THE ECONOMIC OUTLOOK FOR 1979-1980: AN UPDATE

The Congress of the United States
Congressional Budget Office

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

PREFACE

The Economic Outlook for 1979 and 1980; An Update is one of a series of reports on the state of the economy issued periodically by the Congressional Budget Office. In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations. The report was prepared by Joan Schneider, George Iden, Frank Russek, Steve Zeller, Lawrence DeMilner, Nariman Behravesh, Marvin Phaup, Yolanda Kodrzycki, Rebecca Shillingburg, Asa Strong, Toni Gibbons, John Jacobson, and Carl Gunn, under the direction of William J. Beeman and James E. Annable. Robert L. Faherty and Francis S. Pierce edited the manuscript; Marsha Mottesheard, Dorothy J. Kornegay, Judy Deason, and Debra Blagburn typed the many drafts.

Alice M. Rivlin
Director

July 1979

CONTENTS

TABLES

TABLES CONTINUED

Page

FIGURES

48-096 O - 79 - 2

SUMMARY

The sharp acceleration of inflation in 1978 and again in the first half of this year not only has caused real incomes to fall for many people, but also has hastened the decline in the economy. The economic forecast prepared last January by the Congressional Budget Office (CBO) projected continued high inflation in 1979 and a mild downturn in the economy in the second half of this year. The economic downturn was expected to result largely from two factors. First, weaker consumer demand was forecast because of the erosion of purchasing power due to inflation and because of the likelihood that rapid consumer sales in 1978 had borrowed from future sales as consumers bought in anticipation of inflation. Second, a more restrictive monetary policy had been adopted last fall in response to inflation and the depreciation of the dollar in international markets.

Since January, inflation has been considerably higher than projected by CBO, largely because of an unexpectedly sharp rise in food and fuel prices. After accelerating from a rise of 6.8 percent in 1977 to a rise of 9 percent in 1978, consumer prices rose at a 13.4 percent annual rate in the first five months of this year. At the same time, economic growth so far this year has been much weaker than expected. Most forecasters currently believe that the economy is now or will be shortly in a recession that will eventually include a rise in the unemployment rate to between 7 and 8 percent. While it is clear that a serious pause in economic activity has already occurred, there is a substantial chance that the economy will turn out to be either stronger or weaker than the consensus of forecasts. CBO continues to believe, however, that a mild recession will occur this year, with recovery in 1980.

The CBO Current Policy Forecast

The major elements of the CBO forecast, which assumes that current budget policies are continued unchanged, can be summarized as follows:

- Real growth in Gross National Product (GNP) is expected to be in the -2.0 to 0.0 percent range over the four quarters of 1979, followed by a rebound in 1980 in the 1.9 to 3.9 percent range.

- o Consumer prices are projected to increase by 9.9 to 11.9 percent during 1979, decelerating to 7.9 to 9.9 percent during 1980. The deceleration in inflation assumes no additional price shocks and a moderation of price increases for both food and fuel.

- o The unemployment rate is expected to rise to a 6.4 to 7.4 percent range by the last quarter of this year and to a 6.7 to 7.7 percent range by the end of 1980.

TABLE 1. SUMMARY OF CBO ECONOMIC PROJECTIONS UNDER CURRENT BUDGET POLICY, CALENDAR YEARS 1979 AND 1980

Economic Variable	1977:4 to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 1980:4
GNP (current dollars, percent change)	13.1	6.2 to 10.3	9.9 to 14.1
Real GNP (1972 dollars, percent change)	4.4	-2.0 to 0.0	1.9 to 3.9
Consumer Price Index (percent change)	9.0	9.9 to 11.9	7.9 to 9.9
Unemployment Rate, End of Period (percent)	5.8	6.4 to 7.4	6.7 to 7.7

Economic forecasts depend critically on assumptions about economic policy and other developments. The current CBO forecast is based upon the following assumptions about fiscal and monetary policy:

- o Federal spending and tax policies will be those of the first budget resolution for fiscal year 1980. These policies are assumed to result in federal budget outlays of $495 billion in fiscal year 1979 and $540 billion in fiscal year 1980. The 1980 outlay figure includes an $8 billion overrun concentrated in transfer payments, national defense, and interest. No tax changes are assumed in the forecast other than those included in the first concurrent resolution.

- o Monetary policy will remain relatively restrictive through most of 1979, even though short-term interest rates are expected to decline because of weaker demands. However, in line with the Federal Reserve's announced preference for monetary stimulus rather than fiscal stimulus, the Federal Reserve growth target for the broadly defined money aggregate, M2, is assumed to be raised in 1980.

