TABLE 5. ALTERNATIVE UNIFIED BUDGET PROJECTIONS, FISCAL YEARS 1983-1988 (In billions of dollars)

	1983	1984	1985	1986	1987	1988
			In Billions of Dollars			
High-Growth Path						
Revenues	615	676	743	798	862	933
Outlays	792	830	904	971	1,041	1,116
Deficits	177	155	162	172	179	183
Low-Growth Path						
Revenues	599	637	686	730	777	825
Outlays	804	868	958	1,032	1,110	1,187
Deficits	205	232	272	302	333	363
			As a Percent of GNP			
High-Growth Path						
Revenues	19.0	18.7	18.7	18.4	18.3	18.1
Outlays	24.4	23.0	22.8	22.4	22.1	21.7
Deficits	5.5	4.3	4.1	4.0	3.8	3.6
Low-Growth Path						
Revenues	18.9	18.7	18.6	18.5	18.4	18.4
Outlays	25.3	25.5	26.0	26.1	26.3	26.5
Deficits	6.5	6.8	7.4	7.6	7.9	8.1

public service jobs and public works. Most of the above programs, however, would entail larger federal deficits unless offset by cuts in other spending programs or increases in taxes.

It is now generally agreed that a balanced federal budget is not an attainable goal for the near future. Moreover, substantial tax increases or spending cuts undertaken to reduce the fiscal year 1983 deficit would probably weaken or delay economic recovery. Caution is also suggested in 1984, but most analysts favor legislative changes this year that would reduce deficits in the later years of the recovery.

Failure to reduce the outyear deficits would mean that the federal sector would absorb a very high proportion of available credit during the recovery, which could drive up real interest rates and crowd out private investment. To the extent that business investment became a casualty of high federal deficits, long-run gains in productivity could be reduced, thereby adversely affecting U.S. living standards and competitiveness in world markets. There might also be a renewed clash between monetary and fiscal policy resulting in a low-growth economy or, possibly, a stop-go economy. Uncertainty about future monetary and fiscal policies may also be one reason for the present high levels of long-term interest rates that hold back recovery.

Although efforts to reduce future deficits are likely to have favorable effects in credit markets, it is difficult to say how much deficit reduction would be necessary to avoid crowding out of private investment and other adverse effects of deficits. Elimination of the noncyclical, or "structural," component of the deficit--that is, the part of it not caused by recession--is favored by many. However, there are many possible definitions of structural deficits. (Chapter IV describes four such measures and provides deficit estimates for each.)

With the projected actual deficit at $267 billion in fiscal year 1988, CBO has calculated that the deficit reduction necessary to achieve a balanced structural deficit in that year ranges between $115 billion and $260 billion, depending on which definition of structural deficit one chooses. By any reasonable measure, the elimination of the noncyclical deficit in fiscal year 1988 would be a major undertaking. Even achieving a minimum target of a downward trend in projected deficits during the recovery would take substantial policy changes.

In a companion publication, CBO reviews numerous possible program changes that would reduce the deficit. 2/ A substantial reduction would require that no major component of the budget be exempt from change. Cuts in defense and entitlement programs, as well as some increase in taxes, would be necessary to start the deficit on a downward trend.

The overall economic impact of deficit-reducing measures would depend critically on monetary policy. Many analysts believe that deficit-reducing measures in combination with a moderately accommodative monetary policy would reduce the likelihood of crowding out investment and

---

2/ Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (February 1983).

would significantly improve long-run economic growth without significant inflationary effects. There is always a risk, however, that policy may become too expansive and generate higher inflation.

CONCLUSION

It is now widely agreed that spending cuts and tax increases will be needed to reduce the projected deficits to acceptable levels when the economy is recovered. If the recovery is more vigorous than projected by CBO, the deficit will be lower and it will be easier to attain this goal. On the other hand, if the economy does not recover as quickly as projected by CBO, the deficits will be larger. In this circumstance, it may be desirable to delay for a time the implementation of spending cuts and tax increases in order to avoid adverse affects on the recovery with accompanying hardships for many people. Ultimately, however, the deficit will have to be reduced in order to avoid crowding out private investment.

CHAPTER II. THE ECONOMIC SITUATION

The current recession is now the worst since the Depression. In the fourth quarter of 1982, unemployment was close to 11 percent, and manufacturers used less than 68 percent of capacity. The recession began in July 1981, after an incomplete recovery from the 1980 recession, and has lasted longer than any other recession since World War II. Inflation, however, has fallen substantially over the past two years--the growth of the fixed-weight GNP deflator dropped from 10.3 percent in 1980 to only 5 percent in 1982, and other measures decelerated similarly (see Figure 2).

Four major economic developments contributed to the current situation:

- The direction of monetary policy changed in 1979. Before 1979, the Federal Reserve Board emphasized controlling credit conditions (that is, interest rates) in an attempt to achieve orderly financial markets and economic growth. By the end of 1979, as the nation became convinced of the overriding importance of inflation control, the emphasis shifted to restricting the growth of the money supply. This change of emphasis occurred in other countries as well. The money growth set by the Federal Reserve Board has achieved a substantial reduction in inflation, but has also contributed to record high interest rates, which produced a deep recession.

