These budget estimates include the tax cuts enacted last year, but no further tax law changes are assumed. The outlay estimates are based on the policies of the second budget resolution for fiscal year 1982, except for the spending cuts not yet enacted. With these assumptions, tax revenues are expected to grow by 46.3 percent while outlays grow by 71.2 percent from 1981 to 1987, resulting in very large and growing federal deficits. It must be emphasized, however, that the budget estimates are subject to a wide margin of error. A very wide range of budget estimates can be projected based solely on alternative economic assumptions. 2/ Nevertheless, the projected rise in the deficits is a matter of serious concern because they are only partially the result of the recession. The projections show deficits rising during the recovery, if actions are not taken to further reduce spending or increase revenues. Such deficits would almost certainly crowd out private investment and, over time, adversely affect long-run growth. They might also re-ignite inflation, particularly if the Federal Reserve decides to adopt an easier policy to accommodate the deficits.

CONCLUSION

The Congress has enacted legislation to encourage investment and long-run economic growth. But the large deficits expected to be produced by present budget policies combined with tight monetary policy have greatly increased the uncertainty of the short-run economic outlook. If financial markets respond to the projected budget deficits or other conditions with substantially higher interest rates than expected by CBO, it is likely that the course of economic activity during the next few years will be less favorable than indicated by the forecast.

Many economists believe that a more coordinated monetary and fiscal policy--essentially, a different mix of policy--would be more favorable for the long-run economic outlook as well. Lower interest rates and smaller federal deficits would encourage residential and business investment over the medium term. The effect on long-run growth would be most favorable if measures adopted to reduce the deficits did not have adverse effects on capital formation.

2/ See Congressional Budget Office Baseline Budget Projections for Fiscal Years 1983-1987 (February 1982), Chapter II.

The policy options available to improve the economic outlook are not easy. One option is to take no actions to reduce projected deficits. If the extreme view of supply-side economics is correct, there will be little cost. In CBO's judgment, however, continued high deficits after the recovery is well under way risk slower long-run growth because large deficits will crowd out private capital spending. In the near term, maintenance of current policy would also risk a serious clash between monetary and fiscal policy and the attendent adverse effects on the economy. A second option is to enact further spending cuts and tax increases (or postpone tax cuts) to reduce the deficit. This would clearly reduce the risk of a monetary-fiscal policy clash and the amount of private investment "crowded out." At the same time, however, it would require sacrifices on the part of many Americans that might be particularly onerous for those who have been adversely affected by the recession. A third option would be to encourage the Federal Reserve to adopt a more expansive monetary policy. This might result in a more vigorous recovery, particularly in sectcrs hard hit by tight credit conditions. Faster growth would also reduce the federal deficit. But an easing of monetary policy, even moderately, might prolong the time required to achieve price stability, while a highly expansionary monetary policy would virtually guarantee accelerating inflation.

THE PROSPECTS FOR ECONOMIC RECOVERY

CHAPTER I. RECENT ECONOMIC DEVELOPMENTS

The American economy is in the midst of its eighth recession in the post-World War II period. In a number of respects, however, the current recession is unique. Unlike many earlier postwar recessions, the decline in real economic activity that began in the summer of 1981 was not preceded by several quarters of rapid, unsustainable real growth. On the contrary, the economy had essentially been moving sideways since January 1981 at a level close to the peak value it attained at the beginning of 1980, and well below the nation's productive potential. Moreover, the economy in 1981 was not buffeted by supply shocks of the sort that figured prominently in the 1973-1975 recession and in the slowdown in economic activity in 1979 and 1980. Indeed, the supply shocks that did occur as a result of the decontrol of domestic oil prices and the hike in Social Security taxes in January 1981 were more than offset by the dip in world oil prices, the slower advance of food prices, the appreciation of the dollar on the world's currency exchanges, and the reduction in the effective cost of capital arising from the capital cost recovery provisions of the Economic Recovery Tax Act of 1981.

The economy was pushed into recession in 1981 because of very restrictive credit conditions. Despite a slowdown in the overall rate of inflation, long-term interest rates rose to record highs over the first nine months of 1981. Early on, the effects of the sharply increased real rates of interest were largely concentrated in a few key sectors, notably housing, autos, and net exports; by late summer 1981, the effects had become more widespread, and the economy moved into recession.

