THE PROSPECTS FOR ECONOMIC RECOVERY

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PREFACE

The Congressional Budget Office 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 in an environment of monetary restraint and fiscal stimulus. Part II, Baseline Budget Projections for Fiscal Years 1983-1987, provides a baseline for the consideration of multiyear budget options and estimates the sensitivity of budget estimates to economic assumptions. Part III, Reducing the Federal Deficit: Strategies and 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.

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CONTENTS

TABLES

TABLES CONTINUED

FIGURES

Page

FIGURES CONTINUED

Page

SUMMARY

In the summer of 1981, the U.S. economy entered its second recession in as many years. The downturn was precipitated by a rise in interest rates to levels that exceeded the record rates recorded a year earlier. By the end of 1981, the economy was operating well below capacity and the unemployment rate had risen to near record levels for the postwar period. The volatile, but overall weak growth observed during 1981 was comparable to the experience of the last several years. In fact, the economy has been in a period of weak growth and high inflation since 1978. The most striking illustration of the economic malaise of recent years is the fact that productivity--the source of improved living standards--was barely higher in 1981 than the level attained four years earlier.

Not all economic news was bad in 1981. Inflation remained high by historical standards but it declined substantially from the peak rates of the previous two years. Most of the improvement in inflation was associated with softness in energy and food prices, along with the appreciation of the dollar in foreign exchange markets (which lowered the cost of imported goods), but inflationary pressures have eased in other sectors as well. Moreover, at year end, there were some signs of moderation in wage gains, offering hope for a sustained improvement in inflation.

In 1981, the Administration and the Congress enacted sweeping changes in budget policies that will sharply reduce tax burdens, boost defense spending, and slow the growth of nondefense spending. Because the tax cuts are larger than the spending cuts, federal fiscal policy will provide substantial economic stimulus during the next several years, unless further budget action is taken. At the same time the Federal Reserve, with the encouragement of the Administration, continues to pursue a stringent anti-inflationary policy.

The fiscal stimulus and tight monetary policies are intended to reverse the pattern of no growth and high inflation experienced in recent years. There is great uncertainty, however, as to the outcome of this combination of policies. If inflation remains high, the Federal Reserve's money growth targets may leave little room for growth in economic activity. Fiscal stimulus may also

increase the severity of credit conditions. Without further spending cuts or tax increases, federal deficits are projected to reach still higher levels in future years even if the economic recovery is stronger than projected. As a result, there is a significant risk of an unprecedented "clash" between monetary and fiscal policy that could produce either a flat, no-growth economy or a "go-stop" economy with a spike in interest rates driving the economy into recession once again. Even in the "consensus" forecast that shows a sustained recovery, economic growth rates are projected to be substantially less than in the typical cyclical recovery.

THE BASELINE FORECAST

The Congressional Budget Office (CBO) baseline forecast for 1982 and 1983 incorporates the following policy assumptions:

- Total federal spending on a unified budget basis is assumed to be $740 billion in fiscal year 1982 and $809 billion in fiscal year 1983. 1/

- The baseline forecast incorporates the tax cuts already enacted and assumes no further changes in tax policy.

- The growth in M1 over the next two years is assumed to be near the top end of the Federal Reserve's announced target range. By this measure, the forecast assumes an easing of monetary policy relative to last year.

The forecast also incorporates the following assumptions about food and fuel prices:

- Consumer food prices increase only 6.4 percent in 1982 and 6.9 percent in 1983, less than the overall rate of inflation; and

- The world price of oil remains flat during 1982, and then increases at a rate slightly less than the overall pace of inflation.

1/ For details, see Congressional Budget Office, Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982), Chapter II.

The main features of the CBO baseline economic forecast, shown in Summary Table 1, are:

- The recession is projected to end during the first half of this year. Following the July tax cut, economic growth accelerates. Economic growth is expected to be in the 1.8 to 3.8 percent range over the four quarters of 1982 and in the 2.9 to 4.9 percent range during 1983.

- The unemployment rate is expected to be at very high levels in the near term and to decline only gradually during the recovery. The average unemployment rate is expected to be in the 7.9 to 9.9 percent range for calendar year 1982 and about one percentage point lower for 1983.

- Interest rates are projected to rise during the recovery, with the average of the three-month Treasury bill rate in the 11.0 to 13.0 percent range for calendar year 1982 and in the 12.2 to 14.2 percent range in calendar year 1983.

