THE OUTLOOK FOR ECONOMIC RECOVERY

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NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force. The Bureau of Labor Statistics will soon publish unemployment rates based on the total labor force, including the military stationed in the United States.

Details in the text and tables of this report may not add to totals because of rounding.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 (Public Law 93-344) to submit an annual report on budgetary options to the House and Senate Committees on the Budget. This year's report is in three parts. This volume, Part I, examines the state of the economy and the outlook, fiscal and monetary policy choices, and policies to reduce unemployment. Part II, Baseline Budget Projections for Fiscal Years 1984-1988, provides a baseline for the consideration of multiyear budget options; the projections show what would happen if current taxing, spending, and lending policies were to continue unchanged for the next five fiscal years. Part III, Reducing the Deficit: Spending and Revenue Options, presents for Congressional consideration a number of broad strategies to reduce projected budget deficits and various specific options for cutting outlays and increasing revenues. In accordance with CBO's mandate to provide objective and impartial analysis, these reports contain no recommendations.

The Outlook for Economic Recovery was prepared by George R. Iden, Frederick Ribe, Robert Dennis, Frank S. Russek, Jr., Peter M. Taylor, Jane D'Arista, Stephan Thurman, Peter Woodward, Debra Holt, Christopher D. Kask, Naif A. Khouri, Emery Simon, John W. Straka, John R. Sturrock, and Stephen H. Zeller, under the direction of William J. Beeman.

Robert L. Faherty and Francis S. Pierce edited the manuscript. Debra M. Blagburn, Dorothy J. Kornegay and Mechita O. Crawford typed the many drafts.

Alice M. Rivlin
Director

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CHAPTER I. SUMMARY AND INTRODUCTION

The recession in the U.S. economy is now the deepest and the longest of the post-World War II period. Contrary to expectations of a year ago, the decline continued through the second half of last year, reducing output to levels achieved four years earlier; by year-end, unemployment rates were at double-digit levels not observed in this country since 1940. Moreover, most economists do not anticipate rapid recovery or a substantial improvement in the dismal unemployment picture this year.

The inflation outlook has improved markedly. The record slack in the U.S. economy, together with a depressed world economy, have sharply reduced inflationary pressures. During 1982, the inflation rate was lower than for any calendar year in the last decade.

The outlook for the future is highly uncertain. Although most forecasters anticipate an upturn in the months ahead, they disagree over how much the economy will grow during the next several years. There are two broad reasons for this: a high degree of uncertainty concerning the prospective behavior of both monetary and fiscal policy and their impact on the economy; and uncertainty about the effect of the debt burden of the developing countries on world trade. Monetary and fiscal policy are critical because they will strongly influence the course of the economy in coming years.

Administration and Federal Reserve spokesmen have indicated that the goal of economic policy is a moderate recovery that would permit a continuing decline in inflation. It is not clear how they would respond to other outcomes, such as stronger growth coupled with higher inflation. Consequently, some of the differences among forecasters reflect different opinions about how the Federal Reserve will behave once recovery is under way. Some believe it will emphasize reducing inflation, whereas others believe it will emphasize short-run growth.

The outlook for fiscal policy is, perhaps, even more uncertain. It is not clear what measures the Administration and the Congress will take to reduce the extremely large federal deficits that current budget policies would generate in future years. In the current economic environment, it may not be desirable to raise taxes or lower spending during the coming year, because that might weaken the recovery. But unless legislation is enacted to reduce deficits in future years, tight credit conditions may threaten the recovery, especially the resurgence of investment needed to enhance long-run economic growth.

RECENT ECONOMIC DEVELOPMENTS

During the last several years, economic growth has been exceptionally volatile, with several periods of decline and recovery. But essentially the economy has not grown since 1979. When the current recession began in the summer of 1981, the economy had not fully recovered from the brief but deep 1980 recession, and at the end of 1982 the economy was operating much further below capacity than at any time since the Depression.