The purpose of this chapter is to review those economic developments that led to the current recession. It begins with a very brief review of the economy since 1978. This historical perspective is important both to an evaluation of the current economic slump and to an assessment of recent changes in U.S. monetary and fiscal policies. The second section of the chapter will provide a more detailed review of domestic and international economic developments during 1981.

A BRIEF REVIEW OF ECONOMIC DEVELOPMENTS SINCE 1978

On several counts, the performance of the economy in recent years has been very disappointing (see Figure 1).

- There has been virtually no growth in real economic activity in over three years. Between the fourth quarter of 1978 and the fourth quarter of 1981, real gross national product (GNP) registered a net increase of only 2 percent.

- This otherwise flat trajectory has been punctuated by highly volatile swings in real economic activity that produced two recessions in as many years--the first in the spring of 1980 and the second beginning in the summer of 1981.

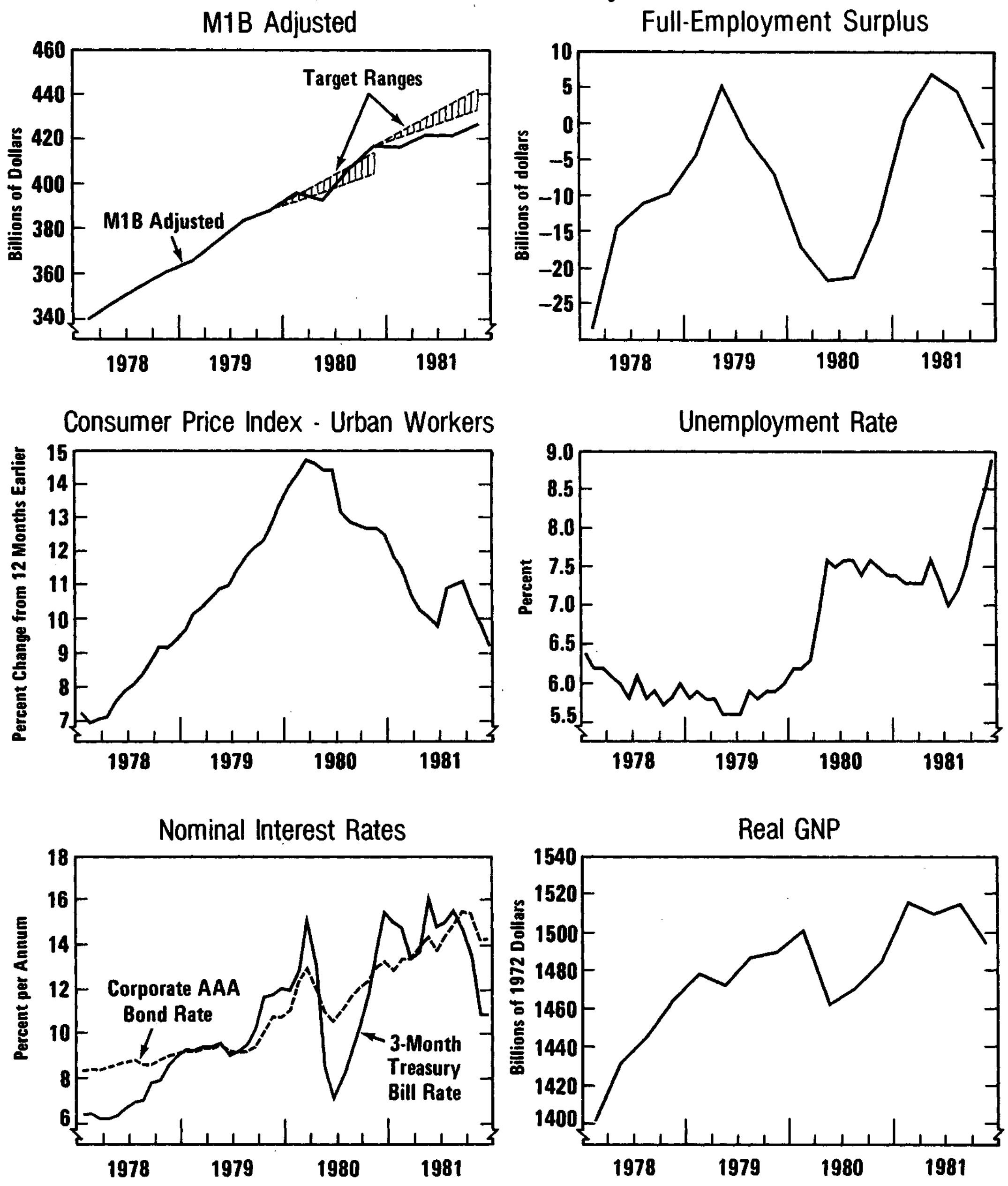
- The unemployment rate has increased markedly over the past three years, from an average rate of 5.8 percent in the fourth quarter of 1978 to an average rate of 8.4 percent in the fourth quarter of 1981.