SUMMARY TABLE 1. THE CBO BASELINE FORECAST

	Actual	Projected	
Economic Variable	1980:4 to 1981:4	1981:4 to 1982:4	1982:4 to 1983:4
Nominal GNP (percent change)	9.3	8.3 to 12.3	9.1 to 13.1
Real GNP (percent change)	0.7	1.8 to 3.8	2.9 to 4.9
GNP Implicit Price Deflator (percent change)	8.6	6.2 to 8.2	5.9 to 7.9
Unemployment Rate (calendar year average)	7.6	7.9 to 9.9	7.0 to 9.0
Three-Month Treasury Bill Rate (calendar year average)	14.0	11.0 to 13.0	12.2 to 14.2

The Decline

The recession is not expected to be quite as deep or as long as the average postwar recession. This recession was brought about by a prolonged period of stringent credit conditions that generated a near-record collapse in final demands. Production cutbacks occurred quickly as producers attempted to prevent a rise in inventories. In this way they appear to have avoided a large buildup of inventories that would require a deeper and more prolonged decline in output. As this report goes to press, economic indicators are showing cross-currents sometimes observed before a turning point; there are sketchy but inconclusive indications that the recession will end soon. Nevertheless, the first half of 1982 is not expected to show much growth. CBO's forecast does not anticipate a substantial rise in economic activity until the last half of the year, when the second round of the personal income tax cut will take effect.

It would be unwise, however, to believe that the quarterly pattern of economic growth can be projected with much confidence. Precise projections of quarterly output patterns, especially near turning points, have always been beyond the state of the art. Moreover, the accuracy of forecasting generally appears to have deteriorated recently, partly because of the volatile behavior of interest rates in recent years. The present circumstance is a case in point. Short-term interest rates fell sharply from July to December of last year, as expected during a decline in economic activity, and long-term rates followed beginning in October. But interest rates began rising unexpectedly in mid-December, despite the recession and what appeared to be improved prospects for inflation. While there seems to be no satisfactory explanation for the recent upturn in rates, it is quite clear that they could have a large bearing on the recovery. Indeed, if interest rates fail to decline significantly in the months ahead, a sustained recovery may not materialize this year.

The Recovery

The large tax cuts enacted in 1981, together with more moderate interest rates and declining inflation, bring about the recovery in economic activity in the CBO forecast. Recovery brings a pickup in household demand for durables, particularly for housing and autos, and, in time, a boost to business investment. The projected recovery in these sectors is not strong, however, despite the tax cuts. In fact, the recovery in general is expected to be less vigorous than the typical cyclical upswing.

Why the weak recovery? The reason is that the Federal Reserve's targets for money growth are so restrictive that a sustained period of rapid economic growth is unlikely during the next few years. The Federal Reserve targets seem to be consistent with nominal GNP growth in the 7 to 11 percent range during the next two years. But with inflation expected to be in the 6 to 8 percent range, there appears to be little room for rapid growth in real economic activity. It is possible, of course, that the Federal Reserve will modify its stringent policies, or that historical relationships between money and GNP growth will not hold during the recovery, or that inflation will decline much more rapidly than now seems likely--developments that might be associated with a more vigorous recovery. At the present time, however, the downside risks appear to be much greater.

The Downside Risks

As indicated earlier, the recent rise in interest rates raises uncertainty about the timing of the recovery. There is also considerable chance that the economic recovery, once underway, will not be as favorable as indicated by the CBO forecast. The major uncertainties relate to interest rates and inflation.

Higher Interest Rates. The CBO forecasts a rise in interest rates during the recovery, although rates are not projected to return to the record high levels of the previous two years. Adjusted for inflation, interest rates remain at extremely high levels in the CBO forecast. Nevertheless, some forecasters expect that interest rates will climb well above those levels and, as a result, that economic growth will be weaker than in the CBO forecast.

Interest rates may rise above the levels projected by CBO for many reasons. The Federal Reserve may pursue a more restrictive policy than assumed by CBO, as in fact happened during 1981. Moreover, interest rates may be more sensitive to projected deficits than implied by the CBO forecast. If so, the failure of the Congress and the Administration to enact budget measures involving further spending cuts or tax increases (or both) could have serious adverse effects on the projected recovery in business and residential investment. The risk of higher interest rates also will be greater if the initial stages of the recovery in economic activity are much stronger than projected by CBO. Some anticipate very rapid growth, reflecting the combined effects of a normal cyclical recovery and the fiscal stimulus. Given Federal Reserve policies, the outcome of such a rapid rebound would likely be a "go-stop" growth situation in which sharply rising interest rates again abort the recovery and drive the economy into recession. Such volatile behavior also appears to increase the possibility of financial failures.

