flator, which is a measure of the costs of production in the United States and thus excludes costs of imports.)

Slack in the Economy. While the foregoing factors will contribute to an increase in inflation, others will work against it. Unemployment remains about 7 percent, still by most estimates at least half a point above the range where tighter labor markets can be expected to push up costs. As already noted, high unemployment, combined with foreign competition in the manufacturing sector, has held down wage growth in recent years. Capacity utilization in manufacturing is around 79 percent, and has never in this expansion exceeded the 82 percent that in the past signalled the beginning of higher inflation. If past relationships continue to hold, this amount of excess capacity taken by itself might be expected to reduce consumer price inflation by between 0.3 and 0.6 percentage points each year.

Composition of Demand

Residential investment and consumer spending more than accounted for the increase in economic activity during the first two quarters of 1986. The upturn in housing was a response to sharply lower interest rates. The response of business fixed investment, on the other hand, was quite sluggish, reflecting excess capacity throughout most of the economy as well as a contraction in the energy sector. The international sector, where high exchange rates undercut domestic output in 1984 and 1985, has been slow to respond to the decline in the dollar that began in early 1985. Finally, changes in business inventories have as usual sharply affected GNP in the short run.

For the remainder of this year and in 1987, most forecasters look for shifts in the composition of growth, with more stimulus from the international sector and business investment but relatively less from housing. The much-needed turnaround in the U.S. trade position will depend heavily on what happens to exchange rates and on how the economy responds to it.

Inventories. Nonfarm business inventories grew substantially in the first half of the year, but the real inventory/sales ratio has not changed significantly from the levels of recent years, and is still far below its levels in the 1975-1982 period. One explanation for the lower inventory/sales ratios of the last three years is the increase in the costs of holding inventories: real short-term interest rates have increased since the late 1970s, as expected inflation has declined faster than nominal interest rates. The cost of holding commodity stocks has been particularly high because of the recent weakness in commodity prices. The CBO forecast calls for both a moderate pickup in sales and a decline in real interest rates. These factors should cause further inventory building over the next year, though at a somewhat lower rate than in the last two quarters.

Consumption. Personal consumption expenditures grew rapidly in the first half of 1986, in real terms, with a large increase in nondurable purchases in the first quarter followed by strong growth in the purchase of durable goods in the second. New car sales were a major part of the growth in durables, but purchases of appliances and furniture also jumped sharply.

Consumer spending has been buoyed by the decline in inflation. The implicit personal consumption deflator fell slightly over the six-month period ending in June, so that even though disposable income growth was only moderately higher in the first half of the year, the absence of inflation meant strong gains in real terms.

Consumers continued to rely heavily on credit. The ratio of consumer installment debt to disposable income remained near its all-time high of 19 percent. In addition, the personal saving rate increased somewhat, from 4.4 percent in the last quarter of 1985 to 5.2 percent in the second quarter, though this was due in part to large farm subsidy payments, and is still quite low by post-World War II standards. The high debt load and low saving rate have caused concern about how long current consumption rates can be sustained. For many analysts, however, the concern is mitigated by the rise in household net worth in the wake of the recent boom in stock market prices and the recent jump in the value of homes. They argue that the personal saving rate tends to be low when household net worth is relatively high, and the ratio of net worth to disposable income has been higher in recent years than at any time in the 1970s. Of course, a sharp fall in the stock market or other forms of household wealth would expose consumer debt positions, and could lead to a retrenchment in consumption.

If, as expected, inflation picks up and real disposable income growth slows in the second half of the year, the growth rate of real consumption expenditures may fall somewhat below its current pace, but a sharp retrenchment in spending does not appear likely.

Residential Construction. Falling interest rates and gains in personal income have combined to form the most advantageous home buying environment in years (see Table I-6). Sales of new homes surged in the first quarter, before slackening somewhat in the second quarter. Housing starts broke the 2 million unit mark during the first quarter of 1986--with single and multifamily units both showing strong gains--but fell off somewhat during the second quarter as multifamily starts dropped sharply. Vacancy rates (not shown in the table) also rose during the second quarter. While the

TABLE I-6. SELECTED HOUSING DATA

	Starts (millions)			Sales (millions)			Interest Rates (percents)				
	Total	Single-Family	Multi-Family	New	Existing	Inventory (months)	Commitment Rate	One-Year T-Bill	Permits (millions)	New Homes Median Price (thousands)	Affordability Index a/
1985:I	1.76	1.10	0.66	0.669	2.96	6.5	13.06	9.39	1.67	82.9	0.81
1985:II	1.74	1.07	0.67	0.681	3.04	6.3	12.78	8.47	1.71	84.0	0.84
1985:III	1.69	1.05	0.64	0.711	3.36	6.0	12.14	7.99	1.78	83.4	0.88
1985:IV	1.77	1.07	0.70	0.696	3.50	6.0	11.73	7.85	1.74	86.8	0.87
1986:I	2.00	1.25	0.75	0.800	3.26	5.4	10.56	7.46	1.83	88.3	0.89
1986:II	1.91	1.24	0.67	0.789	3.48	5.3	10.25	6.61	1.81	91.6	0.90

SOURCES: Congressional Budget Office; Federal Home Loan Mortgage Corporation; Bureau of Census, U.S. Department of Commerce; Federal Reserve Board.

a. The percent of households that can afford the median-priced home. Calculated by the Congressional Budget Office.

expected modest rise in interest rates in 1987 may cause starts of single-family homes to slow slightly, financial conditions for this segment of the construction industry should remain favorable throughout most of this year and next.

The tax reform debate, however, has created some uncertainty regarding starts of multifamily units. Under the Senate bill, rental units not in service by the end of this year would not be eligible for certain tax shelter benefits. This could cause starts of multifamily units to fall in the last half of 1986, especially if they have been boosted in anticipation of these changes.

Government Purchases. Expenditures by the public sector contributed to overall economic growth in 1985, and have helped to offset the decline in growth during the current year. Slower growth in real public-sector purchases is expected to be a drag on the economy during most of the forecast period.

Following recent declines, federal purchases of goods and services (excluding the Commodity Credit Corporation) soared by 12.7 percent (annual rate) in the second quarter--the second strongest growth in the 15 years of data available for this series. An acceleration in defense spending (especially durables) accounted for nearly all of this growth (see Table I-7). Another quarter of growth in defense purchases seems likely. But under the Balanced Budget Act, a downward trend in real federal defense and nondefense purchases is expected throughout the rest of the forecast period, tending to slow the overall growth of the economy.

