding, recall, and response. The interview process has also been computerized, ensuring that questions are asked correctly and transmission errors minimized. In a few cases, most notably that of discouraged workers, concepts have been clarified and redefined.

A parallel 18-month survey using the new methods indicates some of the possible implications of shifting to the new survey methods, but it can provide no more than pointers. The estimates from the parallel survey are variable--the sample is only one-fifth the size of the sample for the CPS itself--and the difference between the CPS measure and the new estimate based on the parallel survey has fluctuated between 0.1 and 1.0 percentage points since September 1992.

The change in the measures also creates various technical difficulties in producing estimates from the survey data. Seasonal adjustment will be performed using the seasonal pattern from the old series, which may not be fully appropriate. The estimates will also be more uncertain than usual in January because a procedure called "composite estimation" that is designed to smooth the series cannot be used without truly comparable data from the previous month.

Despite the many reasons for caution, the parallel survey offers tentative guidance as to how important estimates may change with the new methods. Most significantly, the unemployment rate could be raised by nearly half a percentage point. That figure was the average difference between the old CPS unemployment rate and the new measure in the parallel survey over the 12 months from September 1992 through August 1993. When the January numbers are released, BLS will report the annual average differences over calendar year 1993.

However, even if the new reported rate of unemployment is half a percentage point or 1 percentage point greater than the old measure would have been, it will not represent a weakening of labor markets.

The main reason that has been advanced to explain the increase in the measured unemployment rate revealed by the parallel survey is that the old survey undercounted the participation of women in the labor market (and, to a lesser extent, that of teens and people over age 65) by a substantial and statistically significant amount. The undercount stems in part from a serious bias in the initial question in the survey. The first question often posed to women about their activities in the previous week was whether they were "keeping house or something else." Women who answered that they were keeping house, but who also worked outside the home or were also looking for work, could be wrongly classified as out of the labor force. Such biases are expected to be removed from the survey with the change to the new methods.

In February, BLS will provide estimates of what the unemployment rate under the new method would have been during 1992 and 1993, and what the rate would have been for January under the old method. Later this year, BLS will also try to assist users by providing a version of the old series that is calculated using a three-month moving average.

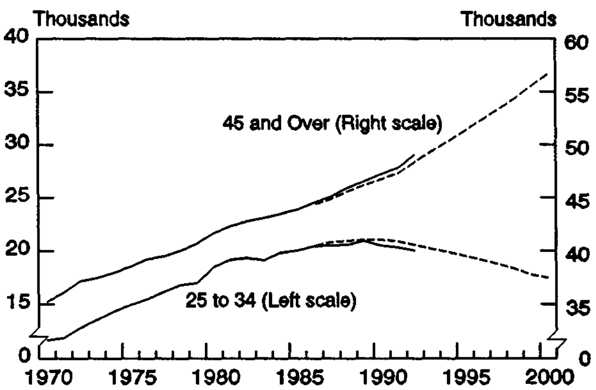
children and for their own retirement, the saving rate may rise gradually.

Housing Has Recovered, but Further Gains Are Uncertain

The general pattern of real investment in residential property during this recovery has not been radically different than in the past, though growth in multifamily housing has been particularly weak. Demographic factors do not augur well for a strong housing sector in the next few years, but increases in the average value of new homes and in home improvements could lead to solid gains in residential investment. Lower interest rates will also offset some of the gloomy demographic outlook.

In general, a decrease in the number of households headed by young adults together with a surplus of apartment buildings built in the mid-1980s--construction that was stimulated in part by changes in the tax code in 1982--indicate that investment in multifamily housing will continue to decline. The number of households headed by people ages 25 to 34 will shrink by about 17 percent from 1990 to 2000 (see Figure 1-5). At the same time, growth in the number of households headed by people over age 45 will continue at a more rapid pace than in the 1980s. As a result, the net new demand for multifamily units will come not, as in the past, from households headed by young people but from older households. Many of these older households may be headed by divorced individuals who are relatively well off and want different kinds of apartments than the typical resident of multifamily housing in the 1980s.

