The picture is more mixed for Mexico and Canada, the United States' two closest trading partners. Analysts attempting to assess the implications of the peso crisis have revised downward their estimates of Mexico's growth for 1995 and 1996. But the economic situation in Mexico should carry only small implications for overall net exports from the United States (see Box 1-2).

At the same time, the Canadian economy has been expanding very rapidly as its currency has weakened and its restructured export sector has boomed. Export-led growth has compensated for the lackluster domestic demand that is hobbled by the exceptionally high real interest rates required by the condition of Canada's public finances. Growth is expected to moderate during 1995, following the U.S. economy but perhaps also checked by the tightening of fiscal policy, if the Canadian Parliament can agree to a package of measures. Because Canada's economy is still expected to grow faster than the U.S. economy in 1995, its slowdown should not worsen U.S. net exports.

Although the prime factor determining net exports is the relative strength of demand between the domestic and foreign economies, movements in the nominal exchange rate can influence exports and imports over a period of a year or two. The decline of the dollar during 1994, though unexpected, was well within the range of recent experience (see Figure 1-8). The dollar has, however, declined enough to provide a slight lift to exports and a brake on imports.

The United States approved the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) in December 1994, and that agreement is

Box 1-2.
The Currency Crisis in Mexico

Mexico is in the throes of a currency crisis, which has precipitated action on the part of domestic and foreign policymakers to dampen the economic repercussions. Although the crisis is likely to have significant effects on the Mexican economy, the overall effect on the U.S. economy will be small, particularly if stabilizing measures and reforms prove successful.

Before 1994, strong capital inflows, attracted by Mexico's economic reforms (including participation in the North American Free Trade Agreement) and by relatively higher real short-term interest rates, helped to sustain an overvalued peso and finance a large current-account deficit. During 1994, however, concern mounted that the ballooning current-account deficit, rising interest rates in the United States and the rest of the world, and political unrest in the state of Chiapas might lead to a devaluation. As a result, capital began to leave the country. The Mexican government increased interest rates during 1994 in an effort to encourage anxious investors to hold peso-denominated assets. But by December, the market's fears forced down the value of the peso.

Policymakers in Mexico, the United States, Canada, and the Bank of International Settlements have sought to stabilize the situation. President Zedillo has tried to restrain wages, reduce government spending, privatize government enterprises to attract foreign direct investment, and secure a rescue package from the international community. The global rescue package, to which the United States contributed $9 billion, consists of an $18 billion loan to replenish international reserves. In addition, the U.S. government is considering loan guarantees of up to $40 billion to back up commercial bank loans to Mexico.

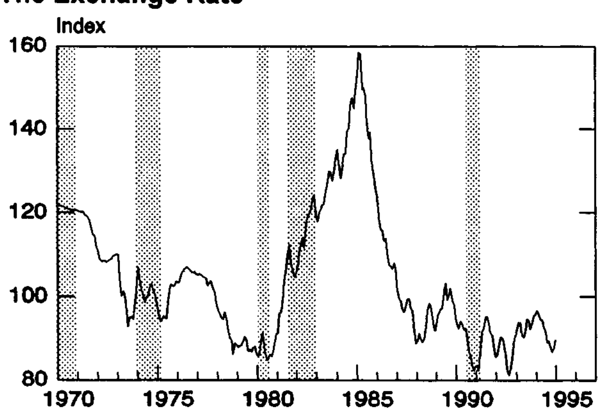
Although the currency crisis in Mexico has had a large impact on individual investors and corporations and will probably depress the growth of the Mexican economy next year, its overall impact for the United States appears to be small. In Mexico, the domestic reform package will require sacrifice in the short term. The policy initiatives mentioned above, along with an attempt to shrink the current-account deficit by 50 percent in 1995, could reduce Mexico's economic growth, and the lower value of the peso will raise import prices and cut the real wage. Because of the trade links between the countries, a sizable share of the reduction in Mexico's current-account deficit should translate into a reduction in U.S. net exports, but that impact should be small compared with the impact of other influences on U.S. net exports.

expected to boost U.S. exports and imports. The reductions in tariffs that will occur in foreign markets will be proportionately greater than those in the more open U.S. markets, and the United States should also benefit from the extensions of GATT's coverage to trade in services and protection for intellectual property rights. However, the agreement will probably produce only a small increase in exports and imports during the next two years. Some other countries still have to ratify the agreement, and the schedules for phasing out the trade restrictions are long enough that more substantial effects will not be realized for several years.

Housing Construction Should Slow. Despite considerable strength during 1994, construction of single-family housing appears to have reached a plateau. The growth of residential investment has been dampened by the rise in interest rates, and many private-sector forecasts of housing for 1995 and 1996 have been scaled back. CBO expects that after having risen by more than 8 percent in both 1993 and 1994, residential investment will fall over the next two years.