The growth of real state and local purchases also soared in the second quarter--the result of a surge in construction spending (51.2 percent at annual rates). This flurry followed record borrowing at the end of last year, undertaken largely in reaction to tax reform proposals that would increase restrictions on tax-exempt borrowing by state and local governments. The outlook is for some decline in construction activity and only moderate gains in other purchases. The growth of purchases will be restrained by slow growth in revenues stemming in part from the termination of general revenue sharing as well as other cutbacks in federal grants. On the other hand, a recent rebound in state and local borrowing should help to bolster the growth of capital spending for a while.

The operating surpluses of state and local governments amounted to $9.0 billion in 1985. In the first quarter of 1986, these balances jumped to $15.7 billion, but most of this surplus reflected a rebate payment from federal fines levied against Exxon for past overcharges. Although some states will be receiving nonrecurring federal grants (settlement payments from dis-

TABLE I-7. GOVERMENT PURCHASES OF GOODS AND SERVICES (NIPA basis)

	1984 a/	1985 a/	1985 I	1985 II	1985 III	1985 IV	1986 I	1986 II
				Billions of 1982 Dollars				
Federal Purchases b/	293.9	311.2	302.6	309.4	318.3	314.9	314.0	323.5
Defense	219.4	235.7	228.0	233.5	242.2	239.3	238.7	247.5
Nondefense b/	74.5	75.5	74.6	75.9	76.1	75.6	75.3	76.0
State and Local Purchases	383.5	397.6	389.5	396.9	401.9	402.2	404.8	412.4
				Percent Change				
Federal Purchases b/	5.2	5.9	-0.5	9.2	12.0	-4.2	-1.1	12.7
Defense	6.0	7.4	3.8	10.0	15.8	-4.7	-1.0	15.6
Nondefense b/	2.9	1.3	-12.4	7.2	1.1	-2.6	-1.6	3.8
State and Local Purchases	2.6	3.7	1.9	7.8	5.1	0.3	2.6	7.7

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

a. The percent changes for calendar years 1984 and 1985 are calculated on a year-over-year basis.

b. Excludes the activities of the Commodity Credit Corporation.

puted Outer Continental Shelf revenue), the outlook is for slower revenue growth and much smaller operating balances during the forecast period. This deterioration in budget positions will require austerity measures in some states. 8/ At the same time, trust fund surpluses are expected

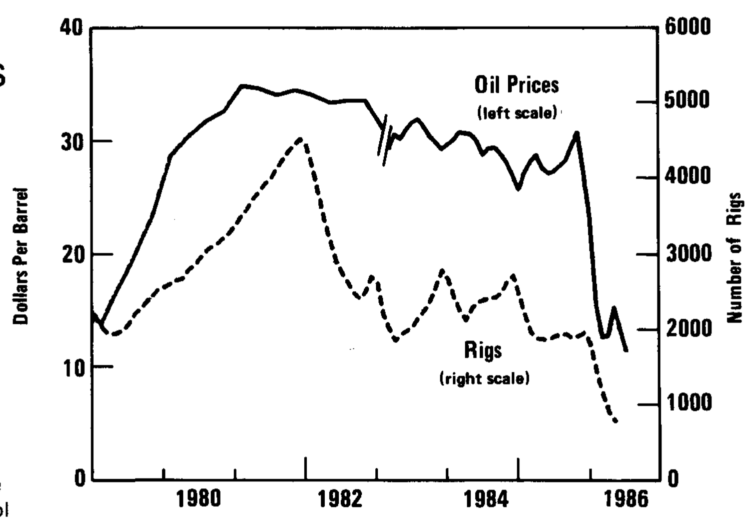
8. However, passage of a tax reform bill that broadens the personal tax base would produce windfall gains for most states that use the federal definition of taxable income.

to grow somewhat more slowly than in recent years, providing less of an offset than otherwise to federal borrowing needs.

Business Fixed Investment. Business fixed investment is a pivotal sector of the economy at present. After growing far more rapidly than overall GNP in 1984 and 1985, it seems likely to contribute little, if any, to growth in real GNP this year. In the near term, several factors are holding back aggregate investment, including the slump in the petroleum industry, relatively low levels of capacity utilization, uncertainties over tax legislation, and overbuilding in some sectors, especially in office buildings. Other factors, however, such as lower interest rates and a generally buoyant stock market, should promote investment growth. If spending in the rest of the economy accelerates in the next few quarters as CBO expects, capacity utilization should improve--and that would also be a major positive influence on investment. By next year, this sector may show more strength, assuming that output of final goods rises as projected by CBO.

Real business fixed investment declined sharply in the first half at a 9.1 percent annual rate, with structures accounting for most of the decline. This decline was in part a reaction to a sharp rise in the fourth quarter, when businesses hurried to qualify for the investment tax credit, but the major near-term negative influence was the dramatic decline in oil prices. Drilling for oil and gas, which accounted for about 23 percent of investment in structures last year, has fallen drastically since late 1985 (see Figure I-9).

Figure I-9.
Oil Prices and Oil Rigs in Operation



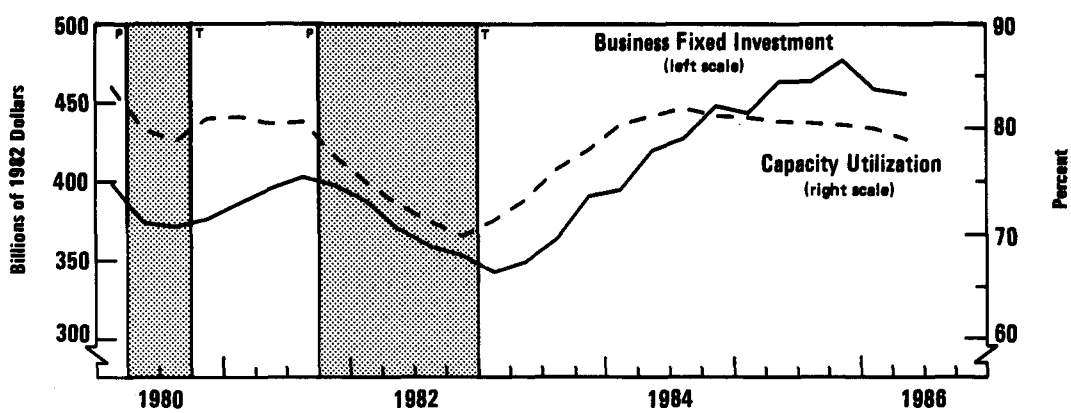
SOURCES: Congressional Budget Office; Directorate of Intelligence, Central Intelligence Agency; New York Merchantile Exchange; Hughes Tool Company.

