

TABLE I-6. NET SAVINGS AND INVESTMENT FLOWS
AS PERCENT OF GNP (NIPA basis)

Period	(1) Net Private Domestic Savings	(2) State and Local Surplus	(3) Federal Deficit	(4) Net Domestic Savings Avail- able for Domestic In- vestment: (1) + (2) - (3)	(5) Net Private Domestic Investment	(6) Net Domestic Savings Shortfalls (5) - (4) = Net Foreign Investment
1950-1959	7.5	-0.2	-0.1	7.4	7.5	0.1
1960-1969	8.1	0.0	0.3	7.9	7.1	-0.8
1970-1979	8.1	0.8	1.7	7.1	6.9	-0.3
1980-1985	6.4	1.3	4.0	3.7	4.7	1.0
Average						
1950-1985	7.6	0.4	1.2	6.8	6.7	-0.1
1986-1991 <u>a/</u>	6.4	1.3	1.9	5.8	6.7	0.9

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

- a. Net private domestic savings and state and local surplus are assumed for illustrative purposes to be at their averages for 1980-1985, while net private domestic investment is assumed to be at its 1950-1985 average. The federal deficit is calculated using the Balanced Budget Act targets and assuming the targets are met through spending or tax changes and not through asset sales or changes in lending programs. Columns 4 and 6 are calculated from the other figures.

- o The reduction in capital inflows would allow the exchange rate of the dollar to depreciate further. This depreciation, in turn, would increase the competitiveness of U.S. goods on world markets, improving output and employment in manufacturing and other sectors that have been depressed for several years because of the high dollar.
- o Shrinking deficits will sharply reduce the danger of explosive growth in federal interest payments and the stock of federal debt, far in excess of GNP growth. If this were to occur, it could leave little choice but to monetize a large part of the debt. Hyperinflation would then be almost inevitable.
- o Even without an explosive increase in the debt, some believe that high deficits might induce the Federal Reserve to monetize a larger portion of the federal debt simply to prevent interest rates from being too high. While the evidence of a tendency to monetize debt is inconclusive, the mere possibility may nurture fears of inflation that keep interest rates higher than they would be otherwise.
- o Finally, moving toward a balanced budget will restore a margin of safety should heavy deficit financing of government expenditures become necessary in a war or other national emergency.

Short-Run Effects of Deficit Reductions. While most people agree that a sizable reduction of budget deficits will have a long-term salutary effect on the economy, some analysts fear that such reduction, if done too abruptly, might temporarily weaken the overall economy. Reducing the deficit means reducing federal purchases and transfers and perhaps increasing taxes. Such actions would reduce demands of businesses and individuals whose incomes are reduced directly or indirectly by budget cuts.^{7/} Curtailment of aggregate demand is likely to reduce output and employment in the short run if it is done too quickly. The greatest risk of a temporary slowdown in business activity appears to be in 1987, when the structural deficit is estimated to decline by \$60 billion from the previous year's level, or by 1.5 percent of standardized GNP.

7. These demand reductions could be relatively severe during the next few years because consumers' estimates of their long-term incomes and businesses' estimates of long-term demand for their products might be curtailed relatively sharply by the outlook for repeated federal budget reductions.

In the current situation, however, several factors are likely to mitigate these risks:

- o Some analysts believe that any short-run economic weakening caused by federal budget cuts would be offset by the effect of anticipated multiyear deficit reductions in reducing long-term interest rates. In response to interest-rate declines, business investment and other types of interest-sensitive private spending should increase after some lag. In the current situation, investment spending may be accelerated because the interest-rate declines have come even before any budget cuts have been implemented. (See the interest-rate discussion in the next section.)
- o As fiscal expansion is replaced by fiscal restraint, the trade balance should start improving after some lag. This should eventually help to offset any weakening of the economy.
- o Some observers would add monetary policy to this list, believing that the Federal Reserve should raise the growth of monetary aggregates if the growth of nominal GNP begins to slacken as deficits are reduced. Others believe that the central bank should confine its role to ensuring that the money aggregates are kept growing at a steady pace, letting interest rates go where they will—very probably downward in the face of deficit reduction. Those favoring a more passive role for monetary policy often do so because they think that the aggregate demand effects of fiscal policy changes are very small or because they believe that economists are so ignorant of the relative strength of monetary and fiscal policy and the time lags with which they work that an activist monetary policy is as likely to do harm as good.

Consequences of Fixed Deficit Targets. The passage of the Balanced Budget Act means a dramatic change in the fiscal outlook, not only because it increases the probability that budget deficits will be significantly reduced, but also because it sets firm targets for several years to come. Advocates of such preannounced deficit targets (including a balanced budget) have maintained for years that deficits reinforce the tendency toward excessive growth of federal spending. The cost of debt-financed spending, they argue, is not readily apparent and tends therefore to be discounted by the electorate. The advantage of having deficit targets written into law, according to this view, is that spending initiatives that push the deficit above the mandated target have to be financed with tax increases, and policymakers are reluctant to raise taxes. Thus, deficit targets may impose tighter discipline on budget decisions.

Opponents of fixed deficit targets have stressed that the targets will have the undesirable effect of eliminating the automatic stabilizing effects of cyclical deficits. Deficit increases that result automatically from a slowdown in economic growth are known as "automatic stabilizers" because they help stimulate private spending and cushion the economic slowdown. Firm adherence to deficit targets would do away with the automatic stabilizers. Indeed, the adverse consequences of an economic shock--such as a sudden decline in foreign demand for U.S. exports--could be magnified by a commitment to reduce deficits. It should be noted, however, that the Balanced Budget Act does make it possible for the Congress and the President to suspend the mandated cuts temporarily if a serious slowdown is under way or if a recession is foreseen.

Uncertainties in the Fiscal Policy Outlook. Some observers doubt that the deficit targets of the Balanced Budget Act will be achieved. These doubts arise from the constitutional challenges to the act and the extraordinary magnitude of the required deficit reductions. This skepticism may be keeping long-term interest rates from falling as much as they might have. Moreover, even assuming that the deficit targets will be met, it is not yet known how this will be done. The targets could be met in part through tax increases, or by sequestration. Lack of knowledge about the likelihood, magnitude, and nature of such future policy changes can have an unsettling effect on private decisions to save and invest. Finally, deficits could be reduced by selling federal assets such as Conrail or the Bonneville Power Administration, as the Administration has proposed. But because budget transactions of this sort represent only a change in the ownership of existing assets, they do not have the same effect on aggregate demand as reductions in spending or increases in taxes.