- Inflationary pressures intensified beginning in 1978, although some moderation occurred during the last year. After rising by 9.0 percent from the fourth quarter of 1977 to the fourth quarter of 1978, the Consumer Price Index accelerated to 12.7 percent and 12.6 percent, respectively, during 1979 and 1980, before declining to 9.5 percent last year.

- Since 1977, there has been no gain in productivity. Not only has this served to aggravate the underlying rate of inflation, it has also contributed to a slowing in the growth of the nation's productive potential.

The generalized stagflation that has plagued the American economy since 1978 is hardly surprising in view of the intensification of inflationary pressures imparted by the OPEC price shocks of 1979 and 1980, and the slower rates of money expansion. The reduced rates of money growth served to limit the rate of growth of nominal GNP. Given the increase in the rate of inflation, most of the rise in nominal GNP was taken up by price increases, leaving little room for any expansion of real economic activity. The growth of real GNP was effectively braked by rising real rates of interest.

Figure 1.
Indicators of Economic Policies and Activity



SOURCES: Federal Reserve System, Board of Governors; U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis; Congressional Budget Office.

Heightened Inflationary Pressures

The near doubling of foreign oil prices in 1979, and the additional 23 percent increase in 1980, caused sharp increases in the general level of prices in those two years. The direct effects of these oil price increases on the rate of inflation were subsequently reinforced by indirect effects. The indirect effects were of two sorts. First, the oil price increases raised production costs and, therewith, the prices of other goods and services. Second, the increase in the overall rate of inflation triggered, with a lag, increases in labor costs as workers attempted to catch up. The lagged adjustment of wages and salaries to cost-of-living increases was largely responsible for the continued strength of underlying inflationary pressures through 1981:

- Three commonly used measures of the underlying rate of inflation--the growth in the "stripped" CPI, the growth in normalized unit labor costs, and DRI's "core" rate of inflation--are provided in Table 1. As is evident, the underlying rate of inflation accelerated sharply in 1979 and again in 1980, leveling off or declining slightly in 1981 to a rate significantly higher than the rate for 1978. This increase in the underlying rate of inflation was largely the result of the passthrough of higher energy prices and increased mortgage interest costs to other goods and services and to labor costs.

The accelerated pace of inflation in the wake of the OPEC price shocks was a major contributing factor to the slowdown in real economic activity after 1978.

- Because U.S. residents were paying more for imported oil, the growth of real domestic income was reduced. This directly restrained the growth of economic activity generally.

- Because the adjustment of wages and salaries to price level increases is sluggish, higher inflation served to erode the growth of real personal income further.

- Income tax "bracket creep" (the rise in tax rates as inflation pushes individuals into higher tax brackets) caused reduced growth in real disposable personal income (and consequently consumer spending). Since 1978, the ratio of individual income taxes to taxable personal income has risen sharply, from 12.9 percent in 1978 to 14.3 percent in 1981. Social Security tax increases added to this drag on income growth.

- o Higher inflation reduced the real value of business depreciation allowances, thereby increasing effective tax rates on corporate income above what they would otherwise be.

TABLE 1. MEASURES OF THE UNDERLYING RATE OF INFLATION (Percent change from one year earlier)

	1978:4	1979:4	1980:4	1981:4
"Stripped" CPI-U	7.3	8.3	10.2	8.1
DRI's "Core" Inflation	8.2	8.9	9.3	8.4 a/
Normalized Unit Labor Costs (Annual data) b/	7.6	8.8	10.1	9.6
Addendum: Derivation of Stripped CPI-U				
CPI-U (All items)	9.0	12.7	12.6	9.6
Energy	7.5	36.5	18.9	12.4
Mortgage Interest Costs	21.1	32.5	27.1	23.9
Food	11.5	10.0	10.3	4.9

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

a/ The fourth-quarter value of DRI's "core" inflation rate is from DRI's forecast of January 25, 1982.

b/ Based on CBO calculations of a compensation index and trend labor productivity. Most empirical evidence supports the view that cyclical variations in productivity growth are discounted in pricing decisions.