Higher mortgage rates have made housing less affordable. A commonly used measure of affordability is calculated as the median family income divided by the annual income needed to qualify for 80 percent fixed-rate financing for a median-priced home,

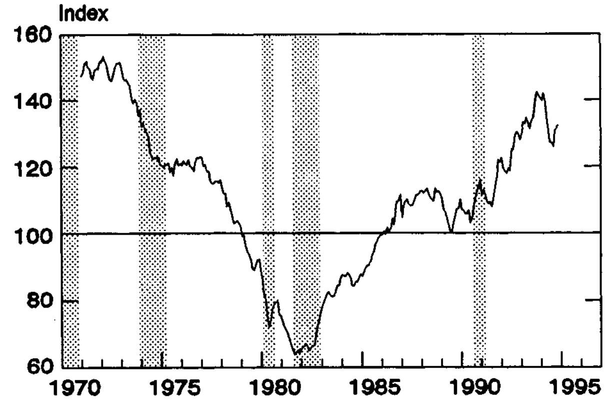
Figure 1-8.
The Exchange Rate



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: The 10-country trade-weighted index equals 100 in March 1973.

Figure 1-9.
Housing Affordability Index



SOURCES: Congressional Budget Office; National Association of Realtors.

NOTE: Figure includes data through November 1994. The index equals 100 when median family income is just sufficient to qualify the family to purchase a median-priced home.

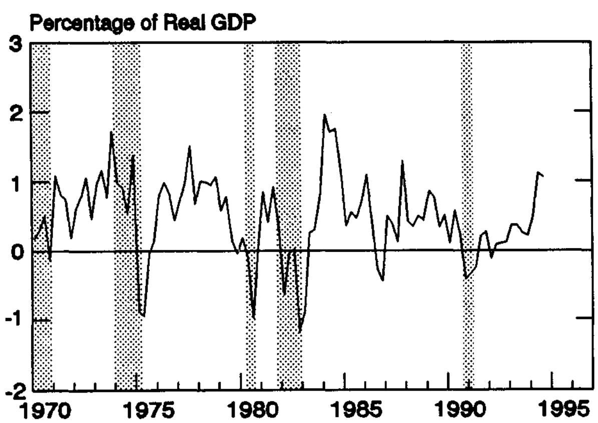
assuming that monthly mortgage payments cannot exceed 25 percent of total income. Fixed-rate mortgages have risen two and a quarter percentage points since late 1993; as a result, the affordability index has fallen more than 10 percentage points from its peak, although it remains significantly above the levels of the 1980s (see Figure 1-9).

The affordability index may overstate the effect of rising rates on demand, however. More widespread use of adjustable-rate mortgages (ARMs) may make demand for housing less sensitive to short-term movements in interest rates than it was in the 1960s and 1970s. As long-term interest rates climbed last year, so did the proportion of new loans originated in the form of ARMs, diluting the adverse effect of the higher rates. In addition, mortgage lenders are offering increasingly favorable terms in the early years of the ARMs, and more lenders appear willing to accept low down payments.

Underlying demographic trends are not likely to bolster the demand for housing during the rest of the 1990s. Even though growth of the population in this decade will be slightly greater than during the past two decades, the number of households will not keep pace. Fewer households will be formed by marriage or by elderly people living independently, and the average number of people in a household will increase. The number of households in the demographic group most likely to constitute first-time homebuyers--the group headed by people between the ages of 25 and 34--has been falling in recent years, a trend that is projected to continue through the end of the century.

The Pace of Inventory Growth Should Slow. Investment in inventories reached a seven-year high in the middle of 1994 (see Figure 1-10). To many analysts, that was a precursor of slower growth; they believed that the accumulation was unplanned and that firms would therefore slow production to bring inventories back in line. Cutbacks in production have not materialized, however, suggesting that inventories are not too high given the pickup in sales that businesses anticipate. CBO expects that inventories will grow more slowly in 1995 than in 1994, and more slowly still in 1996, but that the strong growth in sales projected for 1995 will forestall sharp cuts in production. If sales prove weaker than expected, however, abrupt cuts in production are more likely.

Figure 1-10.
Change in Investment in Inventories



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Wages and Prices Will Not Accelerate Rapidly

As demand continues to outpace capacity, inflationary pressures in the economy will gradually build. The response of wages and prices to excess demand is not, however, instantaneous, in contrast to the oil price shocks that spurred inflation in the 1970s. CBO's forecast for a slowdown in real GDP and for growth in the labor supply presages only a moderate upturn in the growth of wages and in inflation.

Labor costs are by far the largest component of total business costs, and therefore tightness in the labor market is the most important source of inflationary pressures on the prices of goods and services. When the labor market is tight--when unemployment is low--employers have difficulty filling job vacancies at existing wage rates. Because CBO expects the unemployment rate to remain near its current level in 1995 and to rise slightly by the end of 1996 as a result of the economic slowdown that will begin in the second half of 1995, wage inflation will not accelerate much during the forecast period.

An anticipated rebound in the growth of the labor force is one reason the unemployment rate will not decline much further. After having grown very slowly in recent years compared with the 1980s, and much more slowly than CBO expected, the labor force finally showed signs of recovery in the fall of 1994, increasing at an annual rate of 2.0 percent during the last quarter. CBO assumes the labor force will grow 1.8 percent in 1995 and 1.6 percent in 1996. Those rates keep the unemployment rate from falling further despite the forecast for rapid growth in employment during 1995, and the higher number of people seeking work dampens the upward pressure on wages.