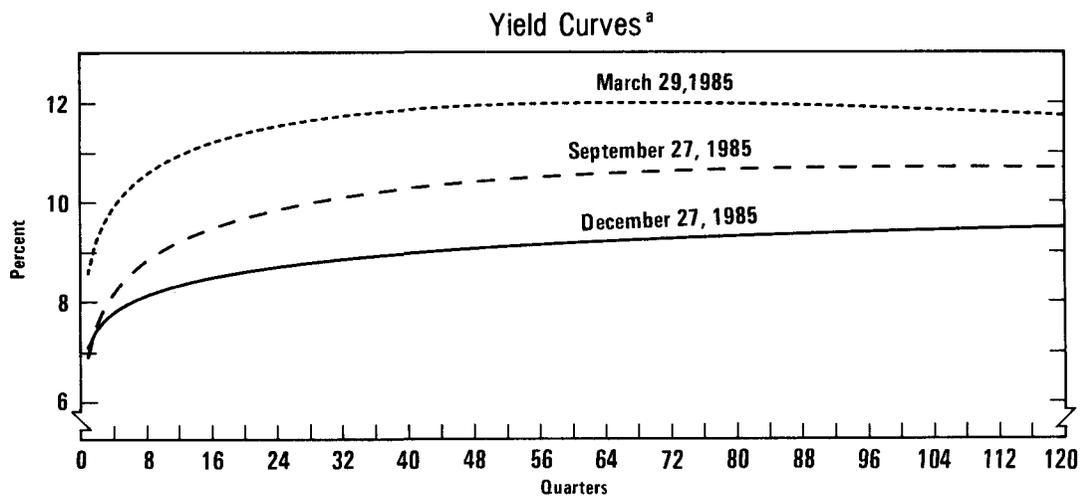
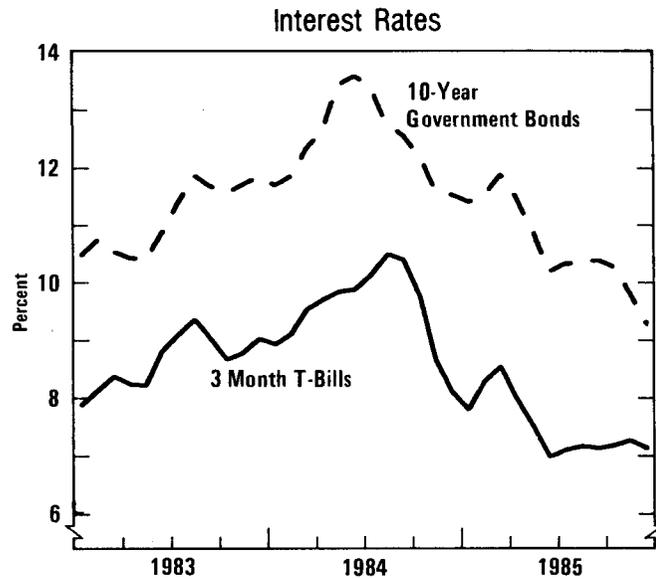
Financial Markets and Monetary Policy

Both long- and short-term interest rates have generally been falling since mid-1984. This prolonged decline, which has left rates at levels not seen since 1980, has reflected a continually expansive monetary policy together with lessening credit demands that result from sluggish economic growth.

More recently, as financial markets began to reflect changes in federal deficit policy, long-term rates have dropped sharply both in absolute terms and relative to their short-term counterparts. Long-term rates fell about 100 basis points between late October and the end of 1985, while short-term rates dropped by only about 15 basis points. The sharp decline in long-term rates has significantly flattened the yield curve and, along with developments in futures markets, it suggests that market participants expect relatively flat short-term rates through the middle of 1986 at least (see Figure I-3).

Bond prices rose almost 20 percent in 1985, paralleling a significant upturn in stock prices. The Standard and Poor's 500 index rose 26.3 percent during 1985, with much of the change coming in the latter part of the year (see Figure I-4). The stock market rally has added significantly to consumers' wealth. This increase in wealth may in part be responsible for the continued underlying strength in consumer spending.

Figure I-3.
Recent Short- and Long-
Term Interest Rate
Movements



SOURCES: Congressional Budget Office; Federal Reserve Board.

^a These curves were fitted to weekly average yields on Treasury instruments using a logarithmic function described by Bradley and Crane in the *Journal of Bank Research*, Spring 1973. The curves were then smoothed by hand.



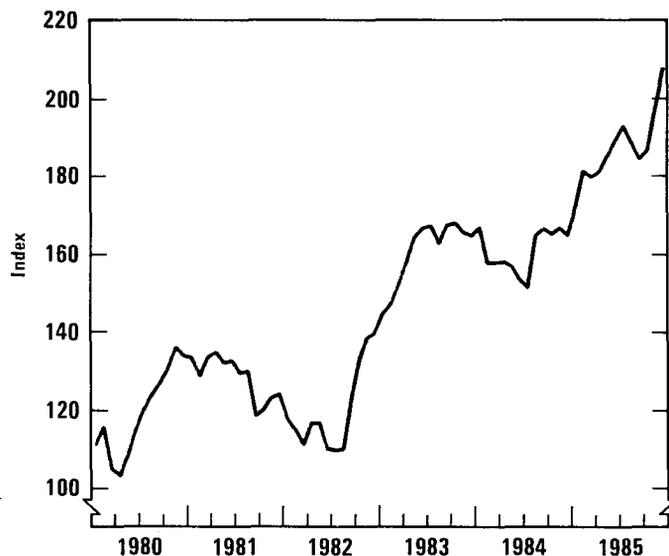
The stock and bond markets could fall sharply if it appeared that the deficit targets in the Balanced Budget Act were not likely to be met. The resulting decline in consumer wealth and the rise in long-term interest rates could place the economic expansion at risk.