Reduced Rates of Money Growth

The restraint on real growth imposed by the inflationary consequences of the OPEC oil price increases was compounded by the strengthened anti-inflationary stance of monetary policy after 1978. Measured fourth quarter over fourth quarter, the growth of the narrowly defined money stock, M1B, slowed in 1979 to a rate of increase of 7.5 percent, down from the 8.2 percent pace of 1978. A modest further reduction in the growth of M1B, to a rate of 7.3 percent, was registered in 1980. In 1981, the growth of M1B was reduced precipitously, to a rate of only 2.1 percent. 1/ 2/

In combination with heightened inflationary pressures, reduced rates of money growth produced volatile and rapidly escalating nominal and real rates of interest in the post-1978 period. Comparing increases in the AAA corporate bond rate to increases in the underlying rate of inflation, for example, it is apparent that real bond rates have increased very sharply since the late 1970s, rising from a rate of about 1 percent at the end of 1979 to around 8 percent at the end of 1981 (see Figure 2). 3/ Although

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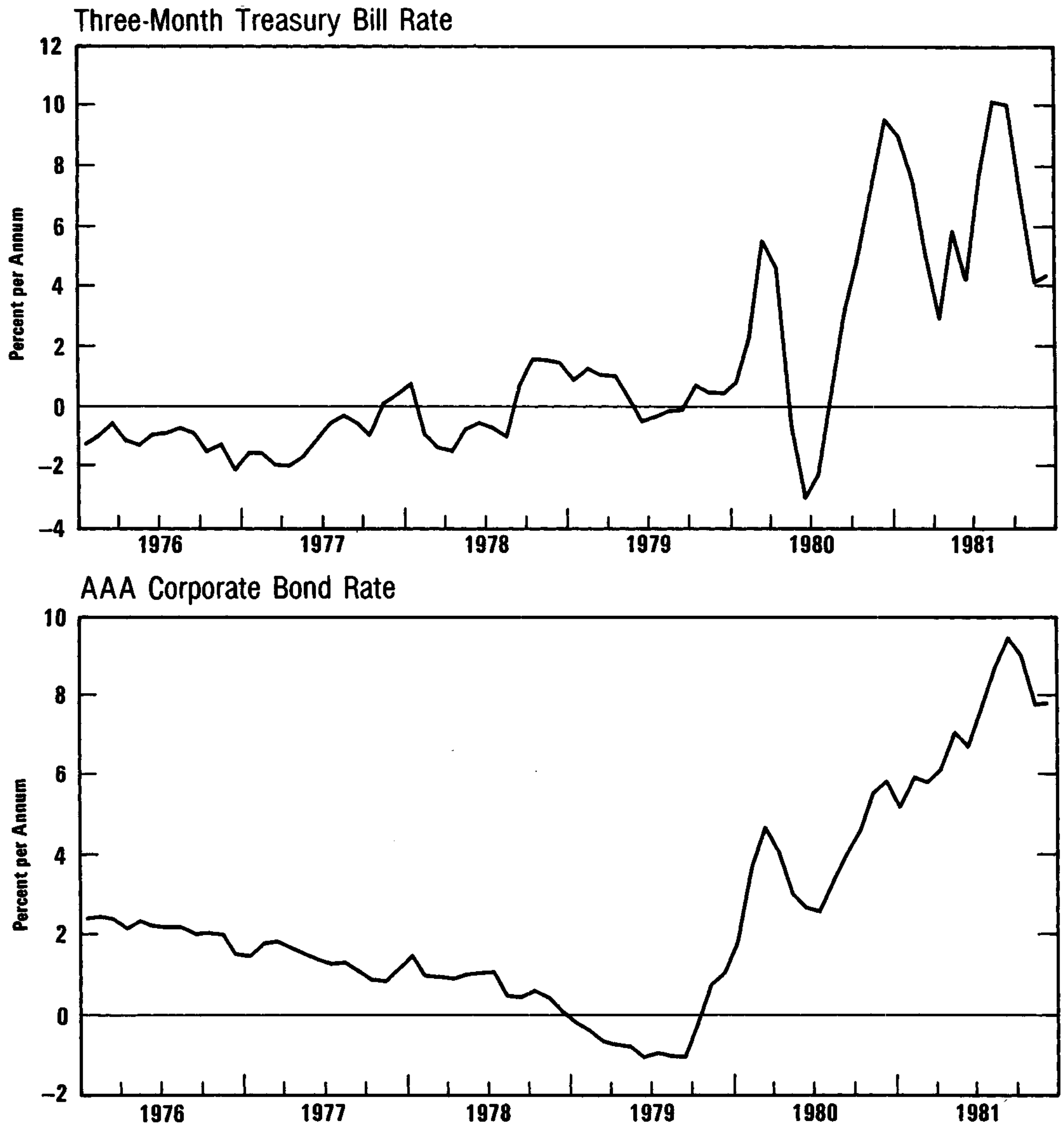
1/ Technically, the 2.1 percent growth figure for 1981 represents the growth rate of "M1B Adjusted." This particular aggregate is defined as M1B adjusted for estimated shifts into NOW accounts from interest-earning assets included in M2. The availability of NOW accounts on a nationwide basis on January 1, 1981, dictated the need to adjust M1B in order to permit meaningful comparisons of the narrowly defined money stock over time. It is appropriate, therefore, to compare the growth of M1B in 1980 and earlier years with the growth of M1B Adjusted in 1981.