Compared with previous late-expansion periods, demand is expected to exceed capacity only modestly in the coming years, and the resulting increase in CPI inflation should be commensurately small. A widely used rule of thumb that describes the inflationary implications of tight labor markets is the so-called point-year rule. If the unemployment rate is below the NAIRU by 1 percentage point for two years (two point-years), CPI inflation rises by 1 percentage point. Thus, with the NAIRU estimated to be 6 percent and the unemployment rate forecast to remain near 5½ percent during 1995, inflation will accelerate by only about one-quarter of a percentage point.

Even though pressures on domestic demand do not seem to justify a big upturn in inflation, inflationary pressures could come from outside the U.S. economy. The general upswing in economic activity worldwide could drive up prices of manufactured goods exported to the United States, or it could further aggravate the price increases in raw materials, commodities such as metals, and petroleum. The falling value of the dollar during most of 1994 might also result in higher prices for imported goods; those prices have not yet shown a significant pickup, however, despite the recovery in Europe and the dollar's decline. Inflation in the economies of most U.S. trading partners is expected to remain mild, and the decline of the dollar was not large enough or prolonged enough to have a significant effect on U.S. prices.

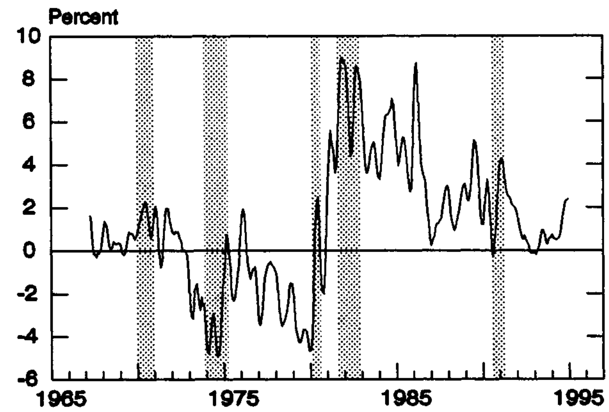
Some commodity price indices rose rapidly in 1994, and a number of analysts see that as a clear harbinger of a sharp increase in inflation. But such indicators are difficult to interpret. Commodity prices generally turn up before the CPI accelerates, but they have also given false signals of inflation. Furthermore, even when the signal is correct, the magnitude of the increase in commodity prices bears little relation to the magnitude of the subsequent increase in the CPI. One widely used index, the *Journal of Commerce* index of 18 commodities, turned upward in December 1993 and by the end of 1994 had risen 17 percent. That index has increased by roughly similar magnitudes six times over the past 30 years, but only three of the increases correctly signaled higher inflation. Therefore, although the commodity price increases of 1994 are important enough to warrant concern, particularly if continued growth in economies worldwide causes further sharp increases, they do not as yet provide strong evidence for a spike in CPI inflation this year.

A Substantial Slowdown in Late 1995 Should Follow Further Rate Hikes

If the economy is as strong as CBO expects during the first half of 1995, the Federal Reserve will probably tighten monetary policy further, which should precipitate a substantial slowdown by the end of 1995. Pointing in that direction are not only the probable strength of the economy but also the level of real interest rates and the slope of the yield curve--that is, the difference between short- and long-term interest rates.

Although real short-term interest rates rose during 1994, they only now are reaching the range in which they are likely to stem the economy's momentum. Real short-term interest rates, which were close to zero during 1993, rose above 2.4 percent in the final months of 1994 (see Figure 1-11). At the end of

Figure 1-11.
Real Short-Term Interest Rates



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

NOTE: The real short-term interest rate is calculated by subtracting from the three-month Treasury bill rate the growth (on an annual basis) of the consumer price index for all urban consumers (CPI-U) over the subsequent three-month period. For the last three months of 1994, however, the real interest rate is based on an estimate of 3 percent growth in the CPI-U for the first three months of 1995. The figure shows a four-month moving average.

the last business cycle in the late 1980s, when the Federal Reserve sought to check inflation as it is doing now, real short-term rates ranged between 3 percent and 4 percent. That level of real rates slowed an economy that was restrained by other forces--the headwinds of businesses' restructuring, defense downsizing, excessive debt burdens, weakened capital positions of banks, and so on. Such negative factors do not affect the underlying strength of the economy today, however, and still higher real interest rates may be necessary to rein in demand.

The shape of the yield curve reinforces that concern. Typically, as monetary policy is tightened near the end of a business cycle, the spread between nominal long-term rates and short-term rates narrows appreciably, mostly through an increase in short-term rates. That tightening raises current and expected real short-term interest rates while possibly reducing the expected inflation built into long-term rates. The spread between the rates on three-month Treasury bills and 10-year notes was about the same in early November as at the start of the year, but it has narrowed noticeably since the Federal Reserve raised the federal funds and discount rates in November. Nevertheless, it remains much wider than during the late-expansion phases of past business cycles. Judging from previous expansions, a rise in short-term rates may further narrow the spread.