NOTE: The price series is the official OPEC price (quarterly data) until 1983:1. The N.Y. Merchantile Exchange forward price for oil to be delivered in the next month is used thereafter.

Low rates of capacity utilization are currently a more fundamental short-run drag on investment. Historically, capacity utilization and investment have tended to move together. As shown in Figure I-10, investment accelerated as capacity utilization increased in 1983 and 1984. After that, however, capacity utilization leveled out near its long-term average, and more recently it dipped below 80 percent; correspondingly, the pace of investment has flattened in recent quarters. The current overhang of too much commercial building is also retarding investment. In particular, vacancy rates for office buildings are relatively high, and in some geographic areas extremely high.

Proposed tax legislation may be deterring investment in equipment this year. The tax bills passed by both the Senate and the House of Representatives would repeal the investment tax credit, which generally applies only to equipment. The effective date for the repeal is January 1, 1986 for both bills. The Senate bill would provide for more rapid depreciation for most equipment, but this provision would not be effective until January 1, 1987, thus offering an incentive to defer investments in equipment until 1987. By contrast, since the Senate bill would cut back on depreciation for structures on January 1, 1987, there may be an incentive to complete investments in structures this year to qualify for more rapid depreciation

Figure I-10.
Real Business Fixed Investment and Total Industry Capacity Utilization



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

To the extent that tax incentives have contributed to and prolonged the boom in commercial construction, however, their repeal could possibly dampen spending.

Current indicators of business fixed investment have generally been lackluster, and surveys of capital spending plans confirm the outlook for flat capital spending this year (see Table I-8). The recent survey by the Commerce Department indicates that businesses plan to spend about the same amount in 1986 as in 1985--up only 0.2 percent in current dollars. Allowing for the Commerce Department's adjustment for changes in capital goods prices, real spending would be down 1.3 percent.

In 1987 conditions should be more favorable for investment than in 1986. The effects of lower oil prices on petroleum-related investment should constitute a smaller drag on overall investment in 1987, and the recent declines in interest rates together with the increases in the stock market should by then have had a positive effect. More important in the short term, however, should be the stimulative effects on sales from lower oil prices and interest rates, and the declining dollar.

Net Exports. During the first half of 1986, the dollar continued its decline against most other major currencies, as had been expected. Factors underlying the dollar's decline in the latter half of 1985 continued to be important, such as:

- Sluggish growth in the domestic economy and associated sluggish growth in credit demands early in 1986;

- An accommodative U.S. monetary policy (see the next section); and

- An improved likelihood that the federal deficit will be gradually reduced.

One result of these factors was that long-term interest rates in the United States continued to fall in early 1986 relative to those abroad. Relative interest-rate differentials fell at a much slower pace than in late 1985, however, because monetary authorities in the major foreign industrial countries progressively lowered their interest rates, sometimes in coordination with U.S. authorities. In fact, the real long-term interest-rate differential moved against the U.S. dollar in May and June, as shown in Figure I-11. The sharpness of the dollar's decline in the first half of 1986 was probably attributable in part to a number of other factors that affected international confidence in the value of the dollar. Persistent signs of strain in the U.S. banking system (energy and farm loan difficulties, insolvency of many thrift

TABLE I-8. CURRENT INDICATORS OF BUSINESS FIXED INVESTMENT AND SURVEYS OF CAPITAL SPENDING PLANS FOR 1986

			1985				1986	
	1984	1985	I	II	III	IV	I	II
Current Indicators								
Nondefense Capital Goods Orders (billions of dollars per month)	27.0	27.2	26.8	26.3	27.8	27.8	26.5	26.3
Manufacturers' Capital Appropriations (billions of dollars, quarterly rate) a/	29.0	26.8	29.9	27.6	24.2	27.2	24.5	n.a.
Capacity Utilization (percent)	81.2	80.6	81.0	80.7	80.5	80.3	79.9	78.9
Corporate Economic Profits (billions of dollars, annual rate) b/	265	281	266	274	296	286	296	n.a.
Corporate Net Cash Flow (billions of dollars, annual rate) c/	345	375	361	372	389	380	397	n.a.
Corporate AAA Bond Rate (percent)	12.7	11.4	12.3	11.6	11.0	10.6	9.6	9.0
Standard and Poor's 500 Stock Index (annual percent change)	0.0	16.4	32.7	18.0	7.8	19.7	55.5	43.1

Surveys of Capital Spending Plans for 1986 (In percents)

	Nominal	Real
U.S. Department of Commerce d/	0.2	-1.3
McGraw-Hill Survey e/	-0.5	-4.1

SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; McGraw-Hill, Inc.; Conference Board; Federal Reserve Board.

NOTE: n.a. = not available.

a. Because of the seasonal adjustment procedure, the annual figure does not equal the average of the quarterly figures.

b. Economic profits are adjusted for inventory valuation and capital consumption allowances.

c. Net cash flow equals corporate retained earnings with inventory valuation adjustment, plus economic depreciation.

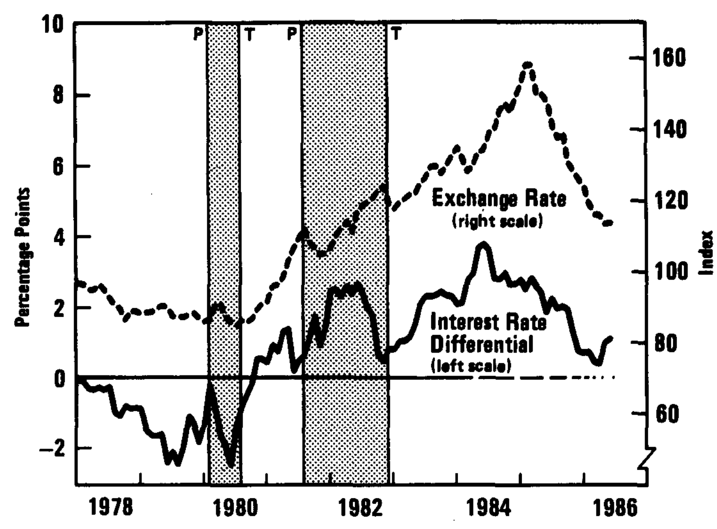
d. Conducted in April and May 1986.

e. Conducted in March and April 1986.

institutions, and a record number of bank failures) may have deterred international investors from adding to their dollar holdings at the rate they did earlier. Although the value of the dollar may level off for a time as the domestic economy strengthens and interest rates in the United States firm, CBO expects it will ultimately decline further.