The 1981-1982 recession resulted largely from high interest rates that had already cut deeply into residential construction and auto sales even before the recession began. Between the third quarter of 1981, when the recession began, and the first quarter of 1982, real gross national product (GNP) declined 2.6 percent--nearly all of the decline being in inventory investment. Weak sales, high interest rates, and declining inflation caused most businesses to cut their inventories sharply. Net exports were also weak, and have continued to decline in response to global recession and the high exchange rate of the dollar. Although business investment held up fairly well early in the recession, perhaps because of the tax cut and the expectation of an early recovery, it has declined sharply during the last year in response to continuing weak final sales and high real interest rates. As shown in Table 1, output dropped sharply in the last quarter of 1981 and the first quarter of 1982. After two quarters of very weak growth, with some inventory building, the economy renewed its decline in the fourth quarter of last year. As a result, unemployment rose steadily, reaching a record 10.7 percent in the last quarter.

Interest rates fell as usual in the early months of the present recession. But they rose again sharply at the end of 1981 and remained at very high levels during the first six months of 1982 despite weak demands, record unemployment, and declining inflation. The high rates during this recession period have been attributed to a sharp increase in money demand that was only partially accommodated by the Federal Reserve, and to the realization that federal credit requirements would be very large in future years. The unusual and unexpected behavior of interest rates in the first half of 1982 deepened and prolonged the recession.

The record slack in the economy has contributed to the sharp decline in inflation. As measured by the Consumer Price Index (CPI), inflation declined from a 12.6 percent rate during 1980 to a 4.5 percent rate during 1982. The growth of the fixed-weight GNP deflator, a broad measure of production costs, declined from 10.3 percent to 5.0 percent in the same period. More than half of the decline in inflation appears to stem from lower import prices--related to the oil price decline and the appreciation of

TABLE 1. RECENT ECONOMIC INDICATORS

	1979	1980	1981	1982	1981 Q3	1981 Q4	1982 Q1	1982 Q2	1982 Q3	1982 Q4
Levels (billions of 1972 dollars)										
GNP	1479.4	1474.0	1502.5	1475.5	1510.4	1490.1	1470.7	1478.4	1481.1	1471.7
Inventory Change	7.3	-5.0	9.0	-8.5	16.5	4.8	-15.4	-4.4	3.4	-17.7
Net Exports	37.2	50.6	42.0	30.3	39.2	36.5	36.9	35.7	27.5	21.1
Rates of Change (at annual rates in 1972 dollars)										
GNP	2.9	-0.4	1.9	-1.8	2.2	-5.3	-5.1	2.1	0.7	-2.5
Final Sales	3.5	0.5	1.0	-0.6	1.0	-2.3	0.2	-0.9	-1.3	3.2
Consumption	2.7	0.3	1.8	1.0	2.9	-3.3	2.5	2.5	0.6	5.0
Business Fixed Investment	7.4	-2.2	3.5	-3.8	9.3	0.6	-5.0	-11.8	-7.7	-9.0
Residential Investment	-5.2	-20.2	-4.8	-10.9	-31.9	-25.3	-10.2	12.9	-5.9	23.7
Government Purchases	1.3	2.3	0.9	1.4	3.6	7.0	-2.9	-5.3	8.4	11.3
Industrial Production	4.4	-3.6	2.6	-8.1	1.4	-16.5	-11.7	-6.6	-3.4	-8.7
Averages (percent)										
Unemployment Rate	5.8	7.2	7.6	9.7	7.4	8.4	8.8	9.4	10.0	10.7
Inflation Rate (CPI-U)	11.3	13.5	10.3	6.1	11.8	7.8	3.2	4.6	7.6	2.8
Treasury Bill Rate	10.1	11.4	14.0	10.6	15.1	11.8	12.8	12.4	9.3	7.9

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

the dollar, factors that were themselves related to the recession and high interest rates. But the recession has also brought down the underlying inflation rate in the economy: wage gains declined from 9.6 percent during 1980 to 5.9 percent during 1982, and underlying inflation declined by about three percentage points in the same period.

In response to reduced inflation, a mounting financial crisis, and the failure of the economy to recover as expected, the Federal Reserve changed policies last summer, placing greater emphasis on promoting economic growth. Previously announced money aggregate targets have been suspended and money growth has been quite rapid. Nominal interest rates have declined steadily since last July, though they remain very high in real terms, especially for a recession period. Some interest-sensitive sectors of the economy have responded to the decline in rates. Auto sales seem to have picked up somewhat in recent months, though this sector has not yet shown significant strength. The growth in housing starts since last spring has been substantial, and appears to be gaining momentum. Given the backlog of demand for housing and autos, a further pick-up may be anticipated as interest rates decline. Defense spending has also been a significant positive factor and will continue to be so. Whether general recovery will begin in the months ahead is still not clear, however. Likewise there is much uncertainty about the strength of the recovery, once started, partly because of the unresolved policy issues mentioned above.