Long-term interest rates will probably rise, but not as much as short-term rates. The recent narrowing of the spread between long- and short-term rates suggests that participants in bond markets may believe that monetary policy will soon be sufficiently tight. Moreover, long-term rates already incorporate expectations of stronger growth abroad. For both reasons, long-term rates are probably near their peak.

Even though long-term rates may rise only slightly, past increases, combined with the expected increases in short-term rates, will ultimately cool the pace of consumer and investment spending. Rising interest rates make it harder for consumers to continue making purchases; businesses, faced with the prospect of slowing sales and higher costs of borrowing, are likely to cut back their investment plans.

Risks to the CBO Forecast

This forecast reflects CBO's assessment that the Federal Reserve's preemptive strike will allow economic growth to continue without a significant increase in inflation. But the risks attending such a forecast are considerable.

The predominant risk reflects the uncertainty about how and when the monetary restraint will affect the economy. Will the economy slow before the middle of the year because of the recent rise in interest rates, or will the rapid growth of the past year and a half continue in the face of monetary restraint? If the economy continues to surge ahead, the odds increase that a boom in 1995 will be followed by a recessionary bust. A slowing in the first half of 1995, though possible, is less likely.

Another important uncertainty is whether the economy's potential for noninflationary growth has been over- or underestimated. If overestimated, then continued economic growth could cause inflation to come roaring back by late this year; if underestimated, inflation could remain subdued even with strong growth. In addition, the economy is subject to other uncertainties, such as changes in fiscal policy and in the international environment.

The Federal Reserve's job of providing an appropriate degree of monetary restraint is further complicated by changes in the historical relationships between monetary policy levers and the economy. As a result, the Federal Reserve in recent years has had to shelve monetary aggregates as gauges of the economy. The authorities, moreover, have little experience presiding over recovery and expansion in an arena characterized by the absence of regulated rates at depository institutions, a widely dispersed supply of credit from nonbank institutions, a banking sector operating under new regulations on capital and assets, and more open capital markets worldwide. As a result of such institutional developments, there can be no guarantee that the effectiveness of monetary policy will match that of the past.

A Cycle of Boom and Bust

A boom-and-bust scenario begins with growth that is stronger than expected during 1995, running above 4 percent well into the second half of the year. Such a troubling scenario could occur if the economy's momentum exceeds expectations and if interest rate hikes prove less effective in restraining demand in this business cycle than in previous cycles. Because the Federal Reserve is determined to stifle inflation, growth that is stronger than expected is likely to result in a sharp tightening of monetary policy, as it did in late 1994.

The recent strength in the economy has been supported by spending on consumer durable goods and business investment: if the desired stocks of both durable and investment goods are higher than CBO expects, then spending on those goods will continue to do better than anticipated, despite interest rate hikes. An unexpectedly vigorous economy could fuel further boomlike spending based on robust growth in employment, high levels of confidence among consumers and businesses, and further expansion of credit.

A prominent reason that consumer spending could grow faster than CBO expects comes from the automobile sector, in which, according to some analysts, substantial pent-up demand remains. Given solid growth in both employment and disposable personal income and in the share of disposable income spent on motor vehicles, ownership could rebound toward historical trends--the average age of cars could fall, and the number of vehicles per household could rise.

Higher demand could also be spurred by business investment that is stronger than in previous cycles and continues to surge throughout 1995. Some analysts predict that even after the substantial investment spending of the past two years, businesses could use more plant and equipment. With a healthy outlook for sales and profits, firms may continue to expand capacity, relatively unfettered by the rise in interest rates.

Several features of the economy in the past year have been identified as factors that might delay and reduce the effectiveness of monetary policy. The proliferation of adjustable-rate mortgages in 1994 may have been associated with a delayed, if not a diminished, slowing in residential investment. The exchange rate, running lower than expected, has failed to translate the monetary tightening into a squeeze on demand for U.S. exports. Banks are lending more money, perhaps because the improvement in their balance sheets has allowed them to increase the supply of loans. Equity prices have remained higher than expected in the face of last year's monetary tightening. A larger fall in equities would reduce wealth, thereby slightly slowing the growth of consumer demand.

A Near-Term Slowdown

Alternatively, the economy could begin to slow early in 1995 if recent data have exaggerated its underlying strength--that is, if strong consumer spending and business investment have reflected temporary influences that will just as quickly be reversed. Indeed, advance estimates of retail sales in December 1994 fell back 0.1 percent compared with the Department of Commerce's full-sample estimate for November; in turn, that estimate had been revised sharply downward from its own advance estimate. Unexpected weakness in employment and spending could pour cold water on the confidence consumers and businesses have in the economy's vitality and could reinforce the effects of the interest rate hikes that should already be at work to curtail economic activity.

The prospects for a sharp slowing in consumer spending rest in part on the idea that the recent vigor of consumption, particularly in consumer durables, was buoyed temporarily by the refinancing of home mortgages. Mortgage rates were falling until late 1993, and many homeowners refinanced at lower rates, thus reducing their interest payments. Moreover, some households withdrew equity from their homes at the same time. Hence, refinancing probably enabled many households to buy new cars, furniture, and other durable goods. Refinancing was brought to a halt last year by the increase in long-term interest rates, leading some analysts to argue that consumers' temporary spending binge will also slow soon.