So far, the depreciation of the dollar has not been reflected in an improved U.S. trade position. The real trade deficit continued to deteriorate in the first half of 1986, but at a slower pace than recorded in 1985. Most of the deterioration can be attributed to increased imports from countries whose currencies had depreciated the most in real terms against the dollar between 1980 and February 1985--major Western European countries and Japan. The share of automotive and consumer (nonfood and nonauto) goods in total merchandise imports continued to rise substantially, and the share of capital goods--even with only moderate growth in the U.S. economy--continued to rise as well. Petroleum imports displayed sharp quarter-to-quarter swings in response to the collapse in oil prices: the volume increased significantly in the second quarter of 1986, as inventories needed to be replenished following very low levels of imports in the first quarter, but nominal petroleum imports fell significantly in both quarters as the impact of the lower prices overwhelmed changes in volume.

Figure I-11.
The Exchange Rate and Relative Interest Rates



SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.

NOTE: The exchange rate is a trade-weighted average of bilateral dollar exchange rates. The real interest-rate differential is the difference between long-term real interest rates for the United States and a GDP-weighted average for other industrial countries. Long-term real interest rates are long-term nominal interest rates (on government bonds), adjusted for expected inflation rates. Expected inflation is proxied by a two-year centered moving average of actual and projected CPI inflation rates.

Real merchandise exports have continued a relatively slow improvement; the subdued pace of economic growth overseas, and severe financial difficulties for Latin American countries appeared to offset somewhat the effects of the depreciation of the dollar. Real nonagricultural exports have risen moderately over the last three quarters, with capital goods and industrial supplies the only strong performers. Agricultural exports have continued their prolonged slump, in both real and nominal terms, in response to long-run excess supply conditions in world markets. 9/ Thus, growth in exports was not nearly enough to prevent the further worsening of the trade balance.

Total net services and net investment income flows deteriorated considerably in 1985 before improving slightly in the first quarter. On a national income and product account (NIPA) basis, net investment income flows declined in 1985 relative to 1984 as a whole, in both nominal and real terms, thereby lowering the growth rate of real GNP some three-tenths of a percentage point below the growth rate of domestic output. The improvement in the first quarter of 1986 proved to be only temporary as both total net services and net investment income flows declined in the second quarter. The net balance for other (noninvestment income) services improved, however, throughout the entire first half of 1986.

Most forecasters expect real net exports to improve significantly in the near future, contributing importantly to economic growth by 1987. But the timing of the turnaround is highly uncertain, especially given the slower than expected response of import prices to the depreciation of the dollar (for reasons discussed earlier in this chapter) and the possibility of continued weak growth among U.S. trading partners.

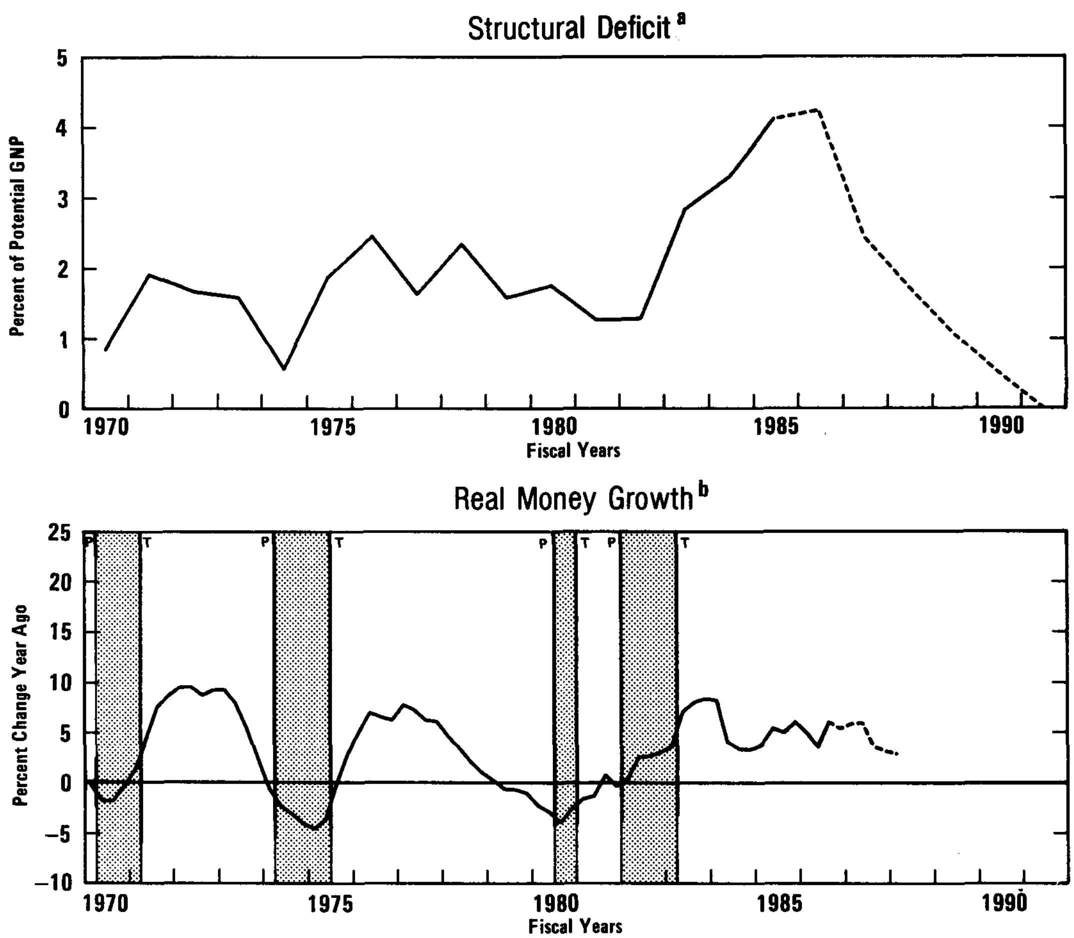
FISCAL AND MONETARY POLICY

In its annual report last February, CBO noted that the mix of fiscal and monetary policy was shifting. At present, fiscal policy under the require-

9. Currently, U.S. agricultural exports are in a state of flux as markets adjust to the government-mandated drop in price support or loan rate levels for most crops this summer and autumn. Since the timing of these price declines has been known since early in the year, foreign buyers have had an incentive to defer purchases until the commodities became available at the lower prices. Once prices drop, the volume of exports is expected to rise sharply, especially during periods immediately after the price changes, to meet pent-up demand. This pattern is already evident for wheat, exports of which fell perceptibly before the drop in the loan rate in June and have since registered large gains.

ments of the Balanced Budget Act is headed toward a restrictive course, while monetary policy has remained accommodative to economic expansion (see Figure I-12). If these trends continue, the new policy combination should be more conducive to capital formation and long-term growth than were earlier policies.