Figure 1-5.
Number of Households Headed by People Ages 25 to 34 and Ages 45 and Over

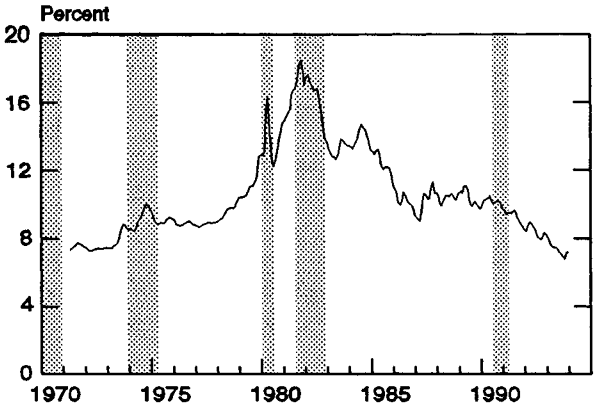


SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: Solid lines are actual; dashed lines are projections.

The Census projections were made in 1986. The last actual data point is 1992.

Figure 1-6.
Interest Rate on Conventional Mortgages

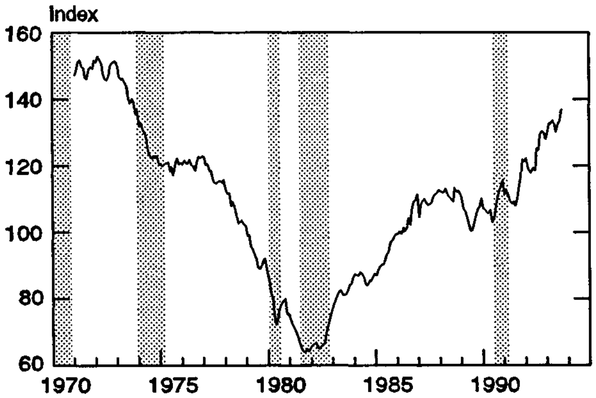


SOURCES: Congressional Budget Office; Federal Reserve Board.

The demographic trends also imply that investment in single-family homes for middle-aged people will be vibrant, even as the market for starter homes weakens. The number of households headed by people ages 45 to 54 will grow rapidly during the 1990s, as the baby-boom generation ages, and these households will probably demand homes with more amenities. Therefore, even if the number of single-family housing starts does not rise, an increase in the average value of new homes built and an increase in additions and alterations to existing homes are likely to support residential investment.

Lower interest rates have offset some of the dampening effect of demographics in recent months and may continue to boost home sales and housing starts during early 1994. Interest rates for conventional, fixed-rate mortgages have reached levels not seen since the early 1970s (see Figure 1-6). The affordability index compares median family income

Figure 1-7.
Housing Affordability Index



SOURCES: Congressional Budget Office; National Association of Realtors.

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

with the income required to purchase a house of median price, and it too has returned to levels not reached since the early 1970s (see Figure 1-7). In October 1993, the median family income was about 30 percent higher than was necessary to purchase the median-priced house, assuming 80 percent financing and a monthly mortgage payment that cannot exceed 25 percent of total income.

Foreign Economies: Slow Growth Implies Lower U.S. Net Exports

The outlook for U.S. net exports is expected to darken over the next year. Foreign economies are likely to grow more slowly than the United States, while demand for foreign goods by U.S. businesses and consumers remains strong. Although foreign growth in 1994 is expected to improve slightly from that of 1993, the trade deficit is expected to widen, depressing economic growth. Exports will rise as a share of U.S. output, but not as fast as imports are rising.

Painfully slow recoveries in two of the United States' major trading partners, Japan and Germany, help to explain the relatively weak export picture. In Japan, the economy registered almost zero growth in 1993, and forecasters anticipate less than 1 percent growth this year. As of late 1993, industrial production was continuing the decline that began in early 1992, and it still shows no signs of recovery. Labor market indicators also continued to weaken. The ratio of job offers to applicants fell during 1993, and the unemployment rate, which rose from 2.2 percent in 1992 to approximately 2.5 percent in 1993, is forecast to increase further this year. Japan's recovery is likely to be delayed by structural factors similar to those that hampered the recent recovery in the United States. Corporations have significant overcapacity, reducing the need for capital spending, and Japanese firms are also undergoing restructuring. Japan's financial system is saddled with many bad loans, and real estate prices continue to weaken. Income tax cuts amounting to about 1.5 percent of GNP are being considered, but political problems have delayed passage of the cuts, which now appear unlikely to be implemented until mid-1994.