2/ Since 1978, there has been almost no deceleration in the rate of growth of M2. This has caused some observers to conclude that monetary policy was less tight in 1981 than is indicated by the growth of M1B. This issue is examined in Chapter II.

3/ Technically, the real rate of interest is the nominal rate of interest minus the expected rate of inflation. The real bill rate is estimated by assuming that the underlying inflation rate realized in any 3-month period equals the rate of inflation expected 3 months earlier. For the real bond rate, it is assumed that the underlying inflation rate realized over a year

Figure 2.
Estimates of Real Interest Rates



NOTE: See text for information about calculation of real interest rates.

SOURCE: Congressional Budget Office.

real short-term interest rates exhibited even more volatility than long-term rates, their trend in recent years has also been sharply upward. This rise in rates served both to aggravate inflation temporarily and to restrain real growth and raise unemployment.

- Rising real rates of interest led to reduced rates of growth of nonresidential fixed investment.

- Residential construction and auto sales were particularly hard hit by the huge increases in real interest rates, especially in 1981.

- The increased demand for dollar-denominated assets on the part of foreign investors seeking higher returns in the United States was an important factor responsible for the sharp appreciation of the dollar on the world's currency exchanges. The appreciation of the dollar, by reducing the dollar price of imported goods and services, helped to slow the pace of domestic inflation, especially in 1981. However, dollar appreciation also slowed U.S. real economic growth by reducing real net exports. The fall-off in real net exports was particularly sharp in 1981.

- Although slower rates of money growth will reduce inflation over time, higher interest rates temporarily aggravated inflationary pressures. First, higher interest rates increased borrowing costs and, therewith, the prices of goods and services generally. Second, because some interest rates are components of the Consumer Price Index (CPI), increased interest rates raised the CPI measure of the price level directly. Mortgage rates are the most important interest rate component in the CPI. Over the course of 1981, the 2.4 percentage-point increase in

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3/ (Continued)

equals the rate expected 12 months earlier. (The inflation time horizon for calculating the real bond rate was chosen somewhat arbitrarily. However, estimates of the real bond rate are not very sensitive to variations in the time horizon for inflation.) The underlying inflation measure removes the volatile food, energy, mortgage interest cost, and used car components from the overall CPI-U index. Inflation rates used for 1982 are CBO projections.

closing mortgage rates raised the CPI measure of inflation by 1.9 percentage points more than it would have been otherwise.