Figure I-12.
Fiscal and Monetary Indicators



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

[a]Forecasted values based on Balanced Budget Act targets.

[b]M2 deflated by the CPI-U. Forecasted values based on midpoint growth rates of the Federal Reserve Board's target bands for 1986 and 1987, and CBO's forecast of CPI-U.

Fiscal Policy

The outlook for fiscal policy continues to be one of greater restraint. CBO estimates that the budget deficit will be $224 in fiscal year 1986, and $184 billion in 1987, taking into account only those policies already in place (see Chapter II). The CBO economic projection, however, and the following discussion of fiscal policy are based upon the assumption that the Congress

TABLE I-9. AGGREGATE MEASURES OF FISCAL POLICY (Fiscal years, unified budget basis)

Measure	1985	1986	1987	1988	1989	1990	1991
			Billions of Dollars				
Standardized-Employment Deficit							
Baseline	168	184	151	126	110	87	68
Balanced-budget target	168	184	111	84	55	28	-1
Publicly Held Debt							
Baseline	1,510	1,739	1,925	2,071	2,195	2,290	2,358
Balanced-budget target	1,510	1,739	1,884	1,989	2,058	2,093	2,092
			Percent of Standardized GNP				
Standardized-Employment Deficit							
Baseline	4.1	4.3	3.3	2.6	2.1	1.6	1.2
Balanced-budget target	4.1	4.3	2.5	1.7	1.1	0.5	-0.0
Publicly Held Debt a/							
Baseline	38.3	41.8	43.5	43.6	43.0	41.8	40.1
Balanced-budget target	38.3	41.8	42.6	41.8	40.3	38.2	35.6

SOURCE: Congressional Budget Office.

a. These numbers are expressed relative to GNP rather than to standardized GNP.

will undertake whatever spending cuts and/or revenue increases needed to achieve the Balanced Budget Act deficit targets. 10/

To gauge the degree of discretionary fiscal policy restraint (or stimulus), it is customary to look at the movement in the budget along some hypothetical path that serves to isolate the deficit from the budgetary effects of fluctuations in output and employment. Table I-9 reports such a measure--the standardized-employment deficit; this is the deficit projected at a constant 6.0 percent rate of unemployment. According to this measure, fiscal policy will become quite restrictive in the coming year as the standardized-employment deficit declines from 4.3 percent of standardized GNP in 1986 to 2.5 percent in 1987. 11/ If there are no large increases in asset sales, this move would represent one of the largest annual shifts toward restraint in the past three decades. However, some increase in asset sales is anticipated by the budget resolution and the Administration may recommend further increases. As explained in the box, deficit reduction achieved by asset sales does not exert a contractionary effect on the economy and does not reduce credit demands because asset sales are simply a substitute for Treasury borrowing. Continued adherence to the deficit targets of the Balanced Budget Act of 1985 would approximately balance the standardized-employment deficit by 1991, given a projected unemployment rate of 6.0 percent in that year. The result would be the largest sustained amount of fiscal restraint in more than 30 years. 12/

10. Since all the specific policies that will be enacted to reach these targets are not yet known, it was assumed that the deficit reductions necessary to achieve the budget targets will involve both cuts in spending and tax increases.

11. These estimates do not incorporate the tax changes proposed in the tax reform bills, which might affect some measures of aggregate fiscal stimulus. These numbers do, however, include $1.4 billion of financial asset sales in 1986 and $6.0 billion in 1987, including the policies of the Budget Resolution.

12. Other measures of fiscal policy show similar degrees of fiscal restraint. Table I-9 shows that the federal debt declines relative to GNP. Such a fall in this ratio generally is viewed as favorable to credit market conditions. The standardized primary deficit, which excludes interest costs and receipts, also shows reduced stimulus. Interest payments on the federal debt have grown considerably in recent years, and some analysts argue that (1) these outlays are not controllable at least in the short run, and (2) they may have relatively less impact on aggregate demand since a substantial component of interest outlays merely compensates bondholders for the loss in the value of their bondholdings due to inflation. When federal interest payments and receipts are excluded from the calculation of the standardized-employment deficit, the resulting measure of stimulus falls from 2.3 percent of standardized GNP in 1986 to a 1.4 percent surplus in 1991, assuming the target path of the Balanced Budget Act of 1985. For other considerations in measuring fiscal policy, see Robert Eisner, *How Real is the Federal Deficit?* (New York: The Free Press, 1986).

Economists generally agree that smaller federal deficits will encourage private capital formation and have a favorable impact on economic growth in the long run. There is a wide dispersion of views, however, as to the short-run consequences of fiscal restraint. According to the standard Keynesian model, reductions in federal spending of the magnitudes now projected would have a magnifying and thus very depressing impact on the economy, at least temporarily, unless offset by monetary expansion or other factors. In the context of flexible exchange rates and efficient international capital markets, however, this depressing effect should be at least partially offset over time. The reason is that a reduction in the budget deficit puts downward pressure on U.S. interest rates, and as a result less capital is attracted from international capital markets. A reduction in net capital inflows should lower the value of the U.S. dollar and eventually reduce the trade deficit, provided that lower income growth abroad does not offset this stimulus to U.S. exports.

Some versions of the new classical model, which assign prominence to economic behavior based on expectations, go further and argue that a reduction in federal spending has no effect on output and employment unless unanticipated. 13/ Finally, the strict monetarist model maintains that fiscal restraint would not significantly depress aggregate output and employment even in the short run, but would instead alter the composition of activity in favor of investment and other relatively interest-sensitive components. 14/

In any event, as discussed earlier in this report, other important developments could offset the contractionary effects of fiscal restraint. These include the recent large drop in energy prices and the continuing fall in the international exchange value of the dollar, which, as suggested above, may be related to the improved prospects for deficit reduction. The net effect of all these factors (including fiscal restraint) on short-term growth depends in part on how fast the impact of each factor works its way through the economy. Given that oil prices and the exchange rate already have declined substantially during the past year, these stimulative factors could dominate the short-term outlook, especially if the complete response to fiscal restraint is not immediate.

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13. Some adherents to the new classical views, however, maintain that a reduction in federal spending would lower output and employment, especially if the spending reduction was temporary and not a perfect substitute for private spending. See Robert J. Barro, "Output Effects of Government Purchases," *Journal of Political Economy* (1981), pp. 1086-1121.