Credit Demands. As shown in Table I-7, growth of nonfinancial-sector debt slowed slightly in the third quarter of 1985 (the most recent quarter for which data are available). The slowdown in corporate-sector debt occurred despite a continued surge in mergers. The growth in household debt rose slightly, reflecting continued increases in mortgage and consumer installment credit. The modest slowing in the growth of public-sector debt resulted entirely from federal operations; growth in state and local government debt rose to an annual pace of more than 26 percent.

This surge in state and local debt is not expected to continue in 1986. It appears partly to have been the result of expectations that tax legislation would be passed limiting the tax-preferred status of some state and local debt, to be effective in early 1986. (In fact, no such legislation was passed.) Although federal funding needs in the near term will remain large by historical standards, the Balanced Budget Act is expected to reduce future borrowing sharply. In addition, an expected slowing in merger-related financing should restrain the growth in corporate debt.

Monetary Policy. According to most indicators, monetary policy was expansionary during 1985, as Table I-8 and Figure I-5 show. Strong growth occurred in all of the monetary and reserve aggregates: M1, M2, M3, total

Figure I-4.
Common Stock
Prices (Standard and
Poor's "500")



SOURCES: Congressional Budget Office;
Standard and Poor's Corpora-
tion.

reserves, and the monetary base. The only suggestion of monetary restraint came in the slight widening of the spread between the federal funds rate and the discount rate that occurred late in the year.

As measured by M1, monetary policy has been especially stimulative (Figure I-5). After growing at almost a 13 percent annual pace over the first nine months of last year, M1 fell briefly in October but resumed its rapid rise in subsequent months. This growth left M1 in December about \$15 billion above the upper bound of the Federal Reserve's target range as revised in July, and \$29 billion above the target range established a year ago. On the other hand, M2 and M3 grew much more modestly. After a brief surge above their target ranges in early 1985, both aggregates dropped within their ranges by mid-year, and have remained relatively on course since then. M2 is currently near its upper bound, and M3 is near the middle of its range.

More than one explanation has been offered for the differences in behavior among the money measures. One is that the declining interest-rate spreads between checkable accounts and other deposits have caused investors to shift funds from savings accounts and money market mutual funds into checkable deposits. Another widely cited explanation is that holdings of corporate demand deposits have increased in the wake of last year's check-kiting scandal as firms have tried to avoid any appearance of similar wrongdoing.

TABLE I-7. GROWTH RATES OF CREDIT MARKET DEBT,
NONFINANCIAL SECTORS (Seasonally adjusted
annual rates of change, in percents)

Sector	1984		1985		
	III	IV	I	II	III
Total Debt	11.5	15.2	10.7	11.8	11.4
Private	10.0	13.3	10.5	10.0	10.0
Corporate	11.6	18.2	10.9	9.0	7.1
Household	11.8	13.3	12.6	12.6	13.2
Foreign	-15.0	-0.2	-3.3	-2.5	2.4
Other	11.4	9.7	8.3	8.4	8.2
Public	15.1	19.9	11.5	16.3	14.8
Federal	15.4	19.4	10.5	15.4	11.3
State and local	14.0	21.5	14.8	19.2	26.1

SOURCE: Federal Reserve Board.

The interpretation of monetary policy has also been complicated by a mystery that affects all three of the monetary aggregates: intermittent but steep declines in velocity below its long-run trend. (Velocity is the ratio of GNP to the money stock.) While the drop in velocity is most evident with respect to M1, the M2 and M3 velocities are also low relative to their respective trends (see Figure I-6). These declines in velocity were not predicted, nor have they been successfully explained. As a result, the usefulness of the monetary aggregates in formulating or interpreting monetary policy has been at least temporarily undermined.

Previous CBO analyses have suggested that the decline in velocity in 1981-1983 may have partly reflected several factors: an increase in precautionary balances during the recession; the sharp drop in inflation and interest rates; and an increase in the interest sensitivity of M1 brought about by deregulation of interest on deposits. The more recent velocity drop in 1985 can be explained in part by a further decline in interest rates, and by an increase in transactions that require increased money balances but do not contribute to GNP: a rise in imports relative to domestic production, and an increase in transactions involving financial assets. Unfortunately, while all of these explanations have merit, quantitative studies suggest that they leave much of the decline in velocity unaccounted for.

TABLE I-8. SELECTED MONETARY POLICY MEASURES
(Seasonally adjusted annual rates of change,
in percents, unless otherwise noted)