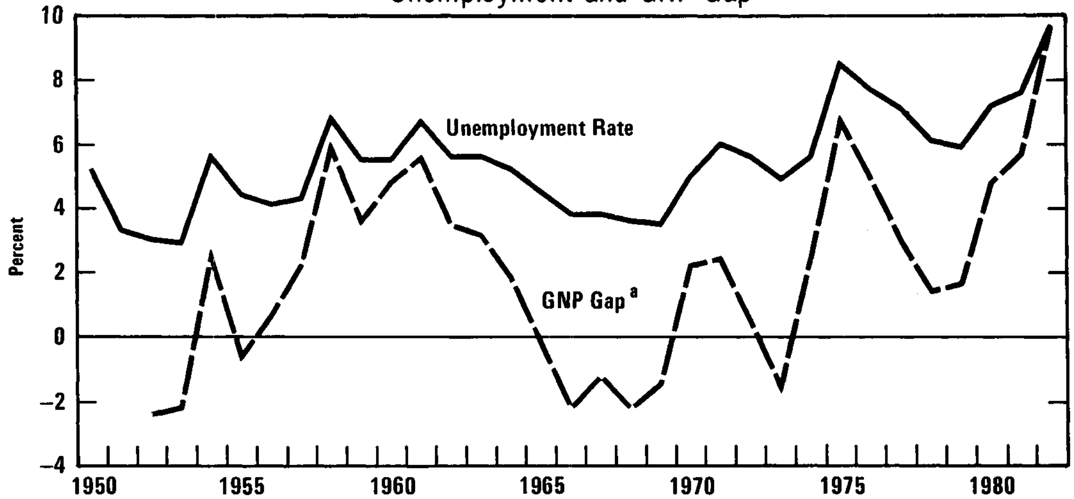
- Oil prices, which contributed two large inflationary shocks to the economy in the 1970s, have been flat or falling since 1980. The big increase in oil prices in 1979 was a major factor in inflation at the time the Federal Reserve decided to give priority to controlling inflation. That decision, together with the recession overseas, has helped to hold down oil prices since 1980. The result has been a substantial reduction in the contribution of oil prices to inflation, and wide swings in the flows of money between oil producers and the rest of the world.

- The federal budget became less stimulative in 1981, but fiscal policy changes were being put in place that implied massive increases in projected federal deficits in the future. In the context of a tight anti-inflationary limitation on the supply of credit, this projected increase in federal borrowing, far beyond

Figure 2.

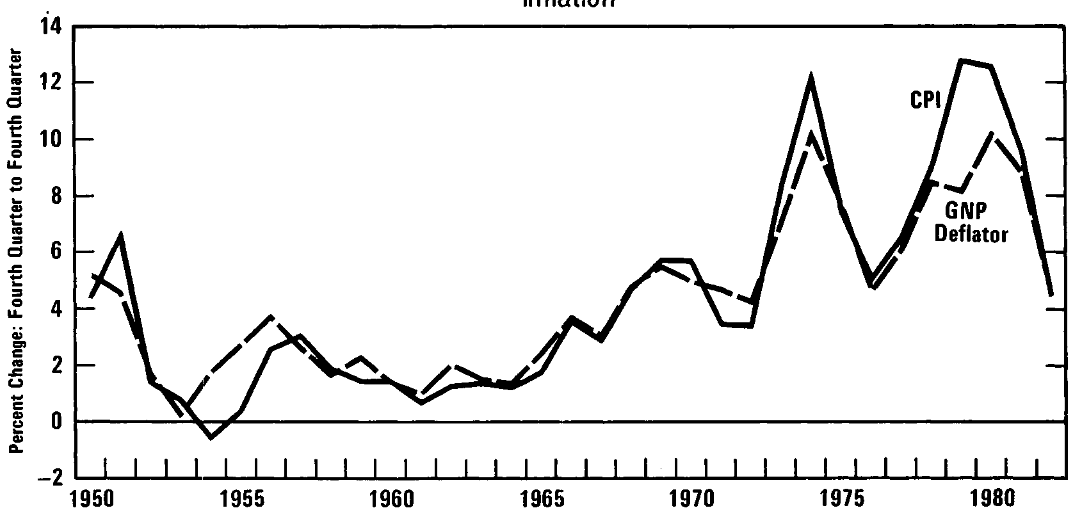
Measures of Economic Performance

Unemployment and GNP Gap



[a] Percentage gap between actual and potential real GNP. Potential GNP is as calculated by BEA through 1981, and projected to 1982 at 2.5 percent growth by CBO.

Inflation



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

RECENT FISCAL POLICY CHANGES

The federal budget became more restrictive in 1981. owing to the inflation-induced increase in personal income tax rates. The change in the deficit, measured at standard levels of employment, between 1980 and 1981 amounted to about 0.7 percent of GNP, and thus may have contributed to the downturn in 1981.

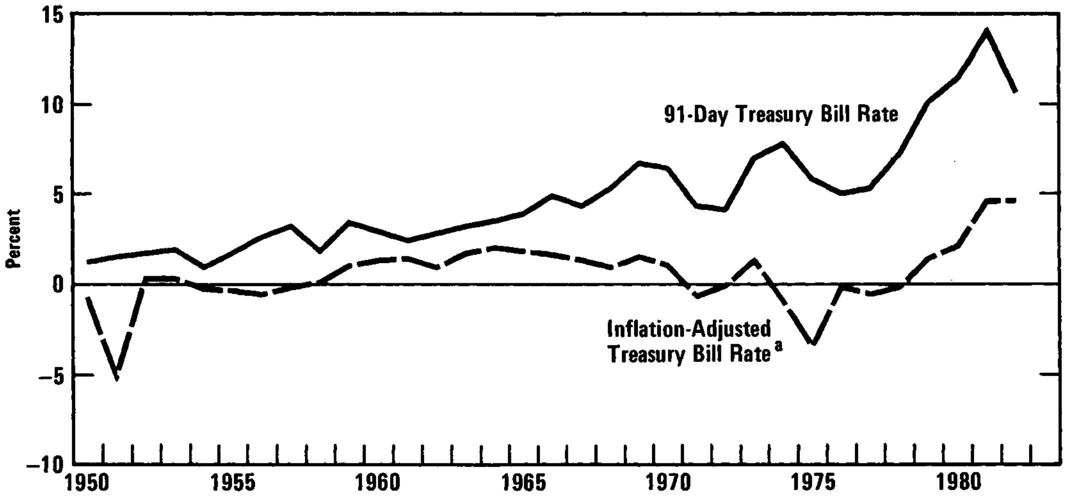
The Economic Recovery Tax Act of 1981 (ERTA) reflected a shift in the goals of fiscal policy toward creating a climate for long-run economic growth. This was thought to require reductions in marginal tax rates, improved incentives for saving and investment. and substantial reductions in the size of the government sector. Taken together, these proposals implied a massive increase in the federal deficit, unless strong economic growth generated a large increase in revenues. Some thought that the ERTA changes would generate higher economic growth in the short run. In fact, instead of rapid growth in 1982 there was a recession and as a result the projected federal deficit has ballooned. The prospect of massive federal credit demands in future years may have contributed to expectations of high interest rates in the future, and along with restricted money growth raised real interest rates in 1981 and 1982.