14. Empirical estimates with a monetarist model generally show output declining temporarily. But over a period of a year or so, the net effect is negligible.

ASSET SALES AND FEDERAL DEFICIT TARGETS

Although the federal government is a net debtor, it nevertheless owns a very large amount of financial and tangible assets. Some analysts argue that economic efficiency would be improved if the government divested itself of some of these assets. Because the sale of financial assets acquired through federal lending would provide a measure of the federal subsidy (the difference between the loan value and the market value of the asset), asset sales may also permit better-informed policy decisions. It is also frequently proposed that the sale of federal assets would help the government reduce budget deficits. The discussion in this box does not address the issue of efficiency, but does examine three other issues regarding the sale of federal financial assets: the appropriate budgetary treatment of such sales, the long-run effects on budget deficits, and resulting distortions in the measurement of fiscal policy.

Budgetary Treatment. By convention, receipts from the sale of federal assets are recorded as negative outlays in the budget, and thus reduce the size of the federal deficit. In this respect, selling federal assets has the same current impact on the reported budget deficit as reducing federal spending. Many analysts, however, argue that this treatment is misleading, claiming that it would be more appropriate to view asset sales as a means of financing the deficit rather than as a reduction in spending. In fact, the Commerce Department excludes the proceeds of asset sales from the federal deficit in the national income and product accounts.

Nevertheless, the significant shift in fiscal policy does entail some risk. There is considerable uncertainty about the timing and magnitude of fiscal effects, especially with regard to whether they are offset by movements in the trade balance. Conceivably, the contractionary impact of the fiscal policy shift could slow the economy before its indirect stimulative effects on the trade balance and interest-sensitive spending take hold. CBO does not assume that this will happen, but the possibility is one more factor making the current forecast even more uncertain than usual.

Long-Run Deficit Effects. While asset sales immediately reduce the reported federal deficit under current budgetary conventions, they may increase future deficits. On the one hand, cash from the asset sale can be used to retire outstanding debt, saving on future interest expense. On the other hand, the government no longer receives the revenues from the payment of interest and principal on these loans. Selling the loans means that future deficits will be larger so long as the forgone receipts from the asset exceed the interest savings on the retired debt.

Distortions in Fiscal Policy Measures. Most economists would agree that reducing the deficit through asset sales would have no direct short-run impact on output and employment. In this respect, asset sales are merely a substitute for Treasury bond sales, and as such have the same net effect on total credit demand. Like Treasury bond sales, they absorb private credit. Therefore, with asset sales, the federal deficit is not a good measure of federal credit absorption. In other words, asset sales do not increase national saving as would a reduction in federal spending.

Given the short-run neutral effects of asset sales on the total demand for goods and services, measures of fiscal policy such as the structural budget deficit are likely to overstate the degree of fiscal restraint if they include increases in the sale of federal assets. In most past years, the level of asset sales has not been large (less than $3 billion) compared with the deficit, and thus has not significantly distorted budget-based measures of fiscal restraint. But if asset sales become a major component of deficit reduction measures, the projected structural budget deficit shown in Figure I-12, would significantly exaggerate the degree of fiscal restraint.

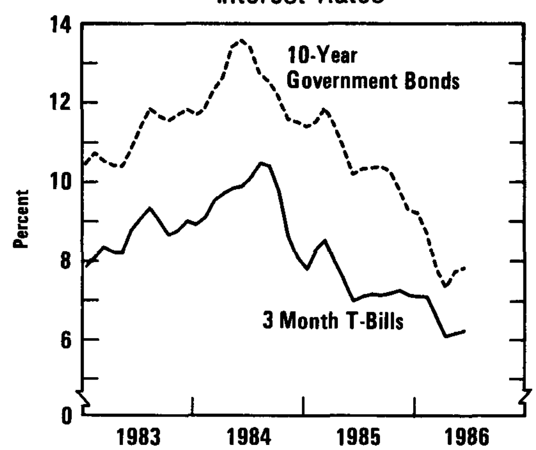
Financial Markets and Monetary Policy

Notwithstanding the recent fall in the stock market, 1986 has marked a continuation of the rally in financial markets that began in mid-1984. The decline in interest rates to levels not seen since the latter 1970s is the outcome of several different factors: slowing economic activity, reduced inflation, accommodative monetary policy, and efforts to cut the projected federal deficit.

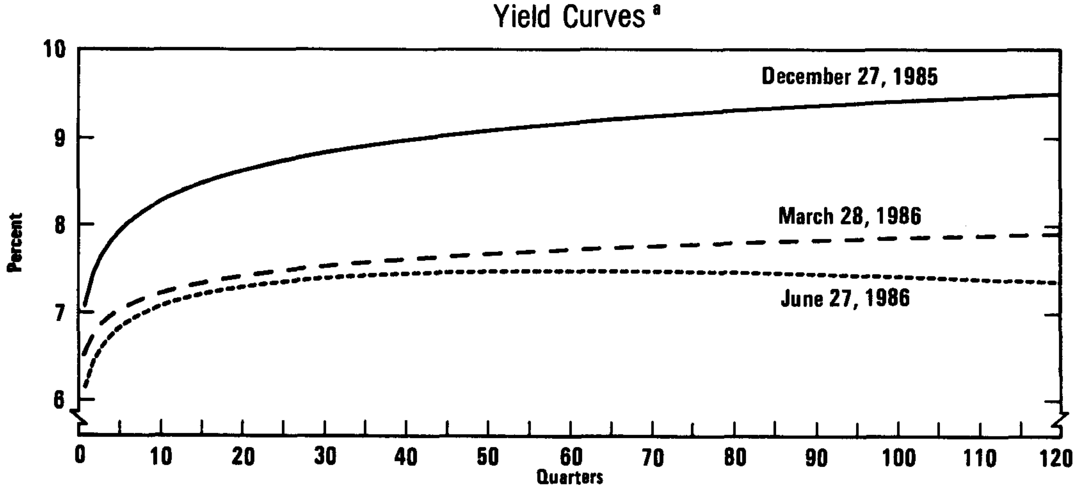
Although both short- and long-term interest rates fell sharply through the first four months of this year, the drop was much more pronounced for the longer maturities (see Figure I-13). The resultant flattening in the yield curve triggered a significant volume of debt restructuring as firms sought to take advantage of the relatively low long-term rates. Beginning in late April, concern that the drop in the international value of the dollar might spur inflation caused rates to rise again, but they have now dropped back close to their previous lows. The prospect of more rapid economic growth in

Figure I-13.
Recent Short- and Long-Term Interest Rate Movements

Interest Rates



Yield Curves [a]



SOURCES: Congressional Budget Office; Federal Reserve Board.