THE CBO ECONOMIC PROJECTIONS

The CBO baseline projection shows moderate growth, well below the average cyclical recovery, on the assumption that monetary policy will in fact limit growth in line with the moderate growth goals enunciated by Administration and Federal Reserve spokesmen. But because of the uncertainty regarding both monetary and fiscal policy and the international situation, it is more difficult than usual to anticipate the condition of credit markets and the strength of the recovery in the year ahead. Accordingly, in addition to its baseline projection CBO has prepared two alternative projections--showing a low-growth path with higher unemployment and lower inflation than the baseline projection, and a high-growth path with lower unemployment and higher inflation.

The Baseline Projection

The short-run forecast, shown in Table 2, incorporates the following policy assumptions.

TABLE 2. THE CBO SHORT-RUN FORECAST

Economic Variable	1981:4 to 1982:4	1982:4 to 1983:4	1983:4 to 1984:4
Nominal GNP (percent change)	3.3	8.9	9.6
Real GNP (percent change)	-1.2	4.0	4.7
GNP Implicit Price Deflator (percent change)	4.6	4.7	4.6
Unemployment Rate (calendar year average)	9.7	10.6	9.8
Three-Month Treasury Bill Rate (calendar year average)	10.6	6.8	7.4

- The tax and spending policies are those in effect at the end of the 97th Congress, including the recently enacted increase in gasoline taxes and all appropriation action to date. Defense spending is at the level for fiscal year 1984 that was specified in the budget resolution for fiscal year 1983. On a unified budget basis, these assumptions result in outlays of $800 billion in fiscal year 1983 and $850 billion in fiscal year 1984.

- In regard to monetary policy, the money aggregate, M2, is assumed to grow at 9 percent annual rates during 1983 and 1984. If velocity growth is close to the historical average, monetary policy appears consistent with the projection. However, if velocity growth deviates sharply from average historical growth rates (as it did during 1982), CBO assumes that the Federal Reserve will adjust its money targets in an attempt to ensure moderate growth in nominal GNP.

The short-run forecast also assumes no food or fuel price shocks. Food prices are expected to rise moderately during the next two years, at 4 percent this year and 5 percent next year. World oil prices are assumed to be flat through 1984. However, an assumed 10 to 15 percent decline in the trade-weighted value of the dollar is expected to provide some pressure on prices by raising the cost of imported goods.

The longer-range economic projections for the 1985-1988 period, displayed in Table 3, are not an attempt to forecast probable economic conditions for those years. They are noncyclical projections that assume what appears to be an attainable average rate of growth. Whether this growth path is attainable with the tax and spending policies now in place is not certain. Monetary policy is assumed to be directed at achieving a further reduction in inflation, but not so rapid a reduction as to prohibit a gradual winding down of the unemployment rate in the outyear projections. It is further assumed that no price shocks occur (oil and food prices rise with general inflation), and that productivity grows at a trend rate of 1½ percent per year.

The baseline economic forecast shows real growth in GNP of 4.0 percent from the fourth quarter of 1982 to the fourth quarter of 1983 and 4.7 percent the next year. The unemployment rate is expected to decline gradually to 9.4 percent by the final quarter of 1984. In its initial phase, the recovery reflects an end to the inventory adjustment and increased activity in the housing and auto sectors as a result of declines in interest rates. Business investment is expected to be weak this year but to make a significant contribution to growth in 1984. Over the ensuing four years, the economy is assumed to grow at a 3.6 percent annual rate, with unemployment decining slowly to 7.5 percent by 1988.

Inflation, as measured by the GNP deflator, is 4.7 percent (fourth-quarter-to-fourth-quarter) in 1983 and 4.6 percent in 1984 in the CBO short-run forecast. Thereafter it is assumed to decline very gradually to 3.8 percent by 1988. Short-term interest rates, as measured by the three-month Treasury bill rate, are projected to average 6.8 percent in calendar year 1983, rising slightly as the recovery proceeds to 7.4 percent in calendar year 1984. Both short and long rates are assumed to drift down slowly in the outyears, though somewhat faster than the decline in inflation.