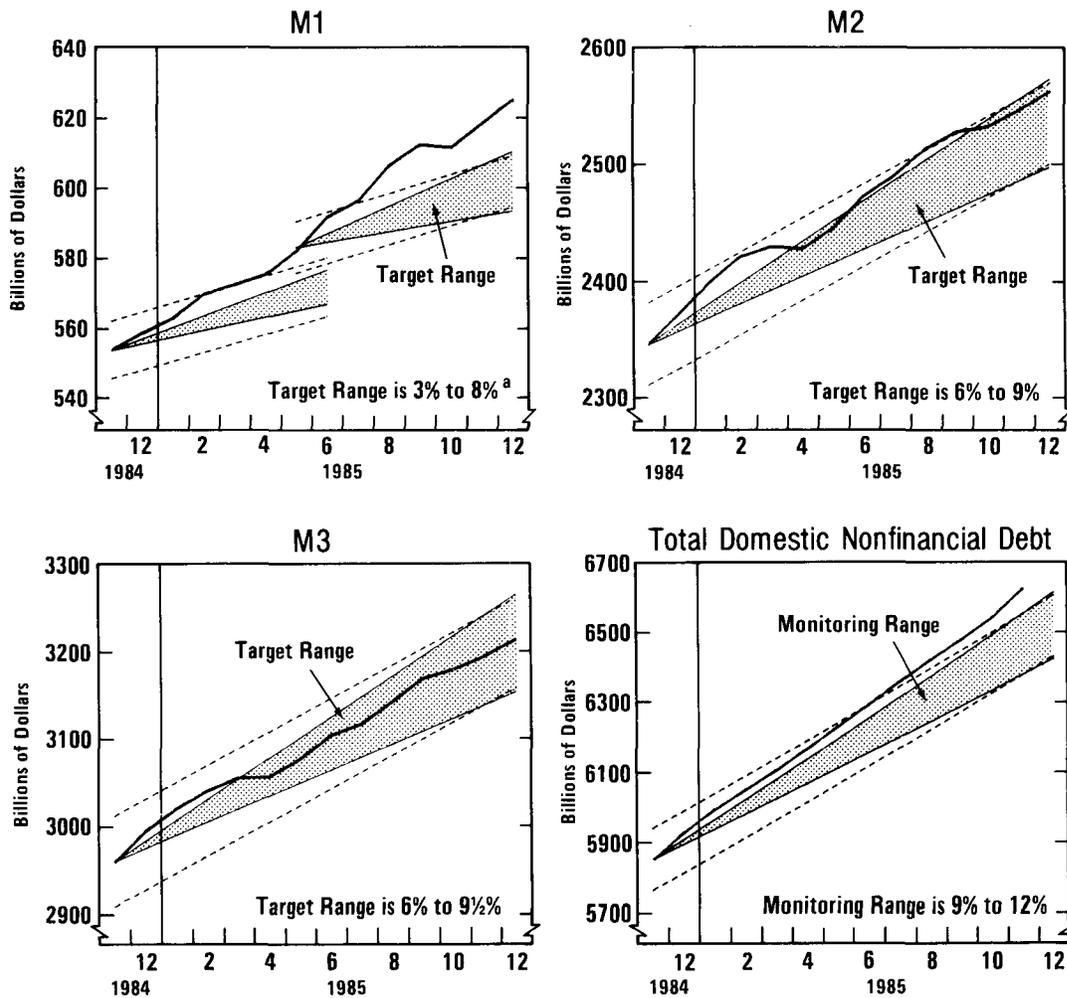
Time Period	Money Base Growth	Total Reserve Growth	Seasonal and Adjustment Borrowings (millions of dollars) <u>a/</u>	Federal Funds Rate-Discout Spread (percentage points) <u>a/</u>
1985:I	8.4	18.6	460	0.48
1985:II	7.7	12.8	593	0.15
1985:III	10.6	17.4	591	0.40
1985:IV	8.7	12.6	858	0.60
October	6.2	4.0	527	0.49
November	10.6	21.9	1,413	0.55
December	9.7	24.2	633	0.77

SOURCE: Federal Reserve Board.

a. Not seasonally adjusted.

Partly because of these issues, there have been signs that the Federal Reserve was adopting a flexible approach to its targets, especially the M1 growth range. Officials of the central bank indicated in Congressional testimony and reports that they were evaluating policy in the light of economic growth, inflation, and the exchange rate of the dollar. Tentative 1986 targets announced in July were a range of 4 percent to 7 percent for M1 growth and ranges of 6 percent to 9 percent for the growth of M2 and M3. The tentative range for the growth of total nonfinancial domestic debt

Figure I-5.
Money Growth and Targets in 1985



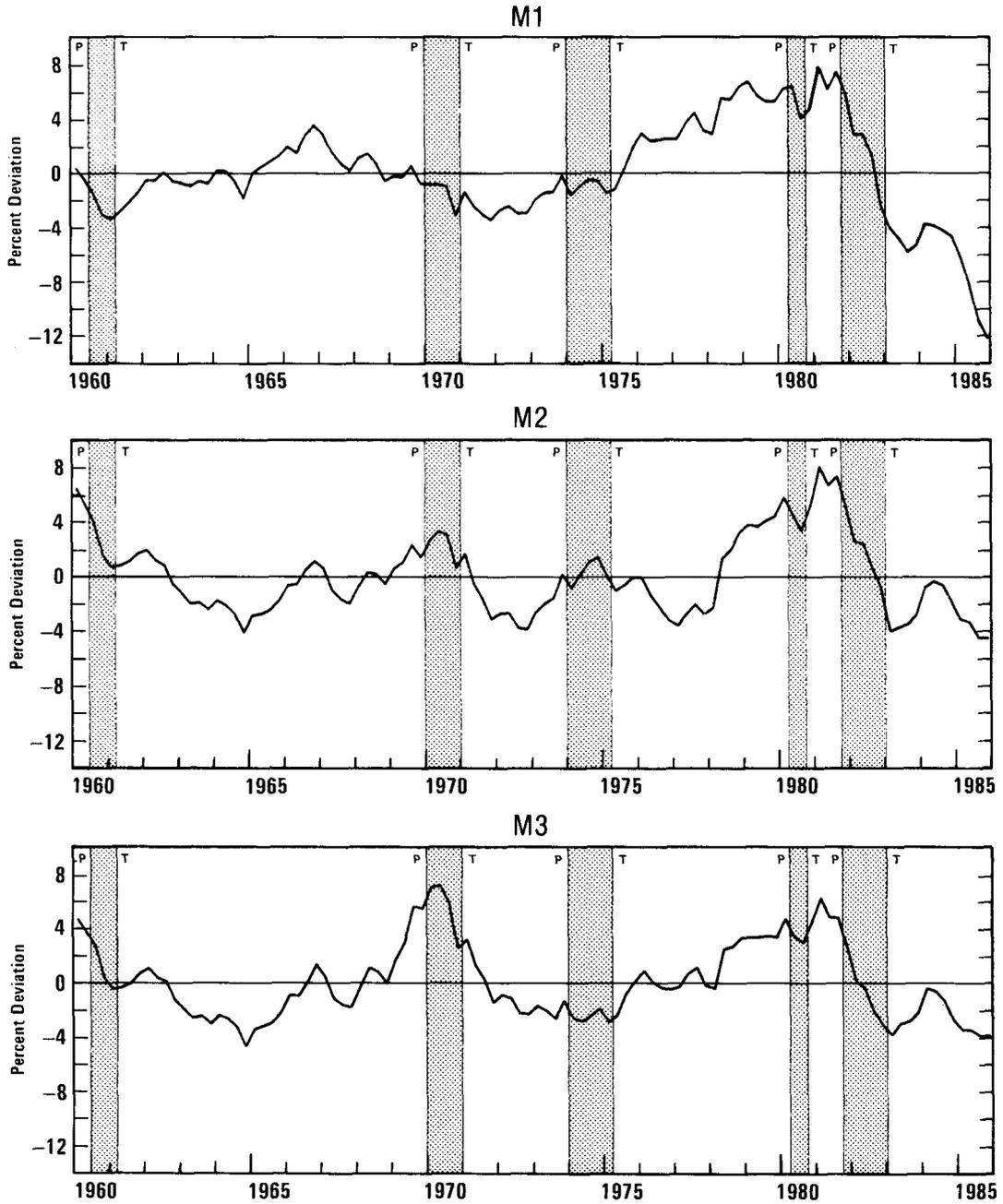
SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Dotted lines refer to growth bands that the Federal Reserve Board considers consistent with its targets.