Although underlying inflationary pressures remained strong in 1981, propelled forward both by worker efforts to catch up with previous high rates of inflation and by rising mortgage interest costs, the actual measured rate of inflation eased considerably. Indeed, measured year over year, CPI inflation fell by more than three percentage points from 1980 to 1981; and the growth of the Producer Price Index for Finished Goods fell by more than four percentage points. Why then did long-term interest rates continue to rise to record highs over the course of the first nine months of 1981? Simply put, money growth was reduced much more sharply than inflation. The result was sharply increased real rates of interest that ultimately pushed the economy off its near-zero growth path into recession in the second half of the year.

Other Factors in the Post-1978 Period

While slower rates of money growth and heightened inflationary pressures have dominated the economic picture since 1978, other factors have also helped shape the course of economic events.

- The performance of fiscal policy was mixed during these three years. Some traditional measures of fiscal stimulus suggest that the budget had a stimulative influence on the economy. However, as measured by the change in the high-employment budget, fiscal policy was mildly contractionary in 1979 and again in 1981.

- The changes in the high-employment budget tell only part of the fiscal policy story since 1978. First, effective tax rates on personal income rose sharply over this period of time due largely to bracket creep and increased Social Security taxes. Business incomes were also subjected to inflation-induced erosion in the real value of depreciation allowances. Whether, and to what extent, these increases in effective tax rates seriously impaired incentives to work, save, and invest continue to be matters of considerable controversy. Nevertheless, rising effective tax rates inspired the formulation and enactment of the Economic Recovery Tax Act of 1981.

  Second, the actual budget deficit rose to high levels during the last two years. These rising deficits, and the prospect of further increases in future years, are a source of considerable concern in view of the effect they may have in raising interest rates higher than they would be otherwise.

- While the factors responsible for the 1981 recession are reasonably clear, the proximate causes of the brief but sharp recession of 1980, beginning in January of that year and ending in July, are less well understood. The rapid surge in interest rates in late 1979 and early 1980, the by-product of slower money growth and rapid inflation, was undoubtedly a contributing factor. However, the Federal Reserve's credit control program, imposed in mid-March and continued until midsummer, may account for the large decline and quick turnaround in the middle of the year when the controls ended. The brevity of the recession, the shortest in postwar history, is largely attributable to the fact that the decline in real GNP was virtually matched by reduced final sales. Accordingly, excessive inventory accumulation, production curtailment in response, and inventory liquidation--characteristic features of other postwar recessions--were largely absent. The rebound from the recession, therefore, was unusually rapid.

A CLOSER LOOK AT ECONOMIC DEVELOPMENTS IN 1981

Recovery from the 1980 recession proceeded through the fourth quarter of 1980 and into the first month or so of 1981. Thereafter, real growth slowed appreciably. Indeed, the recovery from the 1980 recession stalled and the economy returned to the essentially near-zero growth path that had prevailed since the beginning of 1979. Even zero real growth proved unsustainable, however, and beginning in late summer 1981, the economy once again moved into recession. 4/

The rate of inflation slowed substantially in 1981, the consequence largely of very favorable price developments in the food and energy sectors and the sizable appreciation of the dollar in foreign exchange markets. Although lower inflation would normally have caused reduced rates of interest, the slowdown in

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4/ The National Bureau of Economic Research has designated July 1981 as a cyclical peak; it has yet to date the subsequent trough.

money growth was so sharp that nominal and real rates of interest actually rose to record highs in 1981, declining only modestly late in the year, three months into the recession.

At year's end, the economy was in a "free fall" with cyclical imbalances in several sectors feeding on the cyclical imbalances in others. Thus, the production cutbacks required to correct the initial buildup of inventories in the fall of 1981 were aggravated by the reduced pace of consumer and business spending in response to those production cutbacks (see Figure 3). These interactions have caused some speculation that the current recession will be deep and prolonged. That view is not reflected in the current CBO forecast (presented in Chapter III). Indeed, according to the CBO, the downturn in the economy is likely to bottom out early in 1982. There is risk, of course, that the downturn could be prolonged by worsening financial conditions. The sharp increase in interest rates in recent weeks, following declining interest rates during the fall months, is the source of considerable concern. Barring the continuation of such adverse developments, a protracted decline seems unlikely.

GNP Growth: A Flat First Half

The quarterly pattern of real GNP over 1981 shows that the economy was buffeted by highly volatile swings in activity (see Table 2). In fact, by many measures, the level of economic activity remained essentially constant through at least the first two quarters of 1981, followed in the third and fourth quarters by declines. 5/ Monthly data for real personal consumption expenditures and industrial production confirm this view. Further confirmation is provided by the pattern of change of the unemployment rate during 1981: the unemployment rate remained fairly constant for the first nine months of the year, hovering in the 7.0 to 7.6 percent range; thereafter, the unemployment rate rose sharply, peaking for the year at 8.9 percent in December.