Recognition of the problems caused by these projected deficits led to the Tax Equity and Fiscal Responsibility Act of 1982, which modified some investment incentives and increased revenues in other ways. This act may have helped, together with a less restrictive monetary policy, to reduce interest rates in the second half of 1982, but still left projected federal deficits at record levels (see Chapter IV).

what can be ascribed to the recession, has contributed to record high real and nominal interest rates over the past two years (see Figure 3).

- The international economy is also in a recession, brought about in part by generally restrictive monetary and fiscal policies in major industrial countries. While these policies have succeeded in reducing inflation significantly, they have contributed to a world-wide contraction in economic activity and trade. Major foreign currencies have been weakened by a "flight to quality" to the U.S. dollar and precious metals, and the developing countries are experiencing severe debt service problems in the wake of high world interest rates and reduced demand for their exports.

Figure 3.
Short-Term Interest Rates



SOURCES: Federal Reserve Board; Congressional Budget Office.

[a] 91-day Treasury bill rate, adjusted for inflation measured by the GNP deflator in the quarter following issue.

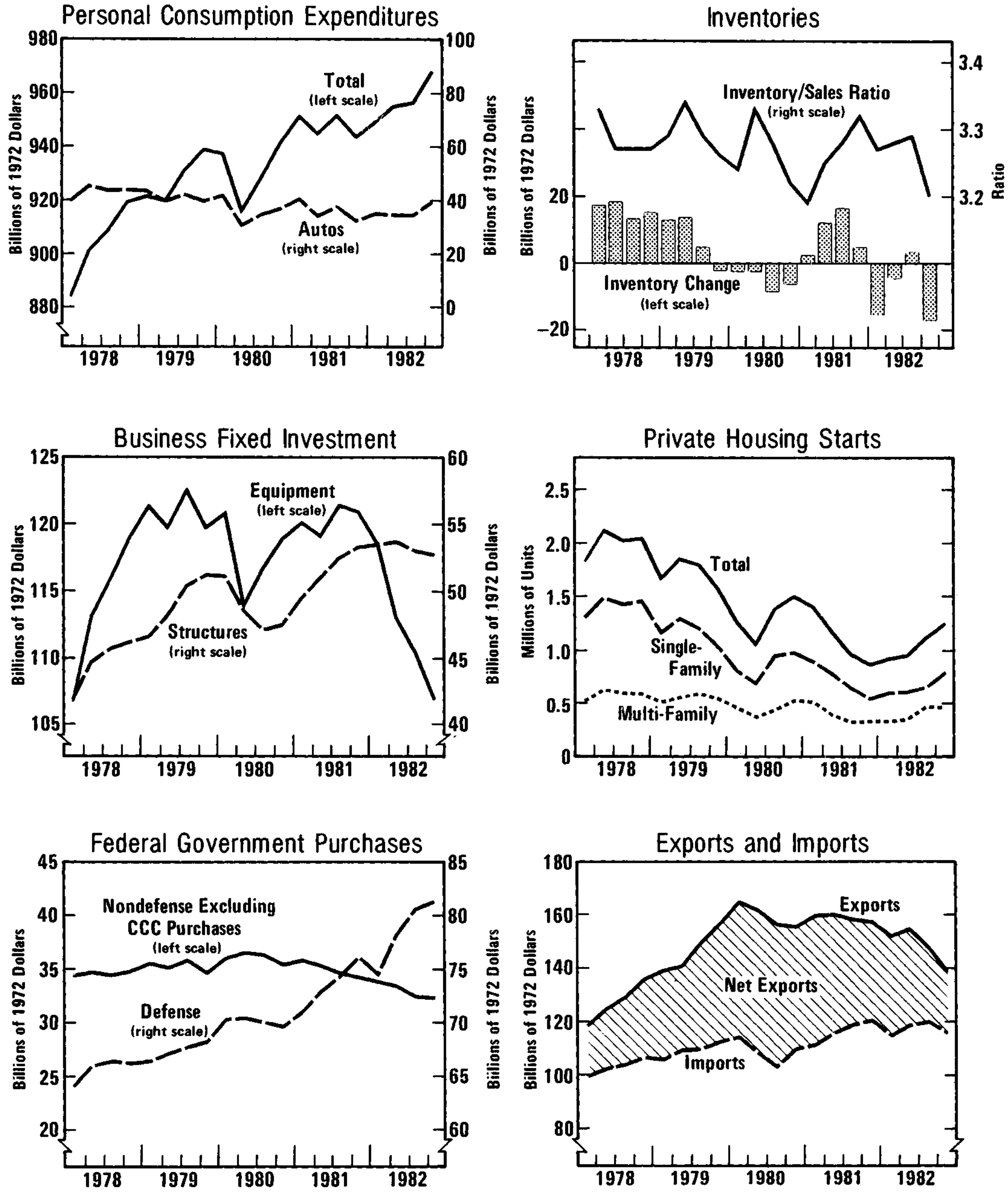
These four developments have brought about, in the United States, a substantial reduction in inflation from the high rates of the late 1970s. This disinflation, however, has been extraordinarily costly in terms of most of the traditional measures of economic success: it has pushed interest rates, unemployment, and bankruptcies to record levels, causing a recession of record magnitude and duration. In terms of the long-run goal of increasing economic growth, the past few years have also been costly because they have discouraged business from investing and individuals from looking for work.

This chapter reviews the factors contributing to the decline in inflation, the costs of this decline in terms of the two recessions since 1979 in the United States and overseas, and the prospects for recovery and economic growth in the remainder of the 1980s.

The current economic situation is summarized in Figure 4, Table 6, and the box on the Economy, which appear on the following pages.

Figure 4.

Components of Real GNP



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis and Bureau of the Census.