Alternative Economic Projections

Although the Federal Reserve may be attempting to achieve a path of moderate real growth and declining inflation, there is no certainty that it will succeed. The past year has shown monetary policy once again to be a very blunt instrument. The extremely tight credit conditions of the first six months of 1982 and the resulting continued deterioration of output were not

TABLE 3. CBO BASELINE AND ALTERNATIVE PROJECTIONS, CALENDAR YEARS 1983-1988

Economic Variable	1983	1984	1985	1986	1987	1988
CBO Baseline Projections						
GNP (percent change)	6.8	9.6	9.0	8.1	7.6	7.4
Real GNP (percent change)	2.1	4.7	4.1	3.7	3.5	3.5
GNP deflator (percent change)	4.6	4.7	4.7	4.3	3.9	3.8
CPI-U (percent change)	4.5	5.0	4.7	4.1	3.9	3.7
Unemployment Rate (percent)	10.6	9.8	9.0	8.4	8.0	7.5
Three-Month Treasury Bill Rate (percent)	6.8	7.4	7.2	6.6	6.1	5.9
Alternative Projections						
GNP (percent change)						
High-growth path	9.0	11.3	9.5	9.1	8.9	9.1
Low-growth path	5.4	7.9	7.9	7.2	6.6	6.4
Real GNP (percent change)						
High-growth path	4.0	6.0	4.2	4.0	4.0	4.0
Low-growth path	0.8	3.3	3.3	3.2	3.0	3.0
CPI-U (percent change)						
High-growth path	4.6	5.3	5.0	4.6	4.6	4.8
Low-growth path	4.5	4.9	4.4	3.8	3.4	3.2
Unemployment Rate						
High-growth path	9.9	8.5	7.7	7.0	6.4	6.0
Low-growth path	11.2	10.9	10.3	9.8	9.4	9.0
Three-Month Treasury Bill Rate (percent)						
High-growth path	4.4	5.4	5.7	5.0	5.0	4.9
Low-growth path	8.4	9.9	8.9	7.7	7.2	6.3

foreseen by the Federal Reserve when it chose its money targets for 1982. Similar events, which would mean faster or slower growth than intended, cannot be ruled out in the next few years, particularly in an environment of high federal credit demands. Many other developments, though perhaps less likely, could significantly affect recovery: major defaults on their external debts by developing countries, or a sharp drop in oil prices resulting from disagreements among the OPEC countries.

To show how events might alter the economic outlook, two alternative economic paths are presented in Table 3. The high-growth path shows a "normal" cyclical recovery, with more than 5 percent growth during the first three years and 4 percent thereafter. As compared with the baseline economic projection, the high-growth path shows a more rapid decline in unemployment, to 6 percent by 1988, but somewhat higher inflation, particularly in the outyears. The low-growth path shows a very weak recovery, with unemployment rates averaging about 10 percent in the 1983-1988 period, but with more rapidly declining inflation.

THE CBO BUDGET PROJECTIONS

The baseline budget projections incorporate the tax and spending policies in effect at the end of the 97th Congress with defense spending in fiscal year 1984 at the level specified in the 1983 budget resolution. 1/ As shown in Table 4, a deficit of about $194 billion is projected for fiscal year 1983 and $197 billion for 1984. The projected deficit rises slowly thereafter to $267 billion by 1988, assuming the same policies together with the CBO baseline economic projections. The deficit as a percent of GNP is about 6.1 percent in fiscal year 1983, well above the previous record of 4 percent in 1976 (see Figure 1). The ratio declines during the 1983-1988 period but remains at 5.6 percent in 1988, according to the CBO baseline projection.

These extremely large deficits result from: (1) the current slack in the economy, together with the baseline projection of moderate growth and declining inflation, which reduces revenue growth more than outlay growth; (2) the large tax cuts enacted in the past two years; and (3) substantial increases in defense, Social Security, Medicare and Medicaid, and interest payments under these assumptions.

1/ For a detailed description of the baseline budget projections see Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1984-1988 (February 1983).

