The Economic and Budget Outlook: An Update

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CONGRESS OF THE UNITED STATES CONGRESSIONAL BUDGET OFFICE

THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE

The Congress of the United States
Congressional Budget Office

PREFACE

The Economic and Budget Outlook: An Update is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations.

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Director

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CHAPTER I. SUMMARY AND INTRODUCTION

The purpose of this report is to update the economic and budget projections of the Congressional Budget Office (CBO) to reflect economic developments of the last six months and recent Congressional actions.

Last winter CBO projected an immediate resumption of economic growth and further gradual improvement in inflation. Despite the depth of the recession, the recovery was expected to be weaker than the average cyclical recovery, largely because of persistently high interest rates. As it turned out, interest rates were higher than anticipated while both unemployment and inflation abated more than expected. Although the economy was even weaker than projected in the first months of the recovery, it scored very large gains in employment, sales, and output in the second quarter. Given the momentum now building in the economy, CBO's updated forecast shows significantly more economic growth during the first year of recovery than anticipated last February. Nevertheless, this recovery looks to be quite precarious, largely because of high interest rates and uncertainty surrounding the future course of monetary and fiscal policy.

The First Concurrent Resolution on the Budget for Fiscal Year 1984 calls for policies that would slow the growth of spending, raise additional taxes, and reduce the growth of structural deficits. According to CBO's budget projections, the resolution's policies in the context of the stronger recovery now in prospect would result in declining deficits in the 1984-1986 period—a turnaround from CBO's projection of rising deficits based on the policies and forecasts of last February. Nevertheless, budget deficits would still remain very high by historical standards, partly because those policies would have little effect on the deficit until after 1984. In fact, the structural element in the deficit would not begin to decline until 1986, suggesting continued pressure on interest rates with attendant adverse effects on interest-sensitive sectors of the economy.

The CBO projections assume that the budget resolution will be implemented, but passage of the budget resolution is only the first step in enacting and implementing specific measures to reduce deficits. Unless Congress and the Administration act to carry out these or similar policies, the outlook is for budget deficits on the order of $200 billion for years to come.

Deficits will also remain very high if economic growth proves weaker than anticipated. While underlying demand is strong, the recovery may not be sustained if inflation and interest rates rise to high levels once again. Projecting inflation and interest rates is difficult especially in view of the uncertainty surrounding the budget, monetary policy, and the foreign debt situation in developing countries. And even small differences in estimated inflation and interest rates can have sizable effects on projections of outlays, revenues, and the deficit.

Many private forecasts are based on the assumption that the deficit-reduction measures of the budget resolution will not be enacted. Such forecasts generally show higher deficits, higher interest rates, and less strength in interest-sensitive sectors than CBO's projection. In addition, money growth has been so rapid that some economists expect Federal Reserve policy to become considerably more restrictive in the months ahead in order to prevent the possible return of high rates of inflation. CBO's economic projection does not presume a substantial further rise in rates from the levels that prevailed in early August.

RECENT ECONOMIC DEVELOPMENTS

The country is now well on the way to recovery from its deepest postwar recession (see Table 1). Just as the downturn was precipitated by tight credit conditions, so an easing of monetary policy, beginning a year ago, together with an expansive fiscal policy brought recovery. The impact of these policies was felt in a strengthening of household demands, particularly for housing and consumer durables, and an end to the cutback in production designed to reduce inventories. Consumer outlays outran growth in disposable income in the first half of this year; by the second quarter the personal savings rate had declined to its lowest level in over 30 years.

Although the recovery began last December, GNP growth was not strong in the first quarter of the year, but consumer spending increased sharply in the second quarter, contributing to an 8.7 percent annual rate increase in real GNP. 1/ The gains in economic activity were large and widespread—except for net exports, which declined in the first half of the year. Labor markets improved dramatically, although unemployment still remains very high. In the March-July period, nonfarm payroll employment increased by about 1½ million workers and the civilian unemployment rate declined to 9.5 percent in July from its record high of 10.8 percent last December.

1/ The National Bureau of Economic Research has dated November 1982 as the trough of the recession. Thus, the first quarter of recovery was Q1 of 1983.