A dramatic drop in investment spending could also follow if the outlook for demand worsened rapidly--for example, if people sharply curtailed their spending. That drop could be amplified by a downswing in the inventory cycle, as businesses cut back on investment in new inventory in response to the unintended accumulation of unsold goods.

The expected downturn in housing activity will deepen if growth in employment slows or some of the vigor of late 1994 turns out to have been borrowed from 1995, perhaps as a result of home buyers attempting to enter the market before rates rose again. Further slowing could also occur if the increases in interest rates during 1994 are more effective than CBO anticipates at reining in spending on consumer durables and business investment early in 1995. The delayed impact of those rate hikes could be compounded if the Federal Reserve tightens monetary policy further in response to unexpectedly rapid growth.

Fiscal Policy Could Change Direction

The 104th Congress could make major changes in fiscal policy, and although any such changes would be unlikely to have major effects on the economy in 1995, they could have an appreciable effect in later years. The Congress appears ready to consider a long-term shift in fiscal policy, judging by its consideration of a balanced budget amendment to the Constitution. Further fiscal tightening is already possible within existing budget procedures, and the Congress may choose to begin a steady path of spending reductions and changes in tax law that, on balance, move the economy toward a balanced budget over the remainder of the decade. (See Box 1-1 on page 8.) The Federal Reserve would, however, take account of additional fiscal tightening and could ease monetary policy to try to avoid a sharp collapse in demand.

A concern of some economists and the bond markets, however, is that fiscal policy could still shift to expansion in 1996. Such a fiscal expansion could occur if the Congress passed broad-based cuts in taxes but failed to offset the resulting revenue losses with sufficient cuts in spending. Some analysts point to the 1980s to highlight the risk that cutting taxes may once again prove to be easier than cutting spending. The Federal Reserve would almost certainly seek to tighten monetary policy in response to any shift toward expansionary fiscal policy, and yields in bond markets could rise.

Uncertainties Lurking in the Global Economy

The international economic and political environment remains a source of uncertainty for economic prospects in the United States. Shocks, both favorable and unfavorable, may be transmitted to the U.S. economy either through trade or through the capital markets.

Net exports offer considerable potential to boost the growth of demand in the U.S. economy. Growth of foreign economies was stronger than expected in 1994 and could exceed expectations again in 1995. That would enhance U.S. net exports, delaying the slowdown of demand in the United States and further straining the available resources of the U.S. economy. A further episode of weakness in the dollar could also spur demand for U.S. output.

Stronger-than-expected demand in the world economy may boost the prices of primary commodities such as agricultural products and minerals, but that need not presage a worldwide rise in general inflation. Many industrialized countries still have capacity for strong expansion in 1995, and in other countries, the monetary authorities have followed the Federal Reserve's moves with prompt tightening of their own.

The main downside risk in the foreign sector may be the political uncertainties that could hamper growth in foreign economies during 1995, resulting in lower-than-expected net exports. Although foreign growth has been strengthening, political turbulence clouds the horizon in many countries and may contribute to poorer economic performance than expected. European economies may be vulnerable to instability or conflict in Russia, the Balkans, and North Africa; in addition, many European governments are experiencing political difficulties at home. Disputes involving China and North Korea may harm the business climate in Asia, and political changes continue in Japan. It is too early to tell how the devastating earthquake will affect Japan's economy and trade.

Closer to home, political uncertainties in Canada, including the status of Quebec, complicate the task of controlling high budget deficits. Mexico still faces political challenges associated with democratization and modernization; more immediately, the effectiveness of its new administration's policy response to the currency crisis remains to be proved (see Box 1-2 on page 11).

Net exports would also be lower than expected if imports from foreign producers captured a larger share of the U.S. market. A strengthening of the dollar--due to lower-than-expected growth and interest rates in foreign economies or, perhaps, to a "safe haven" effect in the event of political turbulence around the world--could improve the competitive position of imported goods. The resulting reduction in the demand for U.S. goods would mitigate inflationary pressure.

International developments can affect the U.S. economy through global capital markets as well as through trade. Increases in worldwide demand tend to raise real interest rates because financial capital is traded in global markets that are largely open. Real global interest rates could also come under pressure if countries that plan to tighten their fiscal positions are unable to reduce their government budget deficits, perhaps for political reasons. At least part of the rise in U.S. bond rates in 1994 reflected increases in real rates that were common to all international markets. If U.S. rates do not move with global rates, the exchange rate may fluctuate: for example, the prospect of higher returns offered in other currencies may have contributed to the unexpected weakness of the dollar during 1994.

Implications of Misestimating the Economy's Potential Output

The level and growth rate of the economy's productive capacity or potential output may be either stronger or weaker than the CBO forecast assumes. The recent strength of business investment may have raised the stock and productivity of existing capital--and so raised potential output--by more than standard measures of capacity indicate. Widespread anecdotal evidence points to increases in productivity resulting from corporate restructuring, and some analysts expect those increase to translate into an economywide rise in the growth rate of productivity. Persistence of slow growth in the labor force, increased regulation, and lower national saving could, however, reduce the economy's potential output.