TABLE 6. STAGES OF THE RECESSION: CHANGES IN THE COMPONENTS OF REAL GROSS NATIONAL PRODUCT (In billions of 1972 dollars, at annual rates)

	Full Recession (1981:3 to 1982:4)	First Stage (1981:3 to 1982:1)	Second Stage (1982:1 to 1982:3)	Last Stage (1982:4)
Gross National Product	-38.7	-39.7	10.4	-9.4
Inventory Change	-34.2	-31.9	18.8	-21.1
Final Sales	-4.6	-7.8	-8.3	11.5
Consumption	16.6	-2.3	7.2	11.7
Business equipment	-14.5	-2.9	-8.1	-3.5
Business structures	0.1	0.9	-0.5	-0.3
Residential	-1.2	-4.0	0.7	2.2
Defense	7.0	0.2	6.1	0.7
Federal nondefense	5.9	3.3	-4.3	6.9
Excluding CCC	-2.3	-0.8	-1.4	-0.1
State and local	-0.3	-0.8	0.0	0.5
Net Exports	-18.1	-2.3	-9.4	-6.4
Exports	-21.4	-6.1	-4.2	-11.1
Imports	-3.4	-4.0	5.3	-4.7
MEMO:				
Inventory Change Plus CCC Purchases a/	-26.0	-27.7	15.9	-14.1
Final Sales Excluding CCC Purchases	-12.8	-12.0	-5.4	4.5

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Commodity Credit Corporation (CCC) purchases of stocks of farm products are treated conventionally in the National Income and Product Accounts as a component of nondefense purchases and final sales, although they are in many ways similar to inventory-building by farmers.

THE ECONOMY

Two recessions have occurred since 1979. In early 1980, a "credit crunch" caused a short, two-quarter recession. Recovery brought new interest rate increases, and in mid-1981 a new recession. The recession had not ended at the end of 1982.

Inflation dropped dramatically between 1980 and the fourth quarter of 1982: from 12.6 percent to 2.6 percent measured by the CPI, and from 10.9 percent to 5.7 percent measured by the less distorted fixed-weight PCE deflator.

Interest rates, which in 1981 were unprecedentedly high, have fallen in the second half of 1982 in response to an easing of monetary restrictions, measures to reduce the deficit, and international capital flows, but still remain at record levels in relation to current inflation rates.

The current recession started with a sharp downturn from the third quarter of 1981 to the first quarter of 1982. Real GNP fell $40 billion (2.6 percent), of which $32 billion reflected inventory correction. Then, through the third quarter of 1982, the inventory correction slowed and real GNP rose slightly, but net exports and business equipment investment dropped $9 billion and $8 billion respectively. Further inventory adjustment, and a $6 billion fall in real net exports, produced another $9 billion decline in real GNP in the fourth quarter of 1982.

Unemployment reached 10.8 percent at the end of 1982, a postwar record. Discouraged workers were 1.7 percent of the labor force, the highest ever for this measure.

Consumption remained a positive factor through the recession because personal tax cuts offset falling labor incomes.

The inventory swing in the first half of the recession resulted from an adjustment of inventories to very high real interest rates and to the early end of the recovery from the previous recession. Oil inventories fell dramatically, reflecting lower oil demand and expected lower oil prices. Sharp cutbacks in auto and truck inventories, together with CCC purchases of farm products, accounted for most of the $21 billion inventory adjustment in the fourth quarter of 1982.

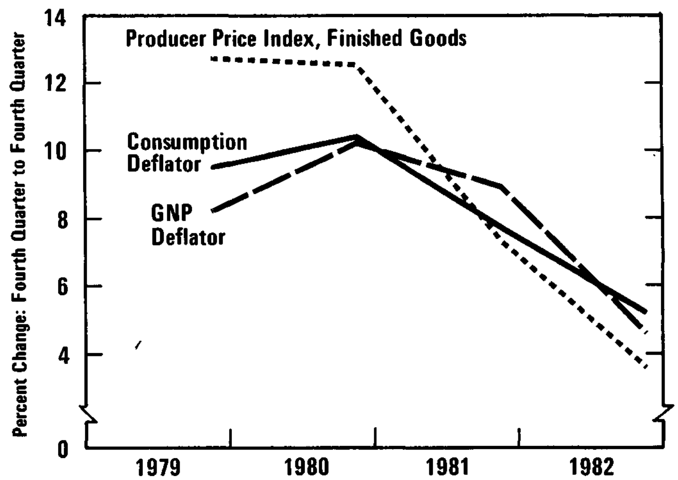
The net export decline reflected a 47 percent appreciation of the dollar since mid-1980, as well as recession overseas. The correction in oil inventories cut oil imports sharply in the first half of the recession. But the oil inventory correction ended in the second quarter of 1982, and real net exports fell $15 billion to the end of 1982. In nominal terms, net exports went from a surplus of $26 billion in 1981 to a deficit of $7 billion in the fourth quarter of 1982.

Business investment stayed strong for a time partly because of forecasts last year that the recovery would start in 1982. Plans were revised down as the recession progressed, and now suggest further declines next year.

Real defense spending rose $7 billion in the last three quarters of 1982, and is likely to be more important from now on.

15-159 O - 83 - 3

Figure 5.
Deceleration in Inflation



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

THE REDUCTION IN INFLATION

By any measure, the reduction in inflation over the past two years has been impressive. Among the commonly used measures of inflation, the Consumer Price Index for all urban consumers (CPI-U), which grew at a 12.6 percent rate during 1980, increased only 4.5 percent during the four quarters of 1982; the fixed-weight deflator for personal consumption expenditures increased 10.9 percent in 1980 and only 5.3 percent in 1982; the fixed-weight GNP deflator, a broad measure of production costs, slowed from 10.3 percent to 5.0 percent over the same period; and the Producer Price Index for finished goods, a narrower measure, decelerated from 12.5 percent to 3.6 percent (Figure 5). The last time GNP inflation was this low was in 1972, when wage and price controls were in effect.

What accounts for the decline in inflation?

- o Wage growth has been slowed substantially.
- o Oil prices have fallen since 1980.
- o The exchange rate, which was falling in the late 1970s, has risen in the 1980s, thus decreasing the price of imports.
- o After a run of bad years in the 1970s, good harvests have brought lower food prices in recent years.
- o House prices and mortgage rates, which previously introduced an upward distortion in the CPI measure of inflation, have recently had the reverse effect.