Because of structural problems in the labor market, tight fiscal and monetary policy, and sagging private consumption, economic activity in Germany in 1994 is also expected to be sluggish. The rate of unemployment in Germany for 1993 approached 10 percent, yet wages continued to rise and profits fell. Recent government spending cuts aimed at reducing welfare and unemployment benefits may restrain the budget deficit of the public sector despite rising unemployment. The central bank of Germany, the Bundesbank, continues to keep a tight rein on monetary policy, largely in response to the extremely expansive fiscal policy of past years that accompanied unification. In light of these restraining influences, unemployment will continue to increase. Uncertainty over the course of reunification may also hold down consumer spending. Moreover, as a result of the slow growth in the rest of the European Community, exports to those areas will not rise much.

Other parts of the world should enjoy slightly faster growth in 1994, and this growth will strengthen exports. Growth in Latin America will ease somewhat but still proceed at a healthy pace of about

3 percent. Countries in Asia and the Pacific region as a whole will expand moderately at about 2 percent. At the same time, Canada is expected to show solid but not exceptional growth of approximately 3.5 percent. Growth in these countries explains why U.S. exports will grow faster than U.S. GDP.

Demand for imported goods by U.S. households and businesses will continue to expand at a good clip in 1994, as it did in 1993. Since imports make up approximately 15 percent of consumer goods, growth of consumption in 1994 will spur imports of these goods. And because imports make up a large share of capital goods, business expansion in the United States will require imports of capital goods to grow as well. Increased investment in computers and the high proportion of computers and peripherals imported from abroad suggests that net imports of computers will grow in 1994.

The value of the dollar will affect net exports as well. Expectations about relative changes in interest rates indicate a stronger dollar during 1994. Faster growth in the United States than in Germany and Japan over the next year or so will cause short-term interest rates in the United States to rise faster than those in the rest of the developed countries. This widening gap in interest rates will push up the value of the dollar temporarily.

Monetary Policy: The Federal Reserve Will Probably Let Short-Term Rates Rise

Long-term interest rates fell considerably during the first half of 1993 as fears of rising inflation subsided, worldwide demand for capital declined, and deficit reduction became more probable. Short-term rates continued to ease through the first quarter of 1993 and have remained low since then. As the economy continues to gain momentum and close the gap between potential and actual GDP, however, the Federal Reserve will probably let short-term rates rise.

The Policy Problem Faced by the Federal Reserve

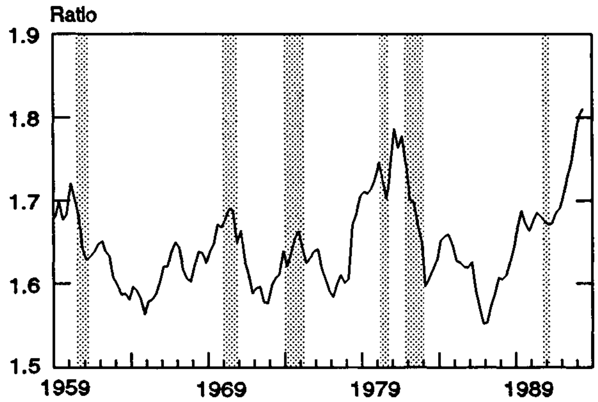
The goal of the Federal Reserve is to promote economic expansion together with low inflation. In pursuing that goal, the Federal Reserve has used a wide variety of indicators to formulate monetary policy over the years, particularly monetary aggregates and interest rates. Currently, however, interest rates have become a primary indicator. The previous relationship between the monetary aggregates and the level of economic activity is no longer a reliable gauge. Movements in interest rates now convey more information on the stance of monetary policy.

In its midyear 1993 report to the Congress, the Federal Reserve announced that it would downplay the role of the monetary aggregates in assessing the stance of monetary policy. Most analysts had abandoned these aggregates even earlier. In the past, the relationship between the broad measure of money known as M2 and GDP had been reasonably stable, so the Federal Reserve was able to use that relationship to guide monetary policy. But in recent years, the economy has grown much faster than M2. As a result, M2 velocity--the ratio of GDP to M2--has become highly unpredictable, reducing the usefulness of M2 as a policy tool.