Changes in the structure of taxation and government spending could also help or hinder the growth of productive capacity through their effects on incentives for labor supply, private saving, and investment. Such effects could have only a small impact on the forecast for 1995 and 1996 but might have a larger impact over a longer period.

In the near term, greater productive capacity could moderate the effects of strong demand on wage and price inflation. Measures of capacity provide the basis for estimates of excess demand. For a given level of demand, higher capacity spells less excess demand and so should translate into lower inflationary pressure; lower capacity spells higher excess demand and greater inflationary pressure. For example, anemic growth in the labor force may prompt employers to bid up wages as new workers become harder to recruit.

Even if the growth of potential GDP turns out to be robust, the Federal Reserve may still seek to keep the growth of spending under control. Federal Reserve Chairman Alan Greenspan has acknowledged that improvements in the economy's productive capacity could be under way, but argued that their impact on the economy would be "evolutionary" and "gradual." With its attention focused on the risk of inflation, the Federal Reserve would need to see strong evidence of improvements in the supply side of the economy before abandoning its restrictive monetary policy.

Comparison of the Forecast with the *Blue Chip* and the CBO Summer Forecasts

The *Blue Chip* consensus, which reflects the average of about 50 private-sector forecasters, indicates a steadier pattern of growth and higher inflation over the next two years than does CBO (see Table 1-3). Those forecasters expect that real growth will be 2.8 percent in the first half of this year, slowing gradually to 2.2 percent by mid-1996. Short-term interest rates increase about the same during the first half of this year as in the CBO forecast. If growth was only slightly above 2½ percent, the Federal Reserve would be less likely to raise interest rates. The *Blue Chip* expects the inflation rate to be higher than does CBO, with prices increasing by 3.5 percent over the four quarters of both 1995 and 1996.

Higher interest rates are the primary difference between CBO's current forecast and last summer's: the outlook for real growth and inflation has changed little. Long-term interest rates are now expected to be almost a full percentage point higher during 1995 than CBO anticipated seven months ago, and the forecast for short-term rates has also been raised. CBO's expectations for real growth over the 1994-1996 period have changed only slightly. Last summer's forecast correctly anticipated the strength of the second half of 1994 and was in line with the current expectation of continued solid growth through the first half of 1995. The current forecast, however, incorporates some weakening in real growth by early 1996 that was not in last summer's forecast. Inflation during the second half of 1994 materialized as predicted, and the current inflation outlook is virtually unchanged.

CBO's Projections for 1997 Through 2000

Real GDP is assumed to grow at an average annual rate of 2.3 percent between 1997 and 2000 (see Tables 1-4 and 1-5). That projection implies that the unemployment rate will average 5.9 percent during that period. Inflation, as measured by the annual rate of change in the CPI, is assumed to average 3.4 percent. The three-month Treasury bill rate, which is forecast to increase between now and mid-1995, is expected to decline gradually during 1996, averaging 5.1 percent for the projection period. The 10-year Treasury note rate averages 6.7 percent.

CBO's projections for 1997 through 2000 do not reflect any attempt to estimate cyclical movements of the economy or the effects of fiscal policy on the year-to-year changes in economic activity. Instead, the projections are designed to approximate the level of economic activity on average, including the possibility of above- or below-average rates of growth, inflation, and interest rates. CBO uses historical relationships to identify trends in fundamental factors underlying the economy, including growth of the labor force, the rate of national saving, and growth of productivity. The projections of variables such as real GDP, inflation, and real interest rates are then based on their historical norms.

The Projection for Growth

CBO projects the path for real GDP by assuming that it will grow smoothly to reach its average historical relationship with potential GDP by 2000. In the current projection, the slowing of growth during late 1995 and early 1996 leaves the gap between GDP and potential GDP only slightly smaller than its historical average at the end of 1996. Therefore, real GDP grows only a shade more slowly than potential GDP--2.3 percent compared with 2.4 percent--in order to restore the gap to its historical average by the end of 2000 (see Figure 1-12 on page 23). That growth leaves the level of real GDP about 0.4 percent below that of potential GDP in 2000, roughly equal

Table 1-3.
Comparison of Forecasts for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast 1995	Forecast 1996
	Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP				
CBO current	5.0	6.3	5.3	4.7
Blue Chip	5.0	6.5	5.7	5.4
CBO Summer 1994	5.4	6.2	5.3	5.0
Real GDP[a]				
CBO current	3.1	3.7	2.5	1.9
Blue Chip	3.1	3.8	2.5	2.2
CBO Summer 1994	3.1	3.6	2.7	2.2
Implicit GDP Deflator				
CBO current	1.8	2.5	2.8	2.8
Blue Chip	1.8	2.6	3.1	3.2
CBO Summer 1994	2.2	2.5	2.5	2.7
Consumer Price Index[b]				
CBO current	2.7	2.8	3.2	3.4
Blue Chip	2.7	2.8	3.5	3.5
CBO Summer 1994	2.7	2.8	3.1	3.3
	Calendar Year Averages (Percent)			
Civilian Unemployment Rate				
CBO current	6.8[c]	6.1	5.5	5.7
Blue Chip	6.8[c]	6.1	5.6	5.7
CBO Summer 1994	6.8[c]	6.2	5.8	5.9
Three-Month Treasury Bill Rate				
CBO current	3.0	4.2	6.2	5.7
Blue Chip	3.0	4.2	6.2	6.1
CBO Summer 1994	3.0	4.1	5.5	5.1
Ten-Year Treasury Note Rate				
CBO current	5.9	7.1	7.7	7.0
Blue Chip[d]	5.9	7.1	7.9	7.6
CBO Summer 1994	5.9	6.8	6.8	6.5