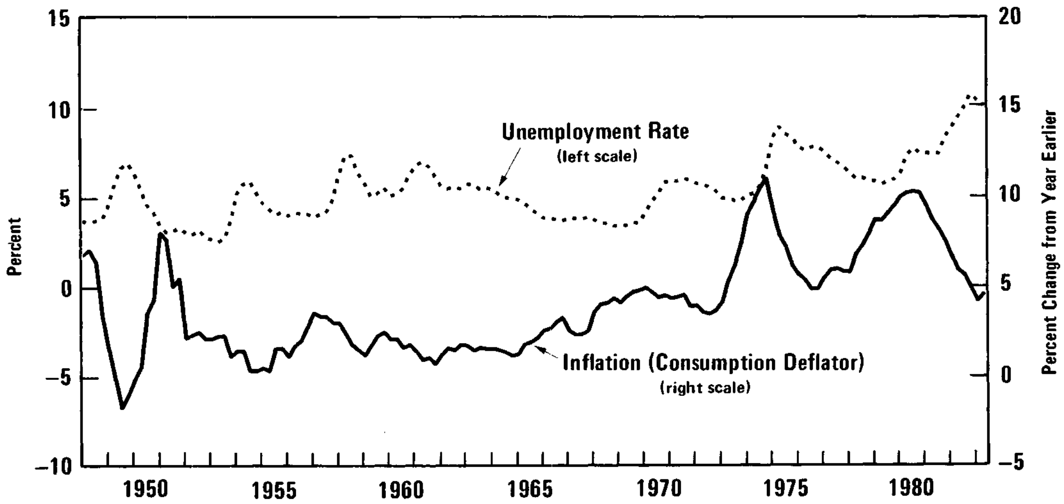
TABLE 1. RECENT ECONOMIC INDICATORS (Percent change from previous period at seasonally adjusted annual rates, unless otherwise noted)

	1980	1981	1982 Q1	1982 Q2	1982 Q3	1982 Q4	1983 Q1	1983 Q2
Real GNP	-0.3	2.6	-5.5	1.0	-1.0	-1.3	2.6	8.7
Final sales	0.5	1.8	-1.3	-0.8	-1.5	4.5	0.6	5.5
Consumption	0.5	2.7	2.4	3.1	0.9	3.6	2.9	10.0
Business fixed investment	-2.4	5.2	-5.9	-14.3	-8.8	-6.6	-1.5	4.6
Residential investment	-20.4	-5.2	-28.5	17.9	-13.0	53.2	57.3	61.1
Government purchases	2.2	0.8	-0.2	-5.0	9.4	10.6	-8.8	-0.9
Inventory Change (billions of 1972 dollars)	-4.4	8.5	-10.2	-3.4	-1.3	-22.7	-15.4	-4.5
Net Exports (billions of 1972 dollars)	50.3	43.0	35.2	33.4	24.0	23.0	20.5	10.2
Industrial Production	-3.6	2.6	-11.7	-6.6	-3.4	-8.1	9.9	17.8
Payroll Employment (millions)	90.4	91.2	90.3	89.9	89.3	88.8	88.8	89.4
Unemployment Rate (percent)	7.2	7.6	8.8	9.4	10.0	10.7	10.4	10.1
Inflation Rate								
CPI-U	13.5	10.3	3.0	5.3	7.8	2.0	-0.4	4.2
GNP deflator (fixed weight)	9.8	9.5	5.3	4.7	5.9	4.7	3.4	5.2
Interest Rates (percent)								
Treasury Bill Rate	11.4	14.0	12.8	12.4	9.3	7.9	8.1	8.4
Corporate AAA Bond Rate	11.9	14.2	15.0	14.5	13.8	11.9	11.8	11.6

The recession brought about a rapid decline in inflation—from about 9.6 percent in 1981 to a 5.3 percent annual rate in the last half of 1982, as measured by the fixed-weight GNP deflator (see Figure 1). Despite the recovery, inflation continued to moderate in the first half of this year to a 4.3 percent rate because of slack in the economy and weak commodity prices, particularly for petroleum products and food. Although commodity prices account for much of the improvement in inflation this year, measures of inflation that exclude volatile food and fuel prices also indicate that inflationary momentum continued to decline. Unusually large reductions in the rate of wage increases have contributed significantly to the decline in underlying inflation.