In addition, the CBO forecast assumes:

- o The price of imported oil will increase to $20 per barrel in July of this year, rising thereafter at a rate that is 3 percent higher than inflation.

- o The exchange value of the dollar will remain near present levels.

- o The price of consumer foods will increase by about 11 percent during the current year, slowing to an 8 percent rise during 1980.

The Recent Slowdown in the Economy

There appears to have been no significant gain in overall economic activity so far in 1979. The weakness evident in the economy since last December has been concentrated in the household sector; business demands have been relatively strong. In real terms, retail sales declined at an 11.1 percent annual rate between December and May. While the weakness in sales has been widespread, sales of automobiles, particularly the larger models, have declined dramatically since March. Sales of domestically produced autos were off almost 13 percent in the second quarter.

The weakened demand of the household sector is also evident in residential construction. Housing starts did not bounce back as strongly as expected from the weather-related decline in the January-February period. Housing starts in the first half of 1979 are expected to be almost 20 percent below the second half of 1978.

Data through May show household employment and average hours worked down in the second quarter of 1979. Nevertheless, production may have outpaced real sales by a greater amount in the second quarter of this year than in the first quarter. This suggests that a rise in inventories has taken place and, if final sales do not snap back, portends some cutbacks in output and employment in the coming months. The auto industry appears to be particularly vulnerable because stocks of unsold domestic autos were at record levels at the end of May.

Recession in 1979

Many of the factors accounting for the recent weakness of household demands are expected to continue to exert a negative influence on the economy in the projection period:

- The direct effect of the rise in OPEC oil prices since December, equivalent to more than a $20 billion increase in personal income taxes, is expected to reduce disposable income by 1 percent in 1980.

- Rapid increases in all prices largely due to supply conditions will continue to depress real incomes and real wealth, thereby eroding purchasing power.

- Consumer debt will remain burdensome and restrain spending.

- Low consumer confidence will impede spending.

- The spate of consumer buying during the last half of 1978 in anticipation of higher prices borrowed heavily from future sales. Consumers are not expected to repeat that behavior in the near future despite continuing high inflation.

- Record high mortgage interest rates and rising house prices are expected to continue to depress housing construction.

- The reduced demand for larger autos, vans, and trucks resulting from rising fuel prices and fuel shortages is expected to continue for a time.

Business spending is now fairly strong but probably will not remain so. In response to weak retail sales and a rise in business inventories, producers of consumer goods are expected to reduce employment and cut production during the second half of this year. The resulting rise in unused capacity and decline in profit margins are expected to dampen demand for capital goods later this year and in 1980.

Nevertheless, CBO does not expect a major recession this year. Except for autos, inventories still appear lean by historical standards, so that cutbacks in production to reduce inventories may be relatively mild. Furthermore, in part because of changing technology and government regulation, investment spending is expected to remain strong in some industries regardless of the slowdown in consumer spending.

Recovery in 1980

Economic developments cannot be forecast as far ahead as 18 months with a great deal of confidence. First, economists have not been very successful at predicting the timing of turning points in the economy. Second, the economy in 1980 is likely to be significantly influenced by some factors that are not yet apparent. Nevertheless, CBO's best guess is that economic growth will recover in 1980. The projected recovery will be brought about by a number of factors:

- The ending of a mild inventory adjustment;
- A moderation in supply inflation that permits greater real income growth;
- A decline in interest rates that boosts housing construction; and
- An improvement in consumer finances and an upturn in durable goods consumption, partly because of replacement needs and increased residential construction.

Moreover, as indicated earlier, the projected expansion in 1980 is assumed to be accommodated by an easing of monetary policy later this year.

Assuming that current budget policies are maintained, the 1980 rebound is likely to be weak compared with earlier postwar cyclical upturns. Rapid price increases are expected to reduce growth in upturns. Rapid price increases are expected to reduce growth in real incomes and put upward pressure on interest rates. In addition, assuming that there is no tax cut, the recovery will be restrained by substantial fiscal drag resulting from the combination of inflation, the progressive income tax structure, and weak growth in government purchases. Accordingly, the unemployment rate is expected to remain above 7 percent through 1980.