^a The initial target range for M1 was 4 percent to 7 percent; this range was widened to 3 percent to 8 percent in May and rebased.



Figure I-6.
Velocity: Deviations from Trend Level



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

NOTE: Velocity is the ratio of GNP to money.

was set at 8 percent to 11 percent. The official announcement of the central bank's objectives for 1986 is expected in Congressional testimony on February 19, 1986.

Stress in the Financial Markets. Despite falling interest rates in 1985, failures among thrift institutions continued, and the year saw a record number of bank failures. Crises in Ohio and Maryland served to highlight the vulnerability of state- and privately-insured institutions compared with those covered by federal deposit insurance. Although the decline in long-term interest rates has dramatically improved the net worth of thrift institutions, they remain very sensitive to interest-rate movements. Moreover, many are still plagued by poor assets in their portfolios. Even the Federal Savings and Loan Insurance Corporation, the government insurer, has been beset by net worth problems and has suggested a recapitalization scheme to the Congress.

Weakening energy and agricultural prices have caused problems for many banks with loans to these sectors, and for the Farm Credit System. About 40 percent of the banks on the FDIC's "watch list" are agricultural banks. Recent legislation has attempted to ensure a continued flow of credit to the troubled farm sector, but a rise in interest rates would make the rescue plan more costly.

Finally, many banks are burdened by loans to some third-world countries whose deteriorating trade balances make them less able to service their debts. The Administration's concern over this problem resulted in the so-called "Baker initiative," which calls for increased commercial bank and official development loans (\$20 billion from the commercial banks and \$9 billion from development banks) to major third-world debtor countries in exchange for their promises of internal reforms designed to promote long-term economic growth.

RECENT ECONOMIC DEVELOPMENTS

Economic expansion slowed in 1985 from its strong pace of the previous year. Employment grew strongly, however, and inflation seemed to subside. Oil prices, the exchange rate, and long-term interest rates fell sharply. These developments, together with evidence of a pickup in economic activity late in 1985, appear to signal improved prospects for growth in coming months.

Aggregate Economic Activity

Real GNP growth was 2.3 percent during 1985, down sharply from the 6.6 percent pace of the previous year (see Table I-9). Industrial production grew only 2.2 percent in 1985 compared with 11.6 percent the previous year.

Capacity utilization was essentially unchanged. Final sales and real final sales to domestic purchasers both grew more strongly than did GNP, reflecting the fact that businesses were reducing their inventory/sales ratios and the fact that the balance-of-trade deficit was continuing to grow, channeling domestic purchasing power to foreign producers.

Employment grew quite strongly over the course of 1985 and the first weeks of 1986, reducing the unemployment rate to 6.7 percent in January of this year, its lowest level since March 1980. The strong growth in employment was, however, a reflection of disappointing productivity growth in 1985.

TABLE I-9. REAL GNP AND INDUSTRIAL PRODUCTION
(Percent change from previous period at
annual rates, unless otherwise noted)

Economic Indicator	1984	1985	1985			
			I	II	III	IV
Real GNP	6.6	2.3	3.7	1.1	3.0	2.4
Final sales	4.5	4.0	6.2	1.2	5.0	2.1
Personal consumption	4.4	3.2	4.8	2.6	4.6	-0.2
Business fixed investment	19.5	9.6	-0.5	12.5	2.4	10.3
Residential investment	13.2	1.9	1.7	7.1	8.5	8.6
Government purchases	4.3	5.8	-1.4	4.7	18.2	7.0
Exports	6.2	-2.9	-8.8	-10.9	-5.1	8.0
Imports	22.8	2.1	-27.6	18.2	12.8	13.0
Inventory Change (billions of 1982 dollars)	62.7	7.3	15.8	15.1	-1.8	0.1
Net Exports (billions of 1982 dollars)	-85.0	-105.1	-71.8	-101.1	-119.8	-127.6
Real Final Sales to Domestic Purchasers ^{a/}	6.4	4.5	2.7	4.5	7.0	2.9
Industrial Production	11.5	2.2	2.3	1.3	1.9	1.3
Consumer durables	14.2	0.2	1.4	-4.2	3.3	4.0
Business equipment	16.9	4.7	3.2	3.8	2.0	-2.2
Defense and space	10.4	10.0	8.0	10.9	9.7	12.1

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

a. Real final sales minus net exports.

Late in the year, several short-term indicators showed signs of a speedup in GNP growth. Retail sales and housing starts rose sharply in December, and oil prices fell sharply both in December and again after the turn of the year. Employment continued its strong growth during the fourth quarter. All these factors increase the likelihood that economic expansion may speed up somewhat in 1986.

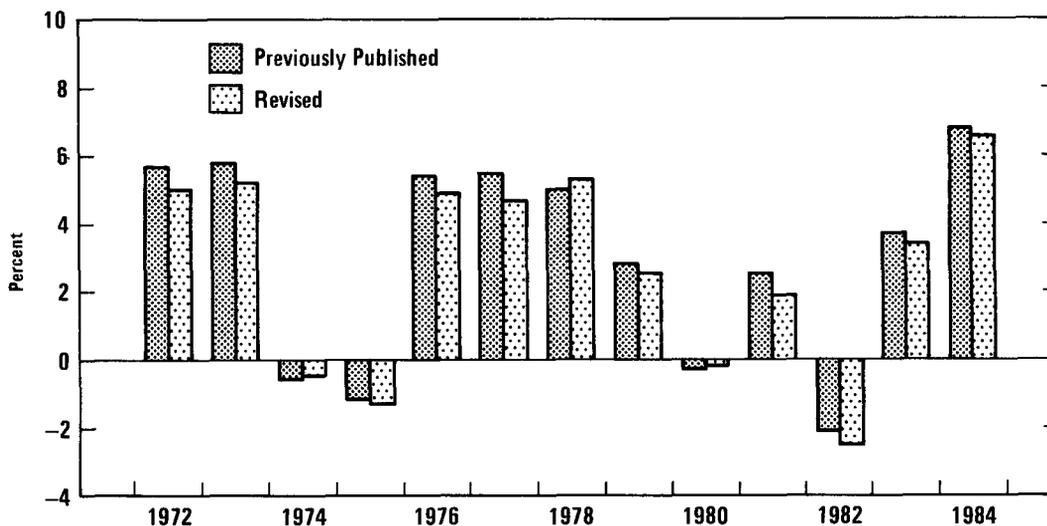
In December, the Commerce Department released major benchmark revisions of the national income accounts (see Box I-1). Periodic revisions are needed to incorporate improved estimating procedures and new information (such as new evidence on the size of the "underground" economy) that had previously been excluded from the official accounts. Analysis of how the revisions change the picture of the economy's performance since the early 1970s is only just beginning. Some of the major effects in particular sectors are described later in this chapter.