Higher Inflation. The second major risk is the possibility that inflation will not decline as in the CBO forecast, either because moderation in wage gains proves more difficult to attain or because of unanticipated price shocks. There is also a chance that the planned buildup in defense spending will encounter serious bottlenecks that boost prices and wages in defense industries, with effects spreading to other sectors. The outcome of such inflationary pressures could be tighter credit conditions (given Federal Reserve policies) and lower real growth. It is also possible, of course, that higher inflation will result from an easing of monetary policy in order to accommodate large federal deficits.

PROSPECTS FOR LONGER-RUN GROWTH

The economic projections for the period after 1983 are subject to even more uncertainty than the short-range forecast. CBO's economic projections for the 1984 to 1987 period are not forecasts of probable economic conditions. They are based on a number of assumptions that point to moderate noncyclical growth with sustained progress in reducing inflation and unemployment.

The distribution and composition of the budget changes enacted last year provide substantial incentives for increased business investment and improvement in economic growth over the longer run.

- The reductions in business taxes significantly increase cash flow and greatly reduce the cost of capital expenditures.

- The high proportion of saving absorbed by investment in owner-occupied homes was encouraged historically by tax laws. But the decrease in business and personal income taxes is expected to reduce (or offset) the tax advantage of home ownership relative to financial investment and investment in productive plant and equipment.

- o The cut in marginal income tax rates, the distribution of the tax cuts, and the special saving incentives (such as the new IRAs) encourage greater personal saving.

- o The reductions in marginal tax rates may also encourage greater work effort, although this particular supply effect is not expected to be large.

- o The change in the composition of federal spending with more emphasis on defense may also favor investment.

However, credit conditions are expected to restrain economic growth. The prospects for easier credit conditions, given Federal Reserve anti-inflationary policies, hinge on the degree of success in reducing inflation. Assuming no price shocks, the key to continued reductions in inflation is a deceleration in production costs--primarily unit labor costs that, in turn, depend on compensation per hour and productivity growth.

CBO's projections for the 1982-1987 period assume steady moderation in wage gains (averaging about one-half percent per year), largely as a result of high unemployment, smaller cost-of-living adjustments, and cuts in personal income taxes. Past experience suggests, however, that a very rapid decline in wage gains is unlikely. In contrast with recent experience, CBO's long-run projections also assume steady gains in productivity (averaging more than 1-1/2 percent per year), but there seems to be no basis for assuming very large gains. Overall, inflation is assumed to decline by more than one-half percentage point per year in the CBO projections through 1987; this is a somewhat more optimistic outcome than anticipated by most commercial forecasters.

Although the CBO long-run projections assume a steady reduction in inflation, credit conditions are assumed to remain tight in the 1984 to 1987 period, given the presumed Federal Reserve policy. Thus, the CBO economic projections through 1987 assume that the increased potential for rapid economic growth resulting from the tax cuts will not be fully realized until after the middle of the decade (see Summary Table 2).

BUDGET PROJECTIONS

The budget estimates associated with CBO's baseline economic projection are shown in the bottom panel of Summary Table 2.

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SUMMARY TABLE 2. ECONOMIC AND BUDGET PROJECTIONS THROUGH 1987

Variables	1981	1982	1983	1984	1985	1986	1987
	Economic Assumptions, Calendar Years						
GNP (percent change)	11.3	7.5	11.9	10.4	9.7	9.4	9.1
Real GNP (percent change)	1.9	-0.1	4.4	3.6	3.5	3.5	3.5
GNP Deflator (percent change)	9.1	7.5	7.3	6.6	6.0	5.7	5.4
CPI (percent change)	10.3	7.5	6.9	6.9	6.4	6.0	5.7
Unemployment Rate (percent)	7.6	8.9	8.0	7.4	7.2	6.9	6.7
Three-Month Treasury Bill Rate (percent)	14.0	12.0	13.2	11.3	9.4	8.7	8.1
	Unified Budget Estimates, Fiscal Years						
Billions of Dollars							
Revenues	603	631	652	701	763	818	882
Outlays	660	740	809	889	971	1,052	1,130
Deficit	58	109	157	188	208	234	248
Percent of GNP							
Revenues	21.1	20.6	19.0	18.5	18.3	18.0	17.7
Outlays	23.1	24.2	23.6	23.5	23.3	23.1	22.7
Deficit	2.0	3.6	4.6	5.0	5.0	5.1	5.0
Percent Growth							
Revenues	16.0	4.6	3.3	7.5	8.8	7.2	7.8
Outlays	13.9	12.1	9.3	9.9	9.2	8.3	7.4

NOTE: The projections for the 1984-1987 period are not forecasts of probable economic conditions. Instead, they are assumptions that point to moderate noncyclical growth with sustained progress in reducing inflation and unemployment. It is uncertain whether the economic progress assumed in these projections can be attained with the prospective trend of money growth and without the enactment of further spending cuts or tax increases to reduce the deficit.