Sources of Uncertainty

The outlook for the economy is always uncertain, but especially at turning points. Most forecasters are now pessimistic about the near-term outlook for both production and employment. But they may be wrong. First, the timing and size of adjustments in production and employment depend on whether business firms regard their inventory stocks as excessive, just right, or too lean. The data on inventories are not sufficiently reliable to permit forecasters to predict with confidence the timing and size of inventory adjustments. Second, a resurgence of consumer spending and continued strength in business investment spending cannot be ruled out. Of course, stronger consumer spending that merely represents buying in advance of expected price increases would not improve the longer-run outlook.

Both inflation and unemployment could, however, be higher than forecast by CBO. Possible events that could darken the outlook over the next 18 months include:

- Further unanticipated supply shocks such as severe fuel shortages that curtail output, a larger than expected rise in OPEC prices, or poor farm harvests that boost consumer food prices above the projected levels;

- A prolonged labor strike in a major sector, such as the auto industry;

- A sharp drop in the international exchange value of the dollar; or

- A more restrictive monetary policy that hinders the projected recovery in housing construction in 1980.

Conclusion

Inflation has been worse than expected, and the economy has weakened since the first of the year. CBO concludes that the most likely outcome for the remainder of 1979 is a mild recession with rising unemployment and high, but moderating, rates of inflation. Economic activity is projected to turn up in 1980. Given current budget policy, however, the recovery is expected to be weak by historical standards, and the unemployment rate is projected to remain above 7 percent throughout 1980.

If the unemployment rate rises significantly, the Congress will be faced with difficult policy decisions. Economic growth could be boosted by cutting taxes, but this action would conflict with the goal of a balanced budget as well as with long-run efforts to reduce inflation. The major impact of fiscal stimulus on the economy is usually delayed for more than a year. Assuming that the recession is mild, lasts only a few quarters, and is followed by a sizable rebound, budgetary measures to stimulate the economy could aggravate inflation by providing delayed stimulus when the recovery is already well underway. If, on the other hand, the recession is deep or lasts quite long, thereby driving the unemployment rate up to high levels for a prolonged period, tax cuts might serve to ameliorate unemployment substantially without significantly aggravating inflation.

Unfortunately, fiscal policy must be made in an environment of uncertainty. We do not know in advance whether unemployment will rise sufficiently to warrant fiscal stimulus. Since the unemployment rate at midyear has not begun to rise and the outlook for inflation and economic growth is very uncertain, perhaps the Congress and the Administration should consider developing a contingency budget plan for future use in case the economic situation deteriorates significantly.

48-096 O - 79 - 3

CHAPTER I. CURRENT ECONOMIC DEVELOPMENTS

On balance, the events unfolding since the end of 1978 have supported the basic message of the January forecast of the Congressional Budget Office (CBO): that a recession is likely to occur in 1979, followed by a mild recovery in 1980. 1/ The economy has slowed down significantly so far this year, although sooner than CBO had anticipated. Also in the January report, CBO was less optimistic than the Administration that the wage-price program would be able to restrain inflation. And the rate of price increase has accelerated sharply, well above the rate foreseen by CBO six months ago. This report reviews recent economic developments and updates the forecast.