TABLE 4. CBO BASELINE UNIFIED BUDGET PROJECTIONS, FISCAL YEARS 1983-1988

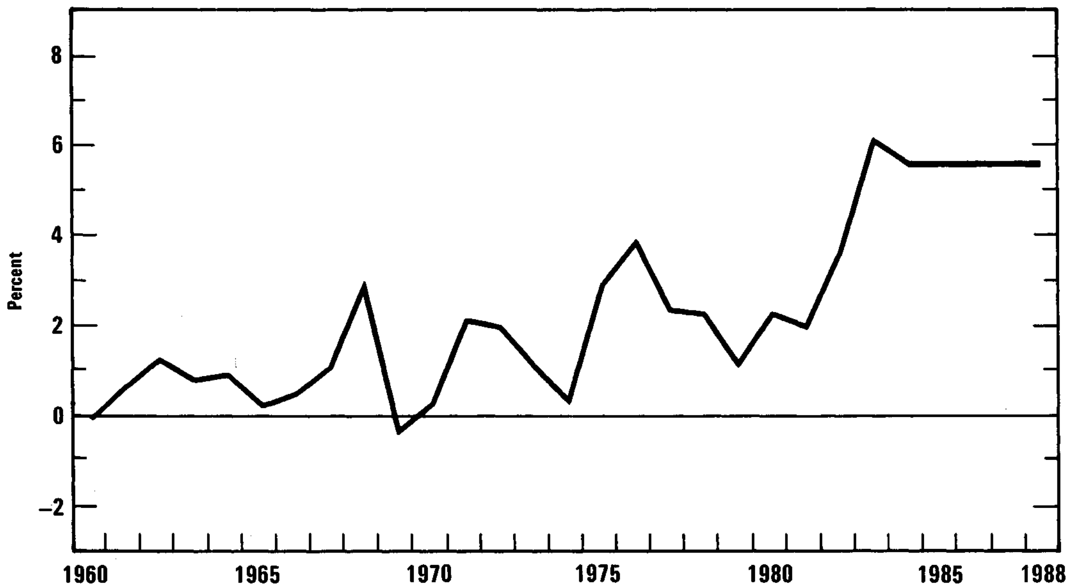
	1983	1984	1985	1986	1987	1988
	In Billions of Dollars					
Revenues	606	653	715	768	822	878
Outlays	800	850	929	999	1,072	1,145
Deficit	194	197	214	231	250	267
	As a Percent of GNP					
Revenues	19.0	18.7	18.7	18.5	18.4	18.3
Outlays	25.0	24.3	24.3	24.1	24.0	23.9
Deficit	6.1	5.6	5.6	5.6	5.6	5.6

As shown in Table 5, the deficit estimates are greatly affected by economic assumptions, even assuming the same tax and spending policies. The low-growth alternative projection shows deficits rising to more than $300 billion by fiscal year 1986. The high-growth path, on the other hand, shows much lower federal deficits. By fiscal year 1986, for example, the deficit is $172 billion--about $60 billion below the baseline estimate. Although deficits are not on a downward path even with the high-growth path, they do decline sharply relative to GNP. Nevertheless, unless policies are changed, the federal deficit is projected to be $183 billion in fiscal year 1988 even with the high-growth path.

POLICY ALTERNATIVES

The present high unemployment rate, and the prospect that it will continue for several years, have given rise to many proposals seeking to reduce it or to alleviate hardship. Undoubtedly, policies that generate rapid economic growth would make the largest contribution to reduced unemployment. However, the baseline budget projection shows that fiscal policy is already moving in a stimulative direction. Further budget stimulus could generate tighter credit conditions. An expansive monetary policy would be likely to improve short-run growth prospects with less threat to interest rates if budget deficits are reduced concurrently. Ultimately, expansionary

Figure 1.
Unified Budget Deficits as a Percent of GNP



SOURCES: Office of Management and Budget; Congressional Budget Office.

policies would risk higher inflation, particularly when economic slack is reduced. Policymakers are thus faced with a choice: emphasize the reduction of unemployment at some risk of inflation or emphasize fighting inflation at the risk of continued high unemployment.

If the emphasis is to be on fighting inflation, efforts can nevertheless be made to reduce the hardship of unemployment. These would include extending unemployment insurance benefit periods and closing some of the gaps in the "safety net" for the unemployed. Programs to alleviate hardship could be combined with measures designed to reduce the noncyclical or structural component of unemployment. This approach might include increased job training, efforts to improve mobility, and information about jobs, along with measures to reduce artificial impediments to employment such as discrimination and minimum wages. Such programs would not have a large impact on total unemployment during the next few years, given the slack in the economy, but might make a significant contribution in later years. For the short run, job-creating programs could be adopted such as