M2 has been growing so slowly that its velocity is at its highest level since official data on M2 were first made available in 1959 (see Figure 1-8). Recent data suggest that M2 and the even broader measure M3 may expand more quickly, perhaps signaling recovery in the expansion of bank credit. Meanwhile, narrow measures of monetary thrust, such as M1 or total reserves held by banks and thrifts, show rapid growth.[2] But since the relationships between these measures and GDP have not been as reliable as

2. M1, M2, and M3 are measures of the U.S. money supply. M1 consists of the public's holdings of currency, travelers' checks, and checkable deposits. M2 is primarily M1 plus small (less than $100,000) time and savings accounts, money market deposit accounts held at depository institutions, and most money market mutual funds. M3 primarily consists of M2 plus large (more than $100,000) time deposits, term repurchase agreements, term Eurodollars, and money market mutual funds owned by institutions.

Figure 1-8.
Velocity of M2



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

NOTE: M2 velocity is the ratio of nominal GDP to the M2 measure of the money supply. M2 consists primarily of currency, traveler's checks, checkable deposits, small time and savings accounts, money market deposit accounts held at depository institutions, and most money market mutual funds.

the M2 relationship in the past, they are not apt to be useful indicators of the stance of monetary policy now.

Since the monetary aggregates have given such an unclear message, movements in interest rates may yield more information about whether monetary policy is constricting or encouraging economic activity. Interest rates, however, move not only because of policy changes but also because of changes in the economy, and distinguishing between the two causes is difficult. As interest rates rise, analysts will not know for sure whether they are increasing because of a higher level of economic activity, fears of higher inflation, or tightening by the Federal Reserve.

Some analysts view the currently low rates of interest on short-term Treasury securities as highly expansionary, lending credence to the notion that the Federal Reserve will allow short-term rates to drift upward as the expansion continues. The rate on three-month Treasury bills hovered around 3 percent throughout 1993 as the economy picked up steam. With inflation as measured by the consumer price index close to 3 percent as well, the real rate of interest--that is, the rate of interest after adjusting for inflation--has been approximately zero. The Federal Reserve has expressed its concern that low real interest rates, if maintained for too long, could lead to an overheated economy and higher inflation such as that which occurred in the late 1960s and in the 1977-1978 period.

CBO's forecast assumes that the Federal Reserve will continue to emphasize the importance of restraining inflation without unduly restricting economic activity. If so, the Federal Reserve will probably allow a modest increase in short-term rates of interest. In fact, in CBO's forecast they rise roughly 1 percentage point above the forecast rate of inflation by the end of 1994 and another one-half of one percentage point above the forecast rate of inflation by the end of 1995.

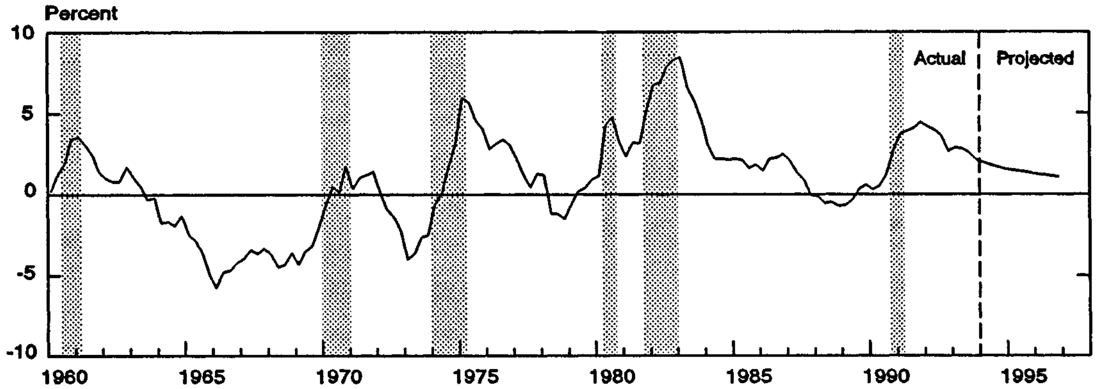
Inflation Is Not Likely to Pick Up Noticeably in the Near Term

With slack remaining in the economy and little pressure from wages or imported goods, inflation is unlikely to be a problem during 1994 or 1995. The underlying rate of consumer price inflation--a measure of inflation that dampens the influence of volatile components of the consumer price index--eased a bit during 1993, although transitory price shocks caused the reported rate to jump erratically from quarter to quarter. CBO currently estimates that the underlying rate is slightly below 3 percent, and inflation will be close to that rate this year.