PRICES AND WAGES

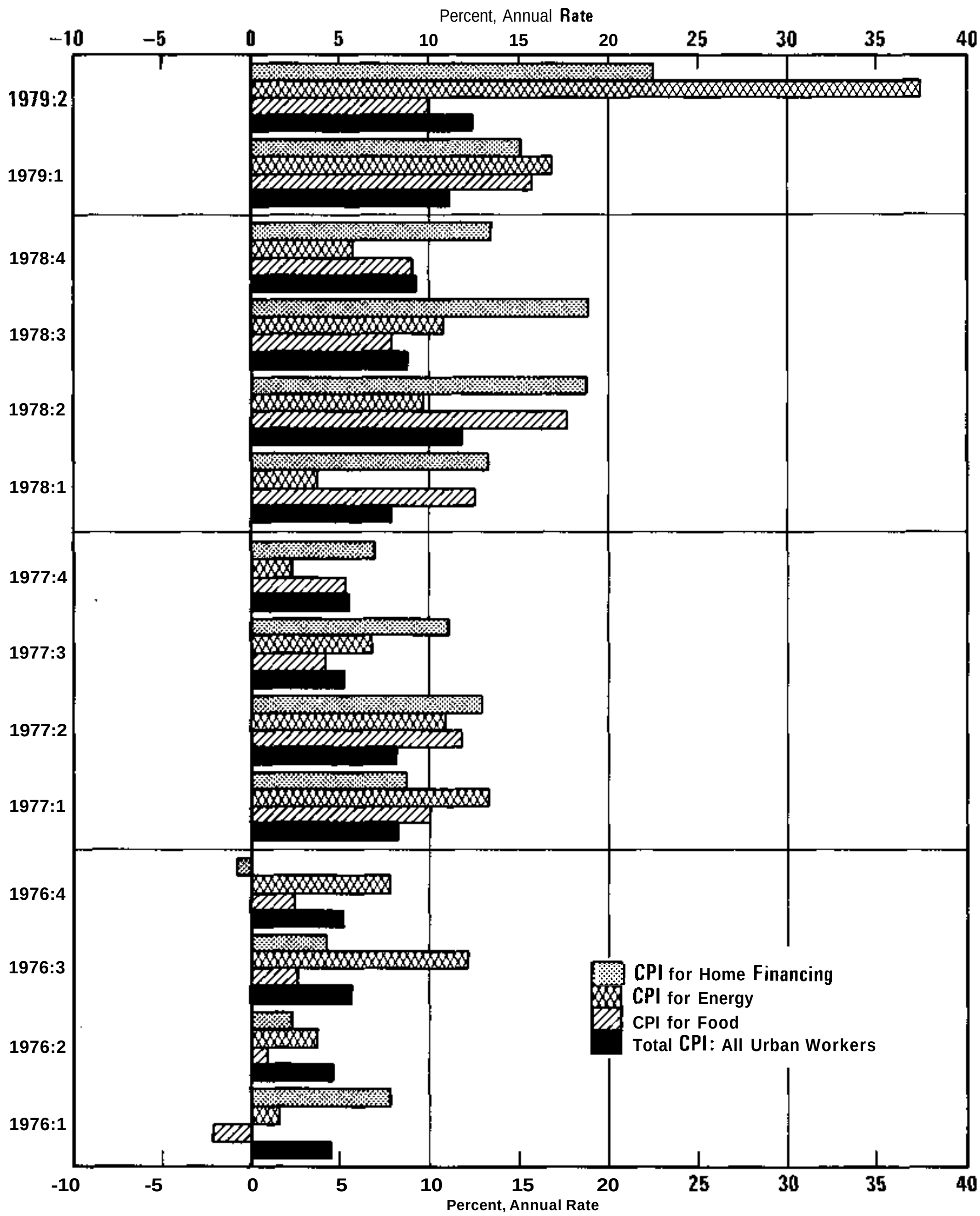
After accelerating from a 6.8 percent increase in 1977 to 9.0 percent in 1978, the Consumer Price Index (CPI) rose at a 13.4 percent annual rate in the first five months of this year (see Figure 1). The acceleration has contributed to the decline in real wage-and-salary incomes, the weakening of the housing market, and the slump in consumer confidence.

Several factors have caused the recent acceleration, but three are most significant. 2/

1/ Congressional Budget Office, The Fiscal Policy Response to Inflation: A Report to the Senate and House Committees on the Budget, Part I (January 1979), referred to hereafter as "January report."

2/ The contribution of each item to the acceleration in the CPI is calculated by assuming that the price of the item continued to rise at the same rate it did in 1978; the assumed all-items CPI change is then subtracted from the actual CPI change. Given the problems of compounding and inconsistent seasonal adjustments, however, the results are only rough estimates.

Figure 1.
Percent Changes in the Consumer Price Index and Selected Components



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

NOTE: Point for 1979:2 is average of April and May values.

- o Food prices rose sharply, contributing about 1/2 percentage point to the overall CPI acceleration;

- o A jump in energy prices added roughly 2-1/2 percentage points to the December-May inflation rate; and

- o Rising mortgage interest costs contributed about another 1 percentage point to the increase in consumer price inflation.

Food Prices. The CPI for food so far this year has risen at a 14.7 percent annual rate, as compared with 11.8 percent in 1978 (see Figure 1) . Much of the acceleration has resulted from rapidly rising beef prices. After drawing down stocks for an unusually long period of five years, ranchers have been attempting to rebuild their herds by withholding heifers from market and, consequently, reducing available supplies of beef (see Table 1) . Recently, beef prices have stabilized as consumer resistance to high costs was encountered and as pork and poultry supplies increased. But a new upward pressure on food prices has developed recently in grains. In part as a result of rising export demand, grain prices have risen sharply over the past three months.

TABLE 1. CATTLE INVENTORIES, 1970-1979: MILLIONS OF HEAD ON JANUARY 1

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Stock	112.4	114.6	117.9	121.5	127.8	132.0	128.0	122.8	116.3	110.9

SOURCE: U.S. Department of Agriculture.