Labor Markets

Labor markets strengthened considerably last year. Nevertheless, unemployment remained high in 1985, particularly among blacks. Wage increases were moderate, and productivity growth slowed.

Figure I-7.

Real GNP Growth Rates: Before and After Benchmark Revisions



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

BOX I-1

REVISING THE NATIONAL INCOME ACCOUNTS

The Commerce Department's recent release of revised National Income and Product Account (NIPA) estimates contains a number of significant changes, even though the nominal GNP growth rates are essentially the same as shown by the old data. The revisions incorporate new data sources, better estimating methods, changes in definitions, and the rebasing of price indexes from 1972 to 1982.

In rebasing, the prices of 1982 rather than those of 1972 are used as the basis for calculating the constant dollar series, and the composition of output in 1982 is used for calculating fixed-weighted price indexes. This makes the new NIPA figures more relevant for measuring recent changes in real output and prices.

Virtually all NIPA data are collected in current dollar terms. To measure changes in real (constant dollar) values, the nominal data are "deflated" by the price index. Because rebasing can dramatically change the relative levels of the price indexes, relationships among the constant dollar series for different items in the accounts can be affected by the rebasing. For example, before the revision the price deflator for personal consumption expenditures for gasoline and oil was 356 in 1982, and the deflator for autos and parts was 191. Dividing the nominal data for these categories of spending by their respective deflators resulted in estimates of real (1972 dollars) expenditures of \$25.0 billion on gasoline and oil and \$57.0 billion on autos and parts. With rebasing, the price indexes for all categories are set to 100 in 1982. The nominal values are not generally changed as part of the rebasing process, so the same nominal values are divided by the new indexes. This results in a real (1982 dollars) value for autos of \$108.9 billion in 1982, and for gasoline and oil of \$89.1 billion. Whereas the previous data would lead one to believe that real expenditures on autos and parts in 1982 were more than two times those on gasoline and oil, the revised data indicate that gasoline and oil expenditures consumed almost the same percentage of consumers' dollars as did spending on autos and parts.

Unemployment. The civilian unemployment rate stayed at about 7¼ percent during the first three quarters of 1985 before edging down to an average of 7.0 percent in the last quarter and to 6.7 percent in January 1986. Among demographic groups, jobless rates continued to be slightly lower for men than for women (in the recession, the opposite had been true). The unemployment rate continued at about 15 percent for black workers and 6 percent for white workers--roughly the same as in 1984 (see Table I-10). Black teenagers continued to suffer by far the highest unemployment of any

The increased "weighting" of the GNP components that have risen more in price since 1972, shown by this example, is a general characteristic of rebasing. It leads to downward revisions in year-to-year real growth rates because, in general, the growth in demand (and consequently the growth in levels of production) for goods that increase more in price will be slower than for goods that have lower rates of inflation. By increasing the weighting of these very categories of goods, rebasing causes the measured growth of real output to be revised downward. Comparisons of previously published and revised data on real values are confused by this aspect of rebasing. The revised data do, however, provide a more accurate reflection of recent year-to-year changes in real economic activity than do the previously published figures.

The average annual growth rate of nominal GNP for the 1972-1984 period was not changed by the revision, remaining at 9.9 percent. The average growth of real GNP for that period, however, was revised down from 2.7 percent to 2.5 percent (see Figure I-7). When the effects of rebasing on the measured growth rate are removed by using 1972 weights, however, the revision actually raises the average real GNP growth rate for the 1972-1984 period to 2.9 percent.

The major factors contributing to the upward revision of real growth when the rebasing effect is eliminated are the use of a new deflator for computers, improved adjustments for unreported income (which affects estimates of both the income and product components of GNP), and revisions in residential investment. The sharp downward revision in the growth rate of the deflator for computers translates into higher real growth rates for durable equipment, exports, and federal purchases of goods and services. The use of the new deflator for computers is also a major reason for a downward revision in the rate of inflation as expressed by the fixed-weight GNP price index.

The GNP shares of two income categories were radically changed by the revision. Proprietors' income was revised upward by about 2 percent of GNP because of the new estimates of misreported income and the rental income share fell from 1.5 percent to 0.2 percent of GNP. These new estimates are a major reason for a general upward shift in the saving rate of about half a percentage point. In spite of the upward shift, the historical pattern of the movements in the saving rate, including its recent decline, was not changed by the revision.

major group: at approximately 40 percent, their unemployment rate was about the same as in 1984, though somewhat lower than the level of nearly 50 percent that it had reached in 1983, just after the end of the last recession.