5/ For more detail on the first half of 1981, see Congressional Budget Office, The Economic and Budget Outlook: An Update (September 1981), pp. 7-11.

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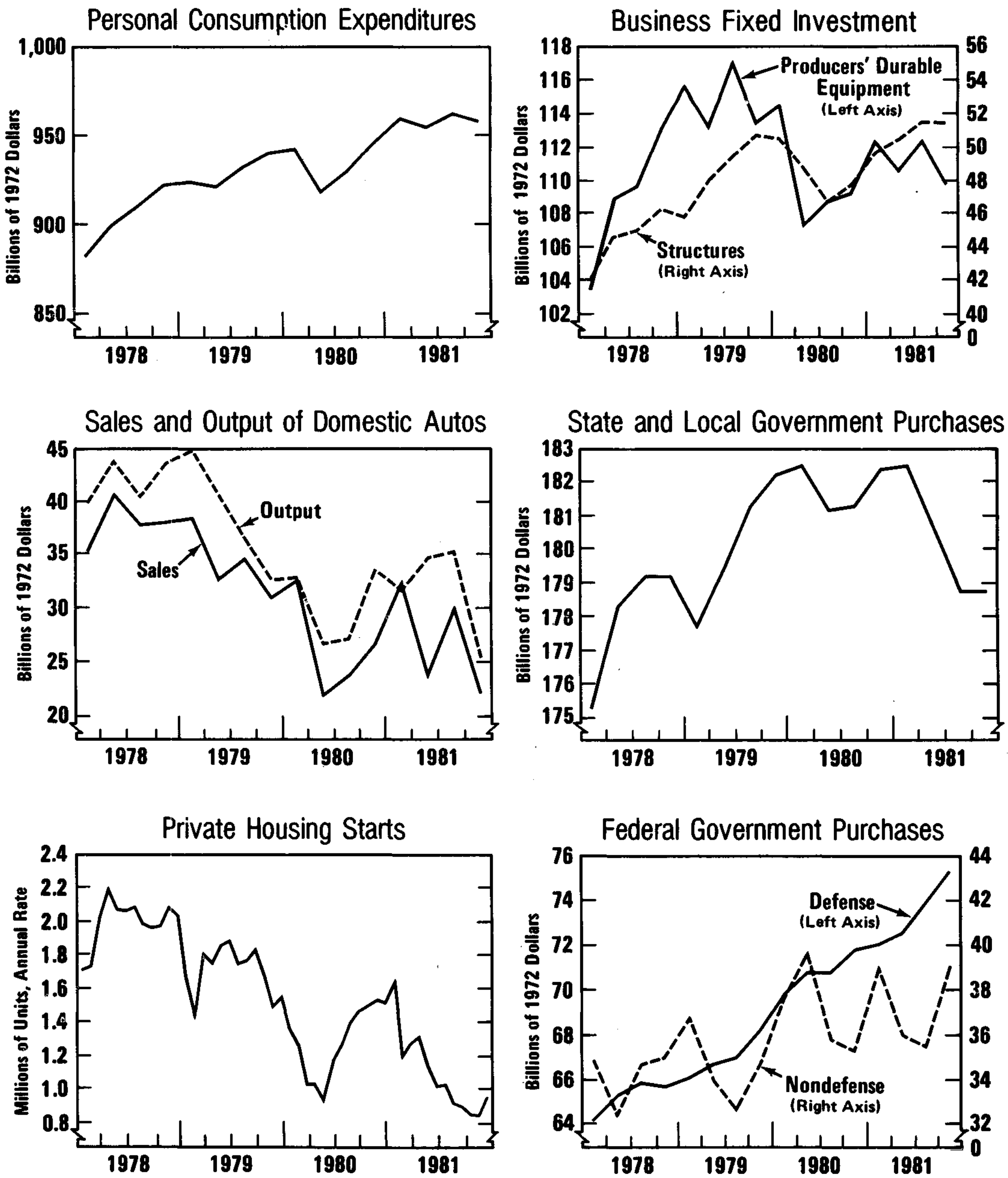
Figure 3.