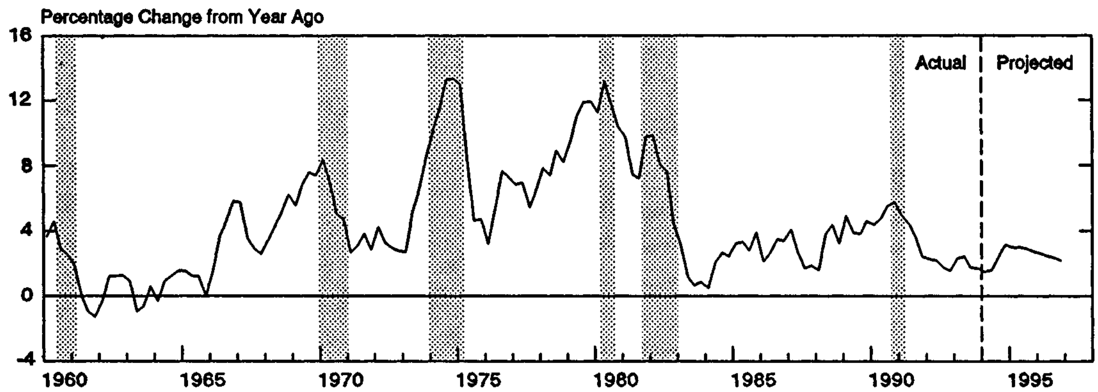
The persistence of excess capacity should keep inflation in check. CBO estimates that the GDP gap, a summary measure of the degree of excess capacity, will remain large enough to dampen inflation even with economic growth close to 3 percent (see Figure 1-9). Labor markets are also unlikely to tighten significantly during the forecast period. Although the unemployment rate is expected to decline over the year, the level of unemployment will still be large enough to slow pressures for wage gains. Increases in total compensation are likely to outpace growth in productivity by less than 3 percent a year, thereby keeping the growth of unit labor costs low.

Figure 1-9.
Inflation Indicators and Inflation

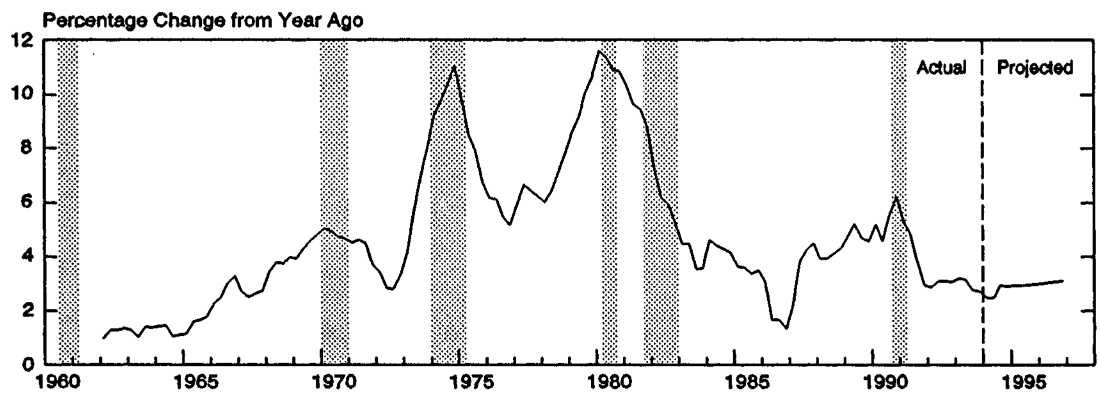
Shortfall of Gross Domestic Product Below Potential[a]



Unit Labor Costs



Inflation[b]



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

a. The shortfall is the difference between actual and potential real gross domestic product.

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

The capacity utilization rate for manufacturing is an important indicator of possible increases in inflation. The current rate is at a level often associated with inflationary pressures. Investment in plant and equipment has been strong, however, and should help keep utilization rates from increasing significantly this year.

Inflation has slowed in most developed economies outside the United States over the last two years, which should further moderate U.S. inflation. Between 1991 and the end of last year, consumer price inflation slowed from 5.6 percent to about 2 percent in Canada, from 3.3 percent to about 1.3 percent in Japan, from 5.9 percent to about 1.5 percent in the United Kingdom, and from 3.1 percent to about 2.2 percent in France. In a notable exception to this pattern, inflation in Germany increased over the same period, but a restrictive monetary policy and recession are beginning to bring down the inflation rate.

Low inflation abroad helps restrain U.S. inflation by both keeping prices of imported goods low and restraining domestic price increases for U.S. goods. Growth in prices of imported goods has been extremely slow for two years--the implicit import deflator for goods excluding petroleum and computers has grown by less than 1 percent over the last year.