Wages. The current recession has brought about a substantial reduction in wage growth, which is the main determinant of underlying inflation. The average hourly earnings index over the 12 months of 1982 grew only 5.9 percent, well below the 9.3 percent in 1980. This rate of earnings growth is lower than in any period free from wage controls since 1968.

The slowing of wage growth since 1980 may be overstated by the slowing of the average hourly earnings index. The employment cost index, a better measure that is somewhat broader in coverage and removes the effect of occupational mix on average wages, has decelerated from 9 percent to about 7 percent since 1980, or only two-thirds the deceleration in the average hourly earnings index over the same period (see Table 7). 1/

The current recession differs from other recent recessions in two major respects: unemployment is much higher, and the reduction in inflation--especially in oil, food, and other commodity prices--has been much larger. The high unemployment has undoubtedly been a major factor in slowing the growth of nominal wages, but the process has been made easier by the decline in inflation. In fact, prices have slowed more than nominal wages, and consequently real wages have risen in 1981 and 1982--as they have in previous recessions (see Figure 6). 2/

High unemployment and the increasingly desperate condition of many companies appear to have had a large impact on major collective bargaining agreements, leading to much lower wage and benefit packages than in the past. The change began in 1980, when the Chrysler Corporation persuaded its workers to accept actual pay cuts to avoid bankruptcy. There have since been several major contract reopenings--an almost unprecedented occurrence that has had a significant impact on economy-wide wage statistics.

1/ The average hourly earnings index adjusts for overtime in manufacturing, interindustry employment shifts, and seasonality. The employment cost index adjusts in addition for changes in occupational mix within industries. These occupational mix changes have proved to be important, suggesting that the cyclical movement of the average hourly earnings index is distorted.

2/ The only past periods of substantial declines in real wage rates have been associated with the massive oil price increases since 1970, rather than with recessions and unemployment. See Congressional Budget Office, The Prospects for Economic Recovery (February 1982), Chapter IV.

TABLE 7. MEASURES OF WAGE AND COMPENSATION CHANGE FOR THE NONFARM BUSINESS SECTOR (In percent)

	Year Ending					
	Dec 1978	Dec 1979	Dec 1980	Dec 1981	Sept 1982	Dec 1982
Compensation Change						
Compensation per Man-hour a/	8.9	9.5	10.6	8.8	6.9	6.6
Employment Cost Index b/	N/A	N/A	9.8	9.8	7.2	N/A
Union	N/A	N/A	N/A	10.7	7.9	N/A
Nonunion	N/A	N/A	N/A	9.4	6.7	N/A
Major Collective Bargaining Agreements c/						
First year	8.3	9.0	10.4	11.3	3.3	N/A
Average over life of contract	6.3	6.6	7.1	9.2	2.5	N/A
Wages and Salaries Change						
Average Hourly Earnings Index d/	8.6	8.3	9.3	8.2	6.1	5.9
Employment Cost Index b/	7.6	8.7	9.0	8.8	6.9	N/A
Union	8.0	9.0	10.9	9.6	7.4	N/A
Nonunion	7.6	8.5	8.1	8.5	6.6	N/A
Major Collective Bargaining Agreements e/						
First year	7.6	7.4	9.5	10.1	3.8	N/A
Average over life of contract	6.4	6.0	7.1	8.1	3.5	N/A

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

a/ Quarterly data, not adjusted for overtime or industry, or occupation mix changes.

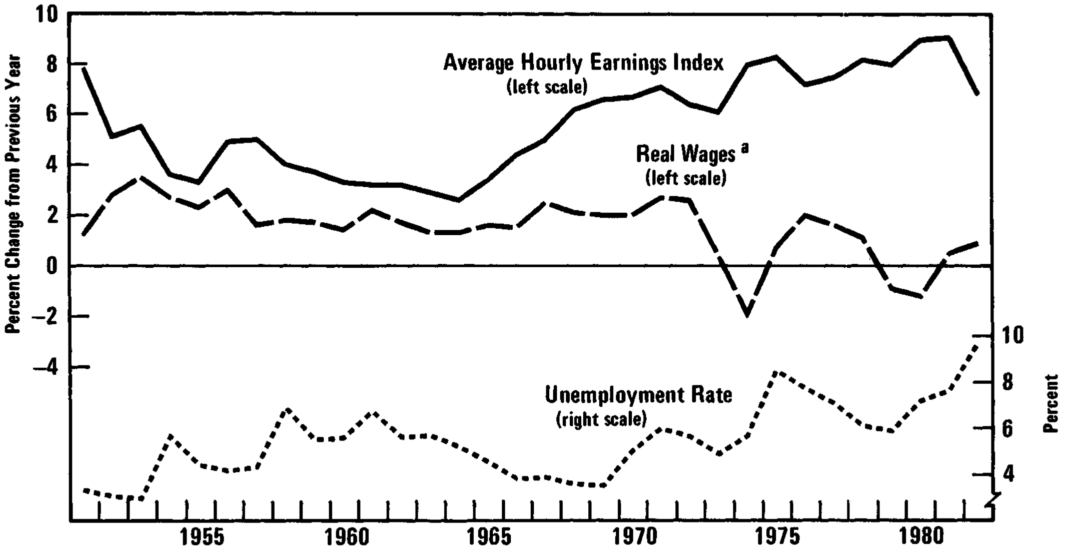
b/ Adjusted for overtime, industry and occupation mix changes.

c/ Settlements in the period covering 5,000 or more workers.

d/ Adjusted for overtime in manufacturing and for industry mix changes.

e/ Settlements in period covering 1,000 or more workers.