The labor market showed signs of strength during the last months of 1985, as Table I-10 indicates, and in January as well. Unemployment fell one-tenth of a percent in November and in December, and another two-

TABLE I-10. EMPLOYMENT AND UNEMPLOYMENT (Percent change from previous period at annual rates, unless otherwise noted)

	1983	1984	1985	1984				1985			
				I	II	III	IV	I	II	III	IV
Payroll Employment											
Nonfarm	0.7	4.7	3.4	5.5	4.3	3.9	4.0	3.3	2.9	2.6	3.5
Goods-producing	-2.0	6.0	1.3	8.0	4.6	3.0	1.8	1.7	-0.3	-1.1	1.8
Service-producing	1.7	4.3	4.2	4.6	4.1	4.2	4.8	3.9	4.1	3.9	4.1
Civilian Employment	1.3	4.1	2.0	4.2	5.3	1.3	2.3	2.5	0.7	1.5	3.0
Civilian Unemployment											
Rate (percent)	9.6	7.5	7.2	7.9	7.5	7.4	7.2	7.3	7.3	7.2	7.0
Adult males	8.9	6.6	6.2	7.0	6.6	6.5	6.2	6.3	6.3	6.1	6.0
Adult females	8.1	6.8	6.6	7.0	6.7	6.8	6.7	6.7	6.8	6.7	6.4
Whites	8.4	6.5	6.2	6.8	6.5	6.4	6.2	6.3	6.3	6.2	6.0
Blacks	19.5	15.9	15.1	16.7	16.0	15.8	15.1	15.5	15.0	14.8	15.1
Teenagers	22.4	18.9	18.6	19.6	18.9	18.7	18.3	18.5	18.3	18.3	19.0
Black teenagers	48.4	42.7	40.1	45.4	42.4	42.2	41.0	41.7	39.7	38.4	40.7
Employment-to-Population											
Ratio (percent)	57.9	59.5	60.1	59.0	59.6	59.7	59.8	60.0	60.0	60.1	60.3

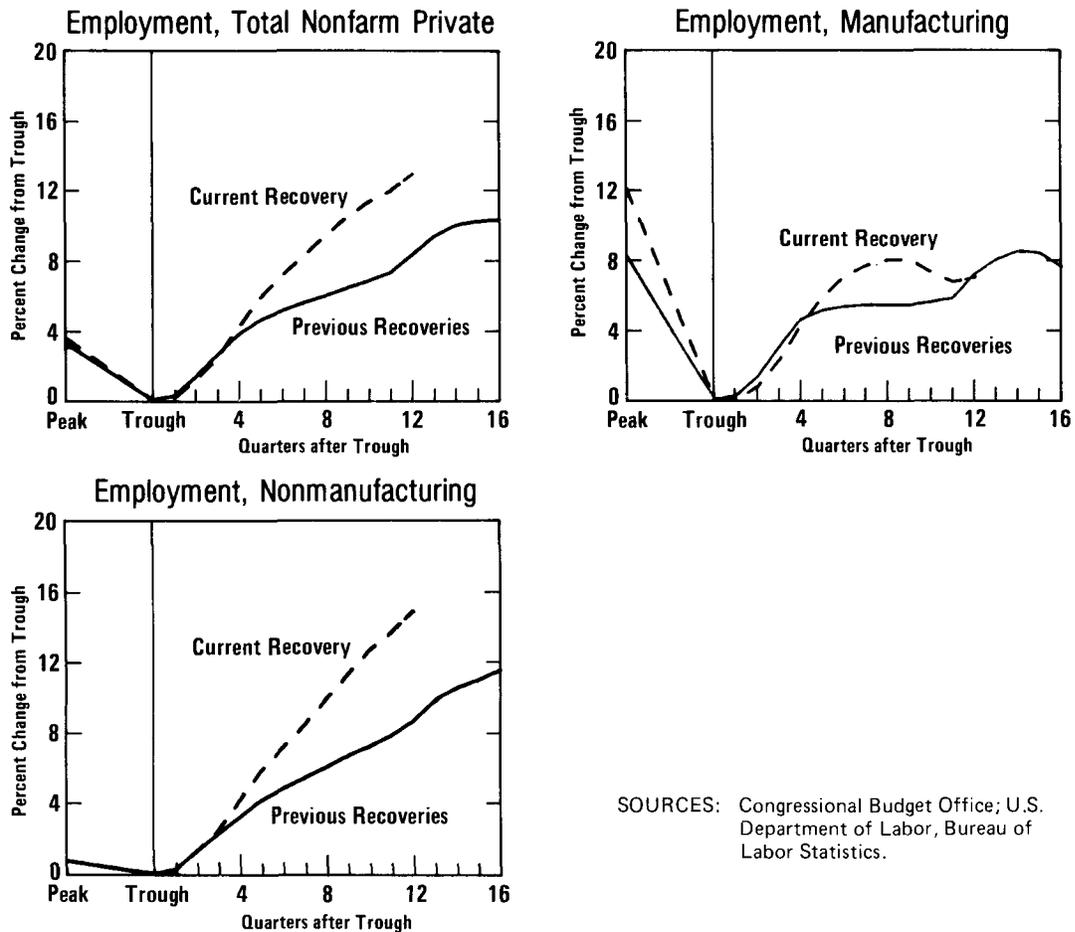
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

NOTE: Nonfarm payroll employment is measured by a survey of business establishments. The civilian employment and unemployment rates cited are based on a survey of households.

tenths in January; the ratio of employment to population reached a new high. Nonfarm payroll employment grew strongly in December and January. Employment in the goods-producing sector, which had been stagnant during the second and third quarters, grew at a 1.8 percent annual rate in the last quarter. (By contrast, service employment grew steadily throughout the year at a 4 percent rate.) Modest employment gains were widespread across industries. In December and January, about two-thirds of all industries were reporting employment gains. The average workweek in manufacturing--a barometer of changes in labor demand--rose to 41.0 hours in December from 40.7 in November. Overtime hours in manufacturing also edged up to 3.6 per week from 3.4 in November.

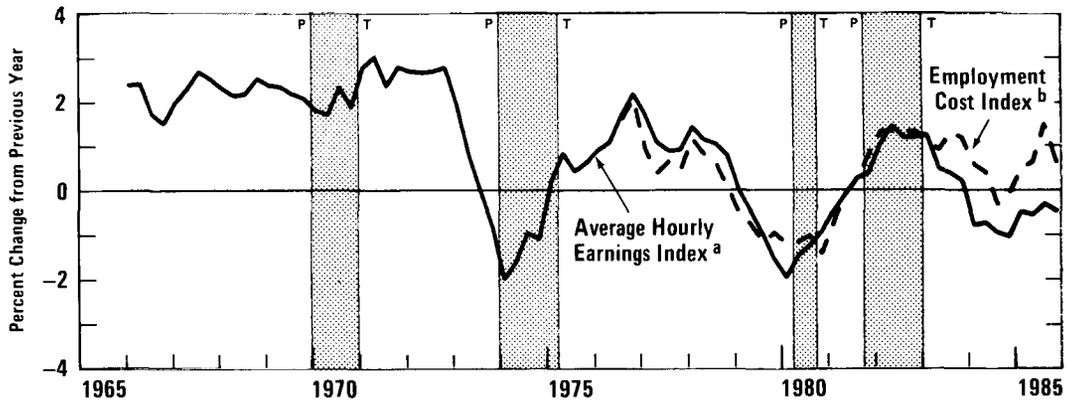
Employment growth in this recovery has been considerably stronger than for the average recovery in the postwar period (see Figure I-8). The

Figure I-8.
Cyclical Comparisons of Employment Growth



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

Figure I-9.
Real Wages



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

NOTE: The Employment Cost Index begins in the mid-1970s.