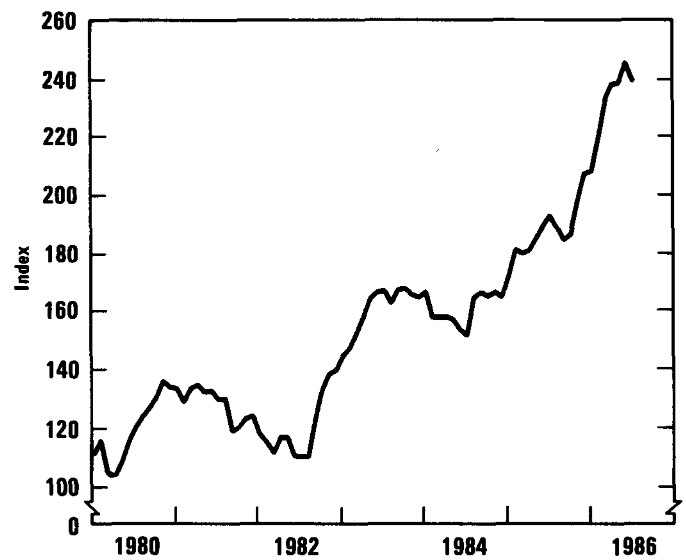
a These curves were fitted to weekly average yields on Treasury instruments using a logarithmic function described by Bradley and Crane in the *Journal of Bank Research*, Spring 1973.

the second half of the year has led some forecasters, including CBO, to expect a modest pickup in nominal interest rates toward year-end and into 1987, though real rates are expected to decline. Some forecasters expect relatively flat rates through mid-1987--as suggested by the expectations embodied in the yield curve and the futures market.

The stock market, as measured by the Standard and Poor's Index of 500 Stocks, rose 26 percent in 1985 and then surged to new highs again this year, rising over 18 percent in the first six months (see Figure I-14). In recent weeks, however, the market has retracted some of the gains in the first half. While the increase in stockholders' wealth may be helping to sustain consumer spending, a prolonged decline in the stock market, by reversing the gains in wealth, could have the opposite effect on consumer spending.

Credit Flows. During the first quarter of this year, both the public and private sectors reduced their borrowings. Households continued to buy on installment credit but sharply curtailed their net acquisition of new mortgage credit. It is possible that many new mortgages were displaced by the surge in refinancing of old ones, and originations will pick up once the bulge in refinancing has run its course. Corporations have taken advantage of lower long-term rates to restructure their balance sheets but have postponed borrowing to fund new capital expenditures. Surveys of planned

Figure I-14.
Common Stock Prices (Standard and Poor's "500")



SOURCES: Congressional Budget Office; Standard and Poor's Corporation.

capital expenditures suggest that corporate demand for credit may remain relatively sluggish.

By far the largest decline in the rate of growth of debt has been in the public sector, especially at the state and local level. During 1985, states and localities issued a record amount of securities, in large part because of pending federal tax reforms that would place more restrictions on tax-exempt financing beginning in 1986. After a sharp decline in the first quarter, state and local borrowing has once again been increasing following a change in the effective date for some of the tax reform proposals. Credit demands by state and local governments are expected to remain moderately strong, at least in the near term, despite the uncertainty over tax reform. At the same time, the volume of federal credit demand is expected to decline in 1987, but to remain much larger than state and local borrowing.

Monetary Policy. By most measures, monetary policy in 1986 has continued to accommodate economic growth. M1, which apparently is becoming an increasingly unreliable indicator of monetary stimulus, surged at a 13.2 percent annual pace over the first half of this year, well above the 3 percent to 8 percent target (see Figure I-15). The burst in M1 has left it over $17

TABLE I-10. GROWTH RATES OF CREDIT MARKET DEBT, NONFINANCIAL SECTORS (Percent change at annual rates)

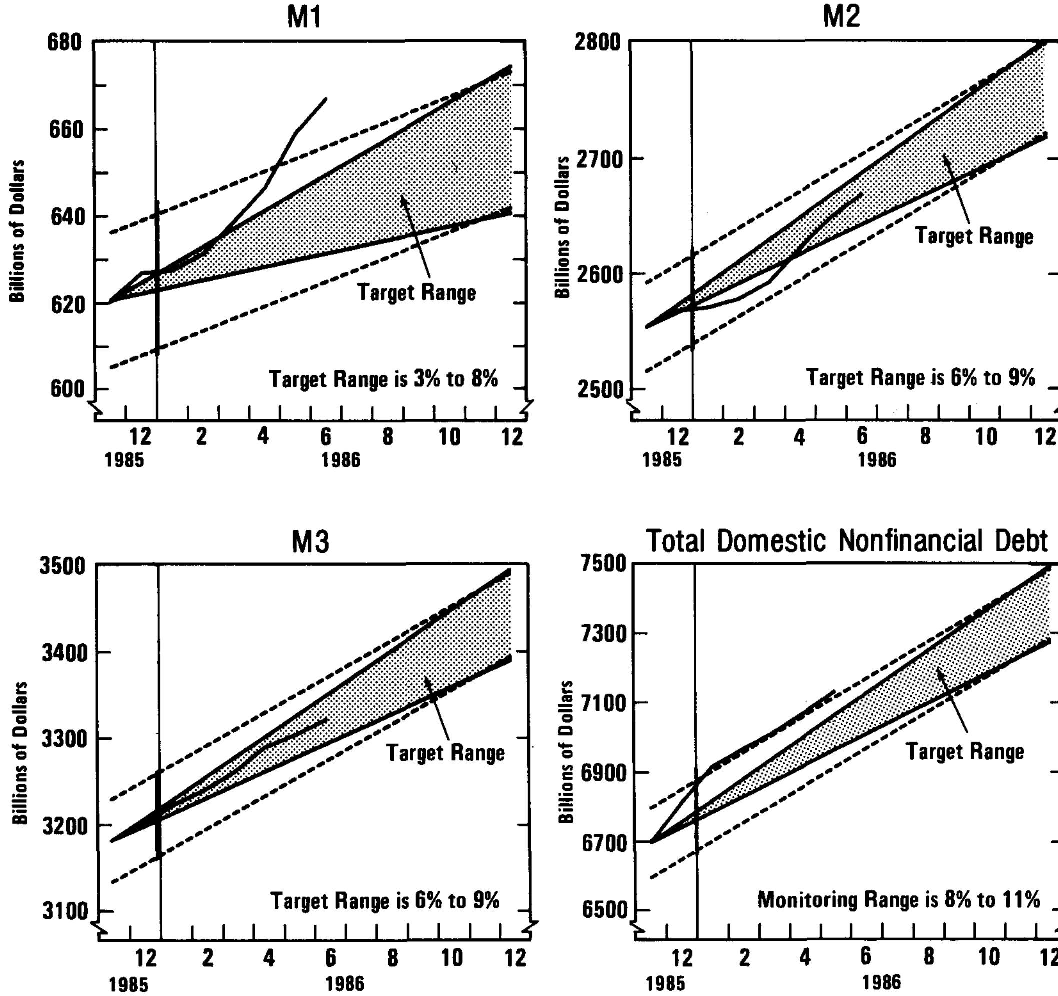
Sector	1985 I	1985 II	1985 III	1985 IV	1986 I
Total Nonfinancial Debt	11.4	12.6	12.8	20.9	8.6
Private	11.5	11.5	13.0	19.5	8.8
Corporate	11.8	10.6	9.0	13.8	11.7
Household	12.0	12.0	15.1	16.8	8.4
Foreign	-1.3	-1.3	4.8	0.5	-4.1
Public	12.0	17.9	15.6	37.6	6.9
Federal	10.9	16.6	12.0	26.0	7.7
State and Local	15.6	22.0	28.2	79.3	4.6