Many economic indicators suggest that consumer demands will grow rapidly in the months ahead. Real earnings, employment, and consumer balance sheets have improved and consumer confidence has risen to the

Figure 1.
Postwar Inflation and Unemployment



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics.

highest level in more than a decade. The sharp decline in the ratio of real manufacturing and trade inventories to sales—from 1.76 in the fourth quarter of 1982 to 1.60 in May of this year—suggests production will pick up with attendant gains in employment and incomes. As consumer confidence rises with incomes—enhanced by the July tax cut—consumer spending should continue to strengthen during the second half of this year. Current indicators of investment spending, which are usually weak in the early stages of recovery, suggest a rebound later this year and in 1984. Indicators of defense spending are strong, suggesting this sector will continue to make an important contribution to growth in the year ahead.

On the other hand, growth in residential investment, which provided the initial impetus for the turnaround last winter, may slow in the year ahead because of the recent rise in long-term interest rates. And the continued appreciation of the dollar in international exchange markets, related to the high budget deficit and high interest rates, gives credence to the view that the international sector is likely to remain a major drag on the economy; imported goods will continue to gain a competitive advantage in domestic markets while exports will be discouraged.

The strength and durability of the recovery will ultimately depend upon the behavior of inflation and real interest rates. Interest rates have not declined to the levels usually experienced during the early stage of a recovery. Although nominal short-term rates during the second quarter of 1983 were nearly five percentage points below their peak of a year earlier, real rates are still very high for this stage of the business cycle (see Figure 2). Longer-term rates have also remained high, perhaps reflecting expectations of increased inflation and fears that large federal deficits will persist in the later stages of the recovery because of failure to implement the budget resolution or to take further steps to curb deficits. Although their impact does not yet appear to have been very large, high real interest rates are likely to have substantial effects on longer-run growth.

THE CBO ECONOMIC FORECAST

The revised CBO forecast shows a more rapid recovery in 1983 than projected last February, although the projected rate of growth during the first year of recovery is still below the average postwar cyclical recovery rate of about 7 percent. The projection assumes that the policies embodied in the budget resolution are enacted and that nominal GNP growth will be in line with the Federal Reserve's monetary policy targets and the objectives set forth by the Administration.

The revised CBO forecast incorporates the following policy assumptions:

- The tax and spending policies of the First Budget Resolution for Fiscal Year 1984 are assumed to be carried out. On a unified budget basis these assumptions result in outlays of $807 billion in fiscal year 1983 and $860 to $868 billion in fiscal year 1984, depending upon the final disposition of the reserve fund included in the budget resolution. 2/

- Money aggregates are assumed to grow within the Federal Reserve target ranges.

The forecast also assumes no commodity price shocks. The refiners' acquisition cost of foreign oil is assumed to be flat in nominal terms through 1984, and food prices are assumed to rise less than the general price level.

2/ The First Budget Resolution for Fiscal Year 1984 included a "reserve fund" for antirecession assistance, which will be included in the spending ceiling if Congress authorizes the new programs.