Figure 6.
Wages and Unemployment



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

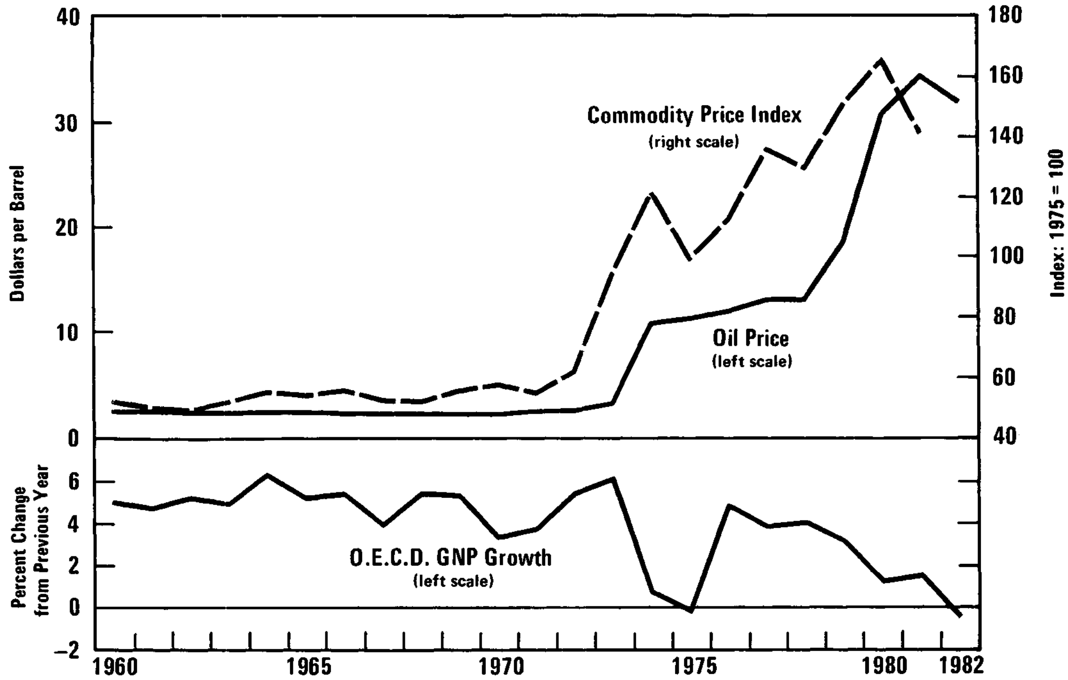
[a] Average hourly earnings index deflated by personal consumption deflator.

These concessions were frequent at the end of 1981 and in the first few months of 1982. Since then, union resistance to further concessions has been reported, and in some cases pressure to roll back previous concessions even in the face of continued high unemployment.

The reduction in wage growth in the major collective bargaining sector has clearly been important, and raises the question whether it represents a permanent change toward more competitive wage rates. The question will not be answered until unemployment rates return to more normal levels: if under those circumstances collectively bargained wages do not accelerate ahead of other wages, it will be clear that an important reduction in wage inflation has been achieved.

Oil Prices. In 1972, the marker price of oil was $2.50 per barrel. The price rose suddenly to about $11.50 per barrel by 1974, and then stayed virtually flat until 1979-1981, when it jumped again to $34 per barrel (see Figure 7). These enormous increases were possible because of the OPEC cartel and because rapid economic growth in the United States and in many other countries had caused the demand for oil, as for other commodities, to press on supply.

Figure 7.
Oil and Commodity Prices



SOURCES: International Monetary Fund; Organization for Economic Cooperation and Development; U.S. Department of Commerce, Bureau of the Census.

Since 1981, the marker price of oil has declined to $33.40, and its value in international markets has dropped to $29.30, despite massive production cutbacks. Saudi Arabian production is currently at about half of its 1979 peak, and Kuwaiti production is at its 1954 level. Other OPEC countries have not shared equally in the cutbacks, but so far at least the major Persian Gulf producers seem willing to accept the reduction in output necessary to maintain OPEC cohesiveness.

Oil prices declined despite lower production because:

- o The dollar has appreciated strongly against the currencies of many countries with which OPEC trades, and the dollar price of goods OPEC imports has fallen. Thus OPEC has been able to permit falling dollar oil prices, while still enjoying increases in its ability to purchase imports. The real price of oil for countries other than the United States has risen, while that for the United States has fallen.

- o The 1979 oil price increases (much larger than those in 1973-1974) set off a new round of oil conservation measures, which will continue as the world's capital stock is replaced by more energy-efficient machines.

- o The worldwide recession itself cut oil demand.

- o High interest rates have meant tremendous increases in the cost of holding oil inventories, and as a result inventory levels have fallen substantially. Oil importers in the United States, for instance, are holding lower stocks than usual and relying on their suppliers to produce more oil to meet increases in demand.

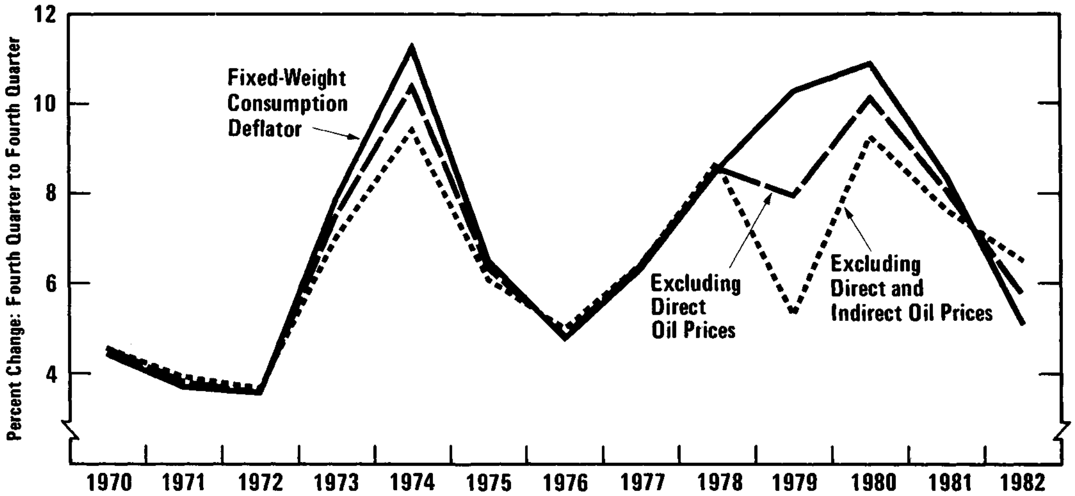
The inventory correction was particularly sharp in the first half of 1982, and pushed spot oil prices down below $30 per barrel, although with emergency production sharing agreements OPEC was able to maintain its official posted price at $34 per barrel for Saudi light. The January 1983, OPEC meeting introduced new production limits. It is not clear, however, whether this agreement, which calls for further substantial cuts in Saudi production, will succeed in preventing possibly large reductions in oil prices in the near future.