^a Average hourly earnings index for nonfarm private industry, deflated by the fixed-weight personal consumption price index.

^b Employment cost index for wages in the nonfarm private economy, deflated by the fixed-weight personal consumption price index.

unusually rapid growth has been concentrated in the nonmanufacturing sector; employment growth in manufacturing has been about average.

Wages. Gains in wages were moderate in 1985, reflecting continued high unemployment and subdued inflation. At more than 7 percent, the unemployment rate was substantially above the roughly 6 percent rate at which many analysts expect labor markets to become a source of inflationary pressures. ^{8/}

Finally, small increases in food and fuel prices contributed to the moderation of wage increases. As shown in Figure I-9, gains in real wages have been unusually low, and according to one measure they have been negative.

Collective bargaining settlements in general showed extremely low wage gains in 1985. Major bargaining contracts provided average wage adjustments of 2.3 percent in the first year and 2.7 percent annually over the life of the contract (not including all potential increases from cost-of-

8. This level is often estimated at between 6 percent and 6.5 percent, which is higher than it was in the 1950s and 1960s in part because women and young workers, who now form a larger part of the labor force, tend to have to spend a larger proportion of their time in job searches than do adult males, more of whom have settled jobs. As the baby boom bulge of people entering the labor force slows down, the level of unemployment consistent with constant inflation is likely to be lower.

living provisions). The last time the same parties bargained (generally two to three years ago), average adjustments were 3.9 percent the first year and 3.7 percent a year over the contract life. Contrary to experience before the 1980s, many contracts were "back-loaded"--that is, they had lower wage adjustments in the first year than in subsequent years.

As shown in Table I-11, the Employment Cost Index grew at a 4 percent to 5 percent rate during 1985, moderately less than in 1984. For the year ending in December 1985, compensation cost increases were almost one percentage point below those of a year earlier (4.3 percent versus 5.2 percent). A deceleration in employee benefit costs was largely responsible for the slowdown in compensation cost increases. The aggregate index masked divergent trends, however. Reflecting differences in labor-market conditions, growth in compensation was faster for workers in service-producing industries than for those in the goods-producing industries and faster for nonunion than for union workers. By occupational groups, the gains of service workers and white-collar workers outstripped those of blue-collar workers.

Productivity. Increases in output per worker hour slowed dramatically in 1985. In 1983 and the first half of 1984, gains in productivity had been quite rapid, though about average for an early recovery period. As the economic expansion slowed, however, productivity growth in the nonfarm business sector disappeared. Productivity growth in manufacturing also slowed sharply in 1985, but it continued at a faster pace than for the nonfarm sector as a whole. During the three years since the beginning of recovery, productivity growth in the nonfarm business sector as a whole was about average for the first six quarters, but it has been far below average for the next six (Figure I-10). Productivity growth in manufacturing appears slightly better than average, but the productivity performance in the rest of the nonfarm business sector appears very poor. It should be noted, however, that data on recent productivity trends in this sector, and to a lesser extent in manufacturing, are subject to wide margins of error.

Inflation

Inflation has not increased in the three years since the last recession, in contrast to the pattern in most postwar recoveries. Recently many commodity prices have grown weakly or have actually fallen. Wages, a source of inflationary pressure in the past, have shown only moderate gains. As a result, inflation in 1985 was somewhat less than that in 1984, as reflected in the fixed-weight GNP deflator (a broad measure of prices for goods and services produced in the United States) and the Consumer Price

TABLE I-11. COMPENSATION, PRODUCTIVITY, AND UNIT LABOR COSTS
(Percent change from previous year or from four quarters ago)

	1983	1984	1985	1984				1985			
				I	II	III	IV	I	II	III	IV
Hourly Earnings Index	4.6	3.4	3.0	3.6	3.5	3.4	3.1	3.1	3.1	2.9	3.0
Employment Cost Index	6.1	5.4	4.6	5.8	5.5	5.1	5.2	4.8	4.6	4.9	4.3
Union workers	6.7	4.6	3.1	5.3	4.9	4.1	4.3	3.5	3.1	3.2	2.6
Nonunion workers	5.7	5.5	4.9	5.8	5.7	5.2	5.2	4.9	4.9	5.4	4.6
Goods-producing industries	5.4	4.6	4.0	4.7	4.6	4.4	4.7	4.6	4.2	4.0	3.4
Manufacturing industries	5.6	4.9	4.3	4.8	4.9	4.7	5.2	5.1	4.6	4.2	3.3
Service-producing industries	6.5	6.0	5.0	6.5	6.3	5.5	5.6	4.9	4.8	5.5	4.8
Blue-collar workers	5.5	4.4	3.7	4.8	4.4	4.2	4.4	3.8	3.8	4.0	3.3
White-collar workers	6.5	5.9	5.2	6.3	6.3	5.4	5.6	5.3	5.1	5.4	4.9
Service workers	6.0	6.5	4.6	6.7	6.1	6.8	6.5	4.8	4.8	5.1	3.9
Compensation per Hour <u>a/</u>	4.7	3.7	3.7	3.5	3.6	4.0	3.8	3.7	3.8	3.6	3.7
Output per Hour <u>a/</u>	3.4	1.6	0.0	2.6	1.7	1.2	0.8	0.2	-0.3	0.1	-0.1
Unit Labor Cost <u>a/, b/</u>	1.3	2.0	3.7	0.9	1.8	2.7	2.9	3.5	4.1	3.5	3.8

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

a. Nonfarm business sector.

b. The index of unit labor cost is calculated by dividing the index of compensation per hour by the index of output per hour.