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

NOTE: The *Blue Chip* forecasts through 1996 are based on a survey of 50 private forecasters.

a. Based on constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. The Bureau of Labor Statistics changed the unemployment survey in January 1994. Data for 1993 use pre-1994 methodology.

d. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

to the average historical gap between the two variables. The projected 2.4 percent rate for potential GDP is little changed from last summer's report.

One of three factors underlying CBO's projection for real GDP is the growth rate of the civilian labor force, which CBO assumes will increase at an annual average rate of 1.3 percent between 1994 and 2000, a rate that is unchanged from the summer projection. In its past two reports, CBO has highlighted an unusual decline in the overall labor force participation rate--the percentage of the working-age population that has been or is actively seeking a job--since the 1990 recession. That decline has caused the labor force to grow much more slowly since 1990 than would be expected based on patterns experienced during previous expansions.

The crucial unresolved question is whether the slowdown in the labor force was caused by short-run factors, such as changes in the availability of jobs because of the business cycle, or by a fundamental change in attitudes toward work on the part of some members of the working-age population. Before last summer, CBO assumed that the slowdown in the labor force was a short-run phenomenon and that participation rates would eventually return to their previous trend. The slow growth persisted, however, and CBO accordingly lowered its projection of labor force growth to 1.3 percent. The current projection is the same as that in the summer report.

Table 1-4.
The Economic Forecast and Projections for Calendar Years 1995 Through 2000

	Estimated	Forecast		Projected			
	1994	1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,735	7,127	7,456	7,847	8,256	8,680	9,128
Nominal GDP (Percentage change)	6.2	5.8	4.6	5.3	5.2	5.1	5.2
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
Fixed-Weighted GDP Price Index (Percentage change)	2.7	3.0	3.3	3.4	3.5	3.5	3.5
CPI-U (Percentage change)[a]	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7
Tax Bases (Percentage of GDP)							
Corporate profits	8.0	7.9	7.6	7.4	7.3	7.1	7.0
Other taxable income	20.2	20.4	20.4	20.4	20.5	20.5	20.6
Wage and salary disbursements	48.7	48.9	48.9	48.8	48.7	48.6	48.5
Total	76.8	77.1	76.9	76.7	76.4	76.3	76.1

SOURCE: Congressional Budget Office.

a. CPI-U is the consumer price index for all urban consumers.

Table 1-5.
The Economic Forecast and Projections for Fiscal Years 1995 Through 2000

	Actual	Forecast		Projected			
	1994	1995	1996	1997	1998	1999	2000
Nominal GDP (Billions of dollars)	6,632	7,036	7,370	7,747	8,152	8,572	9,013
Nominal GDP (Percentage change)	5.8	6.1	4.8	5.1	5.2	5.1	5.1
Real GDP (Percentage change)	3.8	3.4	1.9	2.3	2.4	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.0	2.6	2.8	2.8	2.8	2.8	2.8
Fixed-Weighted GDP Price Index (Percentage change)	2.7	2.9	3.3	3.4	3.5	3.5	3.5
CPI-U (Percentage change)[a]	2.6	3.0	3.3	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.3	5.6	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	3.7	5.9	5.9	5.4	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	6.5	7.8	7.2	6.7	6.7	6.7	6.7
Tax Bases (Percentage of GDP)							
Corporate profits	8.1	7.9	7.7	7.5	7.3	7.2	7.0
Other taxable income	20.1	20.4	20.4	20.4	20.5	20.5	20.5
Wage and salary disbursements	48.7	48.8	48.9	48.8	48.7	48.6	48.6
Total	76.8	77.1	77.0	76.7	76.5	76.3	76.1

SOURCE: Congressional Budget Office.

a. CPI-U is the consumer price index for all urban consumers.

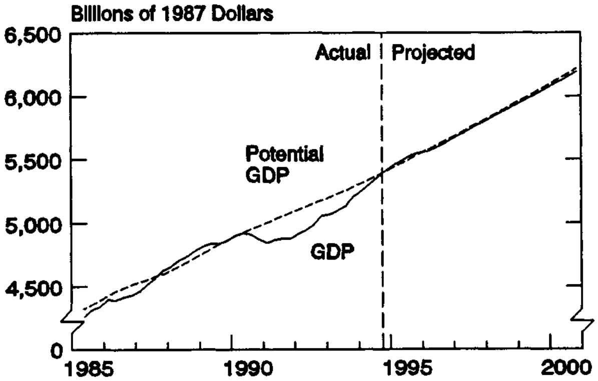
Two other factors that underlie the projection for potential GDP are the rate of national saving and the rate of growth of total factor productivity.[1] CBO projects that the gross rate of national saving, which is composed of private and public saving rates, will average about 13.1 percent during the 1995-2000 period, about 0.1 percentage point higher than was projected last summer. The projection for the rate of growth of total factor productivity is unchanged at 0.7 percent a year.