SOURCES: Congressional Budget Office; Federal Reserve Board.

billion above its target as of June, and has prompted the Federal Reserve to de-emphasize the role of this aggregate in its midyear economic report to the Congress. M2 and M3 grew at rates of 8.2 percent and 7.8 percent,

Figure I-15.

Money Growth and Targets in 1986



SOURCES: Congressional Budget Office; Federal Reserve Board.

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

TABLE I-11. SELECTED MONETARY POLICY MEASURES

Time Period	Money Base Growth a/	Total Reserve Growth a/	Seasonal and Adjustment Borrowings b/	Federal Funds Rate-Discount Spread (in percents)
1985:II	7.6	12.4	598	0.15
1985:III	10.0	16.7	579	0.40
1985:IV	8.4	13.1	862	0.60
1986:I	8.9	13.8	302	0.46
1986:II	9.0	19.0	274	0.31

SOURCE: Federal Reserve Board.

a. Seasonally adjusted annual rates of change.

b. Millions of dollars, not seasonally adjusted.

respectively, in the first half of the year, well within their 6 percent to 9 percent targets but slightly faster than in the second half of last year. 15/

As shown in Table I-11, the reserve aggregates tell a similiar story. The monetary base is expanding at about the same rate as during the last half of 1985, and total reserves are expanding slightly faster. Seasonal and adjustment borrowings from the Federal Reserve are running at less than half of last year's level, and in the second quarter the spread between the federal funds rate and the discount rate fell to about 30 basis points--both indications of a somewhat easier Federal Reserve stance. The Federal Reserve also lowered the discount rate to 6 percent with three cuts of half a percentage point in March, April, and July.

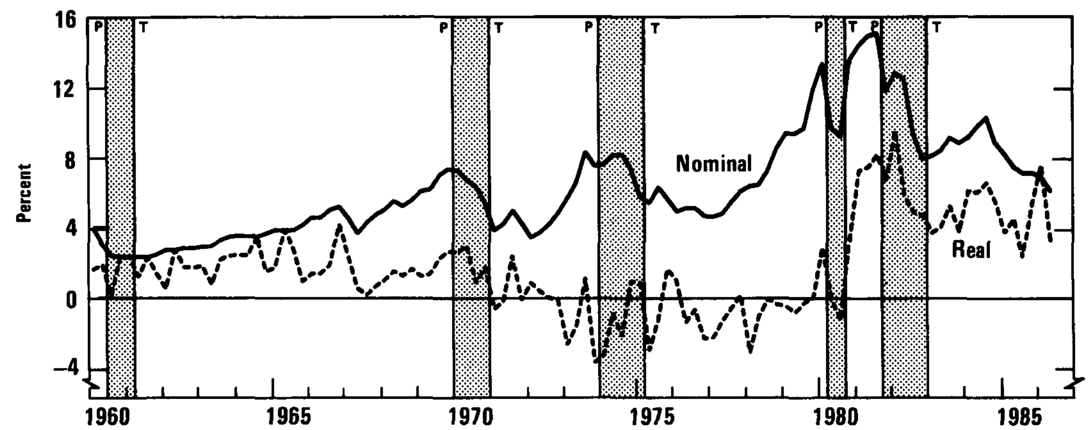
In July, the Federal Reserve Board also announced tentative 1987 aggregate targets for M2, M3, and debt. The targets for the broader Ms were lowered one-half percentage point to a range of 5½ percent to 8½ percent,

15. M1 consists of currency, travelers' checks, demand deposits, and other checkable deposits. M2 consists of M1 plus overnight repurchase agreements, Eurodollars, money market mutual fund balances, money market demand accounts, and savings and small time deposits. M3 consists of M2 plus large time deposits, term repurchase agreements, term Eurodollars, and other institutional funds.

while the debt target was unchanged at 8 percent to 11 percent. These tentative targets for M2 and M3, together with the Federal Reserve's expectation for GNP growth of 5 percent to $8\frac{1}{4}$ percent, imply that the Board expects M2 and M3 velocity to begin growing at close to their respective trends without making up for the shortfall in the level of velocity over the past five years. In keeping with the de-emphasis on M1, the Federal Reserve anounced that a tentative target for M1 of 3 percent to 8 percent (the same as in 1986) would be appropriate "if more stable velocity behavior shows signs of re-emerging."

While these tentative targets and accompanying statements by the Federal Reserve point toward a continued accommodative monetary policy, its effect on economic activity is more uncertain because of the decline in the income velocity of money (see the box). Some analysts see the rapid money growth as a harbinger of future inflation, while others point to the flattening of the yield curve, the still historically high short-term real interest rates, and the weakness in many commodity prices as evidence that monetary easing has some way to go before it will boost economic growth, let alone trigger inflation (see Figure I-16). Although a marked flattening in

Figure I-16.
Three-Month Treasury Bill Rates



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

NOTE: Real interest rates are calculated by subtracting from the nominal interest rate the rate of inflation in the succeeding quarter. This value, the "ex post real rate," is the proxy for the unobserved real rate, which is the nominal rate less expected inflation over the life of the instrument. The inflation rate used is that of the fixed-weight consumption price index and is assumed to be 2.7 percent in the third quarter of 1986.