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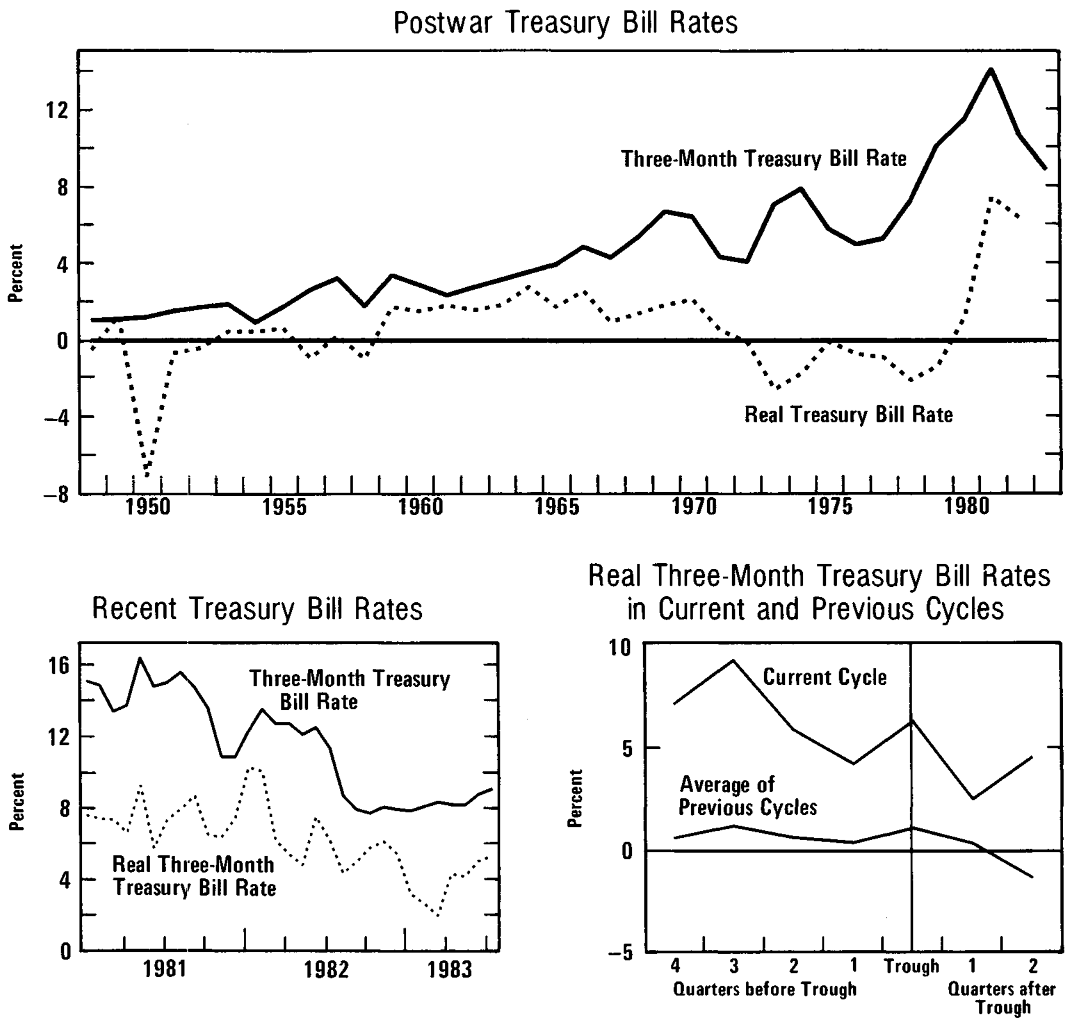
Figure 2.
Short-Term Interest Rates



SOURCES: Federal Reserve Board; Congressional Budget Office.

NOTE: Real rates are nominal rates adjusted for inflation in the succeeding three months.

The forecast (Table 2) shows real GNP growing at 5.8 percent over the four quarters of 1983 and at 4.3 percent during 1984. The unemployment rate is projected to decline to 8.9 percent by the end of 1983 and to 8.2 percent by the end of 1984. Consumer spending is expected to grow rapidly in the second half of this year. Business investment is expected to make a major contribution to growth in 1984 in response to the cyclical increase in capacity utilization, and to business tax cuts. The rise in interest rates in recent months, in part reflecting the Federal Reserve's efforts to slow the rapid growth in money, is expected to have a moderating effect on residential construction and other interest-sensitive sectors later this year and in 1984.

Prices, as measured by the GNP deflator, are projected to rise by 4.6 percent this year (fourth quarter to fourth quarter) and by 5.0 percent in 1984. The projected increase in inflation in 1984 results from increases in Social Security taxes, an assumed decline in the value of the dollar in international exchange markets, tighter labor markets, and further restoration of profit margins as the recovery proceeds. The Consumer Price Index is also expected to show some acceleration in inflation in 1984. Short-term Treasury bill rates are projected to decline gradually from present levels of about 9.5 percent to 8.6 percent in calendar 1984. Long-term interest rates are projected to decline slightly in 1984.

TABLE 2. THE CBO SHORT-RUN FORECAST

	Actual	Projections	
	1982	1983	1984
Fourth Quarter to Fourth Quarter (percent change)			
Nominal GNP	2.6	10.6	9.5
Real GNP	-1.7	5.8	4.3
GNP Implicit Price Deflator	4.4	4.6	5.0
Calendar Year Average (percent)			
Unemployment Rate	9.7	9.7	8.4
Three-Month Treasury Bill Rate	10.6	8.8	8.6