The impact of these oil price movements on U.S. consumer prices can be seen in Figure 8. A significant proportion of the changes in consumer prices can be accounted for by the changes in oil prices--both directly in gasoline and fuel oil prices and indirectly in the cost of oil used to produce other things.

Exchange Rates. Another major influence on inflation is movement in exchange rates. Since 1970, when the Bretton Woods system of roughly fixed exchange rates was breaking up, the dollar has followed a roughly U-shaped course against an average of foreign currencies, falling until 1979, flat through 1980, and rising by 47 percent from mid-1980 to the end of 1982 (Figure 9). 3/

3/ The reasons for the appreciation of the dollar are discussed in detail later in this chapter.

Figure 8.
Contribution of Oil Prices to Inflation



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

NOTE: Direct oil prices are prices for fuel oil and gasoline. The contribution of indirect oil prices is assumed to be about as large as that of direct oil prices, since about half of oil consumption is used in the production of goods and services.

Exchange rates affect prices in the U.S. economy through several channels:

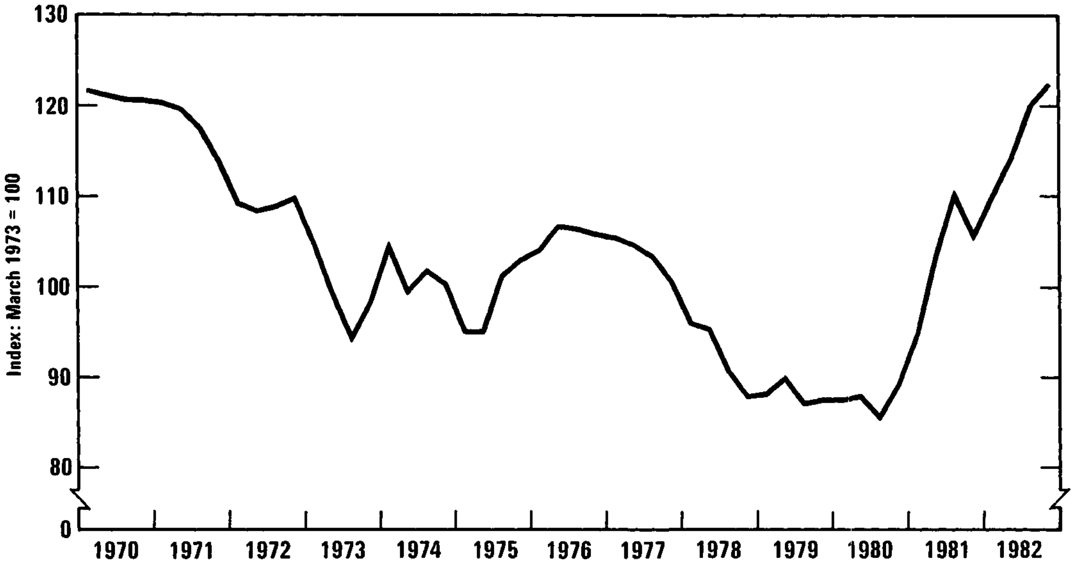
- o An increase in the value of the dollar reduces the rate of increase in the dollar prices of imports. If these relatively lower prices are passed on to consumers, inflation is reduced.

- o Lower prices for imports make them more competitive with domestic goods, helping to reduce domestic prices.

- o A high exchange rate makes it harder to sell goods overseas and therefore increases domestically available supplies and tends to reduce prices.

A commonly used rule of thumb is that a 10 percent appreciation in the exchange rate should reduce U.S. prices by about 1 percent, over a period of one to two years, below what they otherwise would have been. If this rule of thumb is even approximately correct, then the 30 percent appreciation of the dollar from mid-1980 to mid-1981 may have reduced

Figure 9.
Value of the Dollar Against Other Currencies



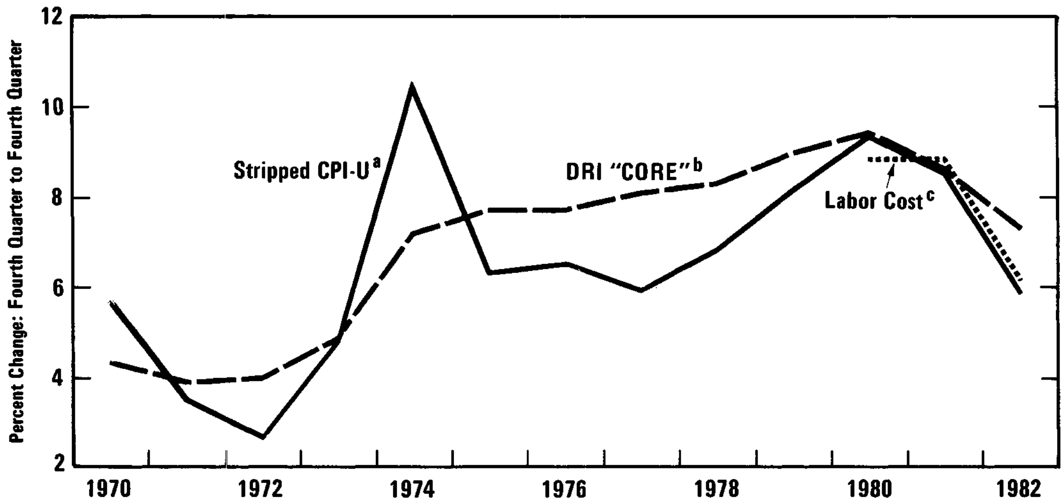
SOURCE: Federal Reserve Board.

U.S. inflation by as much as one percentage point in both 1981 and 1982: the impact of the further appreciation since then presumably has not yet been fully felt.

Food Prices. The last two years, and particularly 1982, have seen remarkable harvests both in the United States and abroad. In contrast to the 1970s, when poor harvests contributed to increasing commodity prices, good harvests have recently tended to hold down the price level.