Table 1-3.
Economic Outlook for Calendar Years 1994 Through 1999

	Estimated 1993	Forecast 1994	Forecast 1995	Projected 1996	Projected 1997	Projected 1998	Projected 1999
Nominal GDP (Billions of dollars)	6,370	6,730	7,099	7,483	7,880	8,287	8,700
Nominal GDP (Percentage change)	5.5	5.6	5.5	5.4	5.3	5.2	5.0
Real GDP (Percentage change)	2.8	2.9	2.7	2.7	2.7	2.6	2.5
Implicit GDP Deflator (Percentage change)	2.6	2.7	2.7	2.6	2.5	2.5	2.5
Fixed-Weighted GDP Price Index (Percentage change)	3.2	2.8	2.7	2.7	2.7	2.7	2.7
CPI-U (Percentage change)[a]	3.0	2.7	3.0	3.1	3.1	3.1	3.1
Unemployment Rate (Percent)[b]	6.8	6.4	6.1	5.9	5.8	5.7	5.7
Three-Month Treasury Bill Rate (Percent)	3.0	3.5	4.3	4.6	4.6	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	5.9	5.8	6.0	6.1	6.2	6.2	6.2
Tax Bases (Percentage of GDP)							
Corporate profits	7.3	7.3	6.9	6.8	6.7	6.6	6.5
Other taxable income	20.5	20.2	20.3	20.3	20.4	20.5	20.6
Wage and salary disbursements	48.4	48.8	49.0	49.0	48.9	48.9	48.8
Total	76.1	76.3	76.2	76.2	76.0	75.9	75.8

SOURCE: Congressional Budget Office.

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

b. Unemployment rate based on 1993 methodology; published rates are likely to be higher (see Box 1-1).

The recent drop in petroleum prices will also dampen inflation, though only for a short time. The price of petroleum has fallen from $18 a barrel in the second quarter of 1993 to about $15 a barrel recently. This drop offsets all of the effect on consumer prices of the federal gasoline tax increase of 4.3 cents a gallon imposed in October 1993, plus the increase of 1 to 2 cents a gallon in the cost of supplying oxygenated fuels to the nation's largest cities. Although the CBO forecast anticipates moderate gains in petroleum prices during 1994, gasoline prices are still likely to be lower on average this year than last.

By the mid-1990s, however, some inflationary pressures may emerge. As the economy continues to grow and gets closer to the level of potential GDP, shortages of goods and labor may put upward pressure on both wages and prices. CBO assumes that by allowing a modest rise in short-term rates, the Federal Reserve will prevent the pressure from building inordinately.

Table 1-4.
Economic Outlook for Fiscal Years 1994 Through 1999

	Estimated	Forecast		Projected			
	1993	1994	1995	1996	1997	1998	1999
Nominal GDP (Billions of dollars)	6,295	6,637	7,006	7,386	7,780	8,185	8,596
Nominal GDP (Percentage change)	6.0	5.4	5.5	5.4	5.3	5.2	5.0
Real GDP (Percentage change)	3.2	2.8	2.7	2.7	2.7	2.6	2.5
Implicit GDP Deflator (Percentage change)	2.7	2.6	2.7	2.6	2.5	2.5	2.5
Fixed-Weighted GDP Price Index (Percentage change)	3.2	2.9	2.7	2.7	2.7	2.7	2.7
CPI-U (Percentage change)[a]	3.0	2.7	2.9	3.0	3.1	3.1	3.1
Unemployment Rate (Percent)[b]	7.0	6.4	6.1	6.0	5.8	5.7	5.7
Three-Month Treasury Bill Rate (Percent)	3.0	3.3	4.2	4.5	4.6	4.7	4.7
Ten-Year Treasury Note Rate (Percent)	6.2	5.7	6.0	6.1	6.2	6.2	6.2
Tax Bases (Percentage of GDP)							
Corporate profits	7.1	7.4	7.0	6.8	6.7	6.6	6.5
Other taxable income	20.5	20.2	20.2	20.3	20.4	20.5	20.5
Wage and salary disbursements	48.7	48.8	49.0	49.0	49.0	48.9	48.8
Total	76.4	76.4	76.2	76.2	76.1	76.0	75.9

SOURCE: Congressional Budget Office.

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

b. Unemployment rate based on 1993 methodology; published rates are likely to be higher (see Box 1-1).