1. Total factor productivity is a measure of the productivity of both labor and capital. A more comprehensive measure than labor productivity, it is defined as the growth in real output that cannot be attributed to the growth of labor and capital.

The Projection for Inflation

CBO assumes that the forces that cause a modest rise in inflation in 1995 will dissipate and that the rate of inflation will level off by 1996. The rate of unemployment, which falls below the NAIRU in those years, is projected to approach its normal historical relationship with the NAIRU from 1997 through 2000. That level is consistent with a projection of inflation that does not change on average over those years. CBO projects that the CPI will grow at an average rate of 3.4 percent a year. Measured using the GDP deflator, inflation is expected to average 2.8 percent. Those projections are essentially unchanged from last summer's report.

Figure 1-12.
GDP and Potential GDP



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

The Projection for Interest Rates

CBO projects interest rates by combining its projection for inflation with that for real interest rates. Real interest rates are projected by comparing current rates with historical averages and then adjusting for any special factors that make the 1990s different from the postwar period as a whole. For example, deregulation of financial markets, increased federal deficits, and increased international mobility of capital--combined with greater demand for capital among newly industrialized and newly liberalized economies abroad--all tend to boost real rates worldwide, compared with historical averages.

Real 10-year Treasury note rates, using the CPI as the measure of inflation, are assumed to average 3.3 percent from 1997 through 2000, and real three-month rates, 1.7 percent. With CPI inflation averaging 3.4 percent, nominal long-term yields average 6.7 percent, and short-term yields, 5.1 percent.

Chapter Two

The Budget Outlook

The Congressional Budget Office projects that the deficit will decline in 1995 for the third year in a row. But according to CBO projections, that sanguine trend will then stop. Under current taxing and spending policies and under CBO's assumptions about the economy, the deficit will climb again--from $176 billion this year to $207 billion in 1996 and $222 billion in 1998, the last year covered by the discretionary spending caps of the 1993 budget agreement. In relation to the size of the economy (as measured by gross domestic product), the deficit will stubbornly hover around 3 percent for the next five years.

The story told by those numbers is not new. As the 104th Congress convenes, it finds the budget outlook substantially the same as CBO has described for the last year and a half (see Summary Figure 2 on page xv). The last major reshaping of the budget took place in August 1993, when policymakers enacted a package of deficit reductions and reforms in the budget process in the Omnibus Budget Reconciliation Act of 1993 (OBRA-93). Legislation passed since then has had little effect on the budget outlook. Moreover, factors other than legislation that affect budget projections--namely, changes in the economic outlook and other, so-called technical factors--have on balance affected the deficit only slightly.

Budget projections are highly uncertain, of course, and there is no guarantee that CBO's latest projections will come to pass even if the Congress and the President do not enact any significant new legislation affecting the budget. But nothing has happened since August 1993 to undercut fundamentally the message broadcast then--that policymakers had reined in the deficit but were still far from achieving budget balance.

This chapter summarizes CBO's new baseline projections. The baseline shows the outlook for federal revenues, outlays, and the deficit if current taxing and spending policies remain unchanged. It is not a forecast of likely budget outcomes, but is essential for sketching the consequences of today's policies and serves as a benchmark for weighing proposed changes. Crucially, the projections assume continued compliance with the Balanced Budget and Emergency Deficit Control Act of 1985. That law bars lawmakers from increasing the deficit, on balance, through revenue or entitlement legislation and sets stringent limits through 1998 on total appropriations for programs that are funded annually.

The Deficit Outlook

The simplest and most widely used measure of the deficit is the gap between all federal revenues and outlays. Nevertheless, several alternative measures exist, including one that omits the cyclical effects of the economy on the budget and one that excludes spending and revenues that have been designated in law as off-budget.

The Total Deficit and Its Variants

If today's policies remain unchanged, CBO expects the total deficit to reach a low this year before rising

Table 2-1.
CBO Deficit Projections (By fiscal year)

	Actual 1994	1995	1996	1997	1998	1999	2000
	In Billions of Dollars						
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit[a]							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
On-Budget Deficit (Excluding Social Security and Postal Service)							
With discretionary inflation after 1998	259	244	280	303	308	343	381
Without discretionary inflation after 1998	259	244	280	303	308	323	340
Memorandum:							
Deposit Insurance	-7	-16	-9	-5	-5	-3	-3
Cyclical Deficit	23	-8	b	5	6	10	13
Off-Budget Surplus							
Social Security	57	69	73	78	84	90	96
Postal Service	-1	b	b	1	1	b	1
Total, Off-Budget Surplus	56	68	73	79	85	90	97
	As a Percentage of GDP						
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit[a,c]							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a. Excludes the cyclical deficit and deposit insurance.

b. Less than $500 million.

c. Expressed as a percentage of potential gross domestic product.