Underlying Inflation. What is the best measure of inflation? Some of the decline in inflation shown by commonly used measures is spurious. The CPI rose much more in the late 1970s than other measures, and has decelerated more over the past two years (see Figure 2). The reason is well known by now: the treatment of homeownership in the current CPI has tended to overstate inflation whenever house prices rose faster than house rents, and whenever mortgage interest rates increased at all, as they did during much of the 1970s. Since 1981, house prices and interest rates have

Figure 10.
Measures of Underlying Inflation



SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Data Resources Inc.; Congressional Budget Office.

[a]CPI-U less food at home, energy, homeownership, and used cars.

[b]A measure of inflation that excludes components due to price shocks and to varying pressures of demand.

[c]Employment Cost Index, less 1 percent trend productivity growth.

reversed course, causing the CPI to understate inflation in 1982. This distortion has now been corrected in one of the two CPI measures. 4/

One way to avoid the distortions and special factors discussed so far is to look at a measure of underlying inflation--that is, internally generated inflation, excluding the effects of shocks such as oil and food price changes, and excluding distortions such as that created by the treatment of homeownership in the CPI. Figure 10 presents several alternative measures of

---

4/ The CPI for urban consumers now uses an alternative measure of homeownership costs (beginning with the data for January 1983), but the CPI for urban wage and clerical workers, which is used for most cost-of-living adjustments, will continue to use the old measure until 1985.

underlying inflation. All of them tell roughly the same story: inflation has decelerated since 1979, probably by about three percentage points. 5/

THE RECESSIONS OF THE 1980s

By conventional standards, two recessions have already occurred in the 1980s. However, the recovery from the first recession had barely begun before the second recession hit in mid-1981. It is thus convenient to treat the two recessions as a single episode of stagnation, in which there has been on average no growth since early 1979. The period since 1979 has been costly both in terms of unemployment and lost output, and also in terms of the loss of much-needed capital formation.

Lost Output and Unemployment. At the end of 1982, the economy was operating much further below its current capacity than at any time since the Depression. The most dramatic indicator is the unemployment rate, which reached close to 11 percent at the end of the year. A conventional calculation (Okun's Law) of the relationship between unemployment and lost output suggests a gap between actual and potential output of about 12 percent. 6/ An alternative calculation, which assumes that, without a recession, GNP would have grown about 2.5 percent per year since early 1979, when output was close to full capacity, yields a current gap of about 9 percent. This is to be compared with a gap of about 7½ percent at the bottom of the 1975 recession, hitherto the largest, and a gap of about 5½ percent at the bottom of an average postwar recession (see Figure 11).

The loss in output can be traced to the major economic developments with which this chapter began:

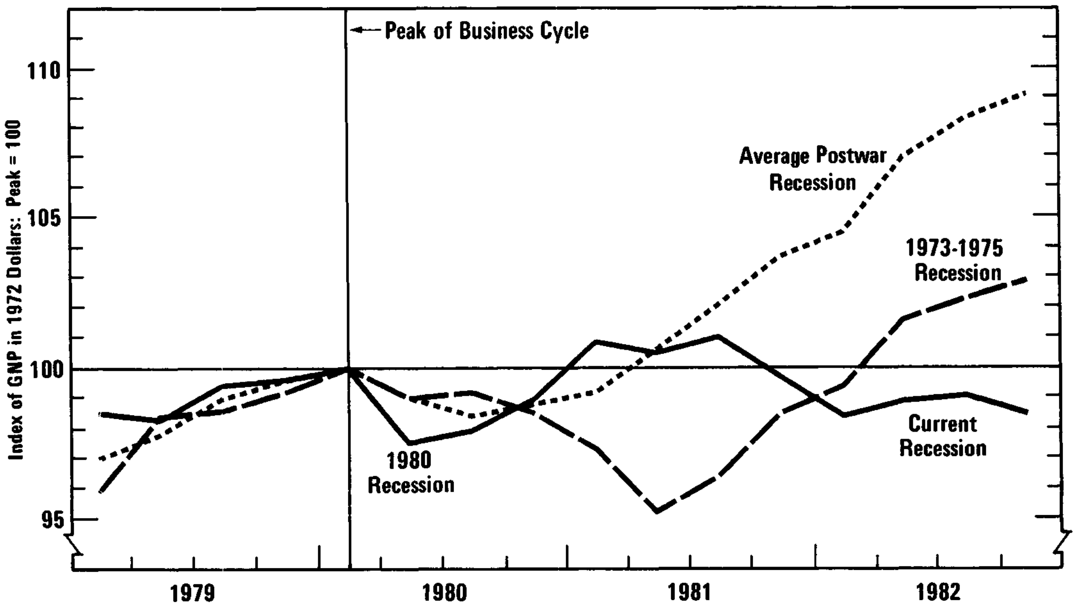
- o The near tripling of oil prices from 1978 to 1980, which transferred an enormous amount of real purchasing power away from the oil importing countries and toward the oil producing countries,

---

5/ The DRI "CORE" measure, which shows a smaller deceleration, is constructed so that it does not react quickly to changes in the inflation rate.

6/ Okun's Law states that unemployment increases by about 0.4 percentage points for each 1 percent shortfall of GNP below potential output. If 6 percent unemployment is regarded as a feasible unemployment rate when the economy is operating at potential, then the current gap is about 12 percent.

Figure 11.
GNP Losses Since 1979—Comparison with Previous Recessions



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

and within the United States away from oil consumers to oil producers. This contributed to the recession, as similar events did in 1973-1975, because of the difficulty of adjusting capital flows and spending patterns to shifts of this magnitude. The shift in purchasing power was much larger than in 1973-1975, but the international financial system was probably better prepared to accommodate it.

- Shifts in fiscal and monetary policy, which brought record high interest rates, discouraging investment in housing, business fixed capital, and durable goods. The housing and auto industries, in particular, have done very badly in the 1980s.

- The world recession, together with a rising U.S. exchange rate, which brought about a dramatic reduction in U.S. net exports. These fell by more than any other final sales component during the current recession.