Components of Final Sales and Output



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

TABLE 2. INDICATORS OF ECONOMIC ACTIVITY (Percent change from previous quarter at seasonally adjusted annual rate, unless otherwise noted)

	1980:4	1981:1	1981:2	1981:3	1981:4
Real GNP	3.8	8.6	-1.6	1.4	-5.2
Final sales	4.4	6.9	-4.7	0.3	-3.6
Personal consumption expenditures	7.0	5.8	-2.1	3.3	-1.8
Durable goods	21.2	24.1	-23.3	8.6	-19.2
New autos	48.6	92.9	-69.1	67.7	-51.4
Nondurable goods	6.3	4.6	2.7	2.1	0.4
Services	3.7	1.4	1.6	2.6	2.2
Fixed investment	15.7	10.8	-7.6	-4.4	-14.4
Nonresidential	4.0	13.3	-2.1	6.9	-10.9
Structures	9.0	16.6	6.7	8.4	-0.4
Producers' durable equipment	1.9	11.8	-5.9	6.3	15.4
New autos	6.1	48.0	-43.6	159.5	-63.8
Residential	64.2	3.6	-23.4	-36.2	-26.9
Government purchases	2.2	5.4	-5.6	-1.5	7.1
Federal	2.0	14.8	-8.4	3.1	19.4
Defense	5.9	1.1	2.6	7.9	7.5
Nondefense	-5.3	46.8	-26.4	-6.1	47.4
State and local	2.3	0.2	-3.8	-4.2	0.1
Exports	-7.4	13.6	-2.3	-3.5	-10.2
Imports	25.8	10.3	14.2	5.5	8.0
Net exports (billions of dollars)	48.5	50.9	46.2	43.2	36.7
Change in business inventories (billions of dollars)	-7.2	-1.4	10.8	14.9	8.5
Real Disposable Personal Income	2.9	3.0	1.4	2.6	1.3
Saving Rate (percent)	5.1	4.6	5.4	5.2	6.0
Industrial Production: Manufacturing Sector	21.6	7.5	2.9	0.3	-18.3
Civilian Labor Force	0.7	2.4	3.7	-1.2	1.4
Unemployment Rate (percent)	7.5	7.3	7.4	7.2	8.4

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

THE BEGINNING OF THE 1981 RECESSION

The sluggish, near-zero growth of real economic activity over the first half of 1981 proved to be unsustainable. In response to weakening final demands, real inventories increased, giving rise to production cutbacks, worker layoffs, and reduced workweeks that apparently continued through December into January of this year.

Unlike most earlier recessions, the decline in real economic activity in the second half of 1981 was not preceded by speculative investment in inventories or capital goods or by several quarters of rapid growth that pushed the economy to its capacity limits. On the contrary, the economy had essentially been drifting sideways since the beginning of the year at a level well below its productive potential. Moreover, the U.S. economy was not forced into recession by external supply shocks of the sort that figured prominently in the 1973-1975 recession and in the slowdown in economic activity in 1979 and 1980. Indeed, the supply shocks that did occur as a result of the decontrol of domestic oil prices and the rise in Social Security taxes in January 1981 were largely, if not completely, offset by the dip in world oil prices, the slower advance of food prices, and the marked appreciation of the dollar on the world's currency exchanges.

The economy was plunged into recession in 1981 because of acutely restrictive credit conditions. Interest rates rose to record levels and money growth was slowed abruptly. Measured from fourth quarter to fourth quarter, M1B Adjusted grew by only 2.1 percent in 1981, down sharply from the 7.3 percent rate of increase recorded in 1980. Importantly, over half the growth of M1B Adjusted occurred in the last two months of 1981.

The reduction in money growth was much sharper than the reduction in inflation in 1981. Thus, despite a slowdown in the overall rate of inflation and a sharply reduced rate of real economic growth--factors that would normally have damped considerably upward pressures on interest rates--long-term interest rates continued to trek upward, albeit at an uneven pace, to record highs over the course of the first nine months of 1981. The coincident slowing in the underlying pace of inflation in 1981 translated these rising nominal interest rates into rapidly escalating real rates of interest. Indeed, the real AAA corporate bond rate rose by about four percentage points between January and its October peak.