Even if prices received by farmers remain stable for the rest of this year, retail food prices likely will continue to rise. Marketing costs, largely for transportation, packaging, and wages, account for roughly two-thirds of the consumer's retail food bill, and these costs are expected to increase significantly further in 1979.

Energy Prices. The OPEC price for crude oil was raised to about $20 a barrel at the cartel's June meeting (see Table 2). This is an increase of nearly 60 percent since last December. But the rise occurred less abruptly than the changes in the official benchmark price suggest. Before the OPEC meeting, the effective price with surcharges was already in the neighborhood of $17, up more than 30 percent from the end of last year. The sharp increase in petroleum prices early this year originated in the drop in Iranian production of crude oil.

TABLE 2. OPEC PRICE OF OIL AND U.S. IMPORTS, 1972-1979

	June								July
	1972	1973	1974	1975	1976	1977	1978	1979:1 a/	1979
OPEC Price of Oil per Barrel (dollars) b/	2.13	2.40	10.95	10.46	10.46	12.09	12.70	14.70	20.00 c/
U.S. Imports of Crude Oil and Refined Products (millions of barrels per day) d/	4.47	5.88	6.36	5.41	7.48	8.94	7.85	8.36	N.A.
Imports as a Percent of U.S. Consumption	28.6	35.7	39.5	34.6	44.4	49.5	43.0	41.0	N.A.

a/ First-quarter average.

b/ Official OPEC marker sales price of Saudi Arabian light oil, except for 1979 which is the average OPEC price.

c/ Estimate of the new average OPEC price.

d/ Excludes imports for Strategic Petroleum Reserves.

SOURCES: U.S. Department of Energy, Energy Information Administration; Central Intelligence Agency, National Foreign Assessment Center.

The OPEC price increase and the accompanying petroleum supply shortages have resulted in the largest jump in domestic fuel prices since the quadrupling of OPEC prices in 1974. Prices for gasoline and fuel oil have risen at an annual rate of over 50 percent during the first five months of the year. This increase in retail prices is significantly higher than would have resulted solely from a passthrough of the higher OPEC prices. Nevertheless, the OPEC increase since December is large. The drain of purchasing power to foreign oil producers as a result of the 1979 price increases could total more than $20 billion (at an annual rate), amounting to roughly 1-1/4 percent of disposable personal income in the third quarter of 1979. The 1974 quadrupling of OPEC prices also drained close to $20 billion in the first year, approximately 2 percent of disposable income.

Even though energy prices are not expected to continue to increase at recent rates, prospects for the future are not favorable. The Administration's policy of decontrol of domestic oil prices, along with the likelihood of a continuing tight supply situation at least in the near term, should keep energy prices rising at a pace greater than the average rate of inflation for the economy as a whole.

Home Financing, Taxes, and Insurance. The cost of home financing, taxes, and insurance (FTI), as measured in the CPI, increased at an annual rate of more than 25 percent in the first five months of the year. Most of the upward pressure has come from rapidly rising mortgage interest costs, which account for nearly three-quarters of this CPI category. Rapid changes in the FTI category can have a significant impact on the overall CPI. In fact, many analysts believe that the FTI category is given an unrealistically large weight in the overall measure so that the recent increase in living costs has been overstated.

Labor and Materials Costs. Although food and energy prices are responsible for much of the increase in consumer price inflation, the prices of other consumer goods and services have accelerated as well. So far this year, the CPI less food and energy has risen at an annual rate of 10.2 percent, as compared with a rate of 8.5 percent in 1978. As noted earlier, most of this acceleration can be attributed to mortgage interest costs. However, large jumps in the rates of increase of unit labor costs and materials prices must share at least some of the blame.

Unit labor costs rose at an annual rate of 15 percent in the first quarter of this year. This is significantly larger than the total 1978 increase of 9.0 percent, even after removing the effects of January's minimum wage and Social Security tax increases. The acceleration, however, was due largely to a sharp drop in productivity of more than 4 percent at an annual rate, as compared with a rise of 0.7 percent in 1978. Firms often view such movements in productivity as transitory and, therefore, these changes are not fully reflected in prices. Thus, the acceleration in unit labor costs probably has had a relatively small impact on the CPI acceleration so far this year. This does not mean, however, that labor costs are not relevant to the inflation problem. On the contrary, high unit labor costs are the major reason why the fundamental rate of inflation--eliminating the transitory elements--is currently in the neighborhood of 8 percent, an exceptionally high core rate.

Prices of raw materials accelerated sharply for most of the period since last fall, although these prices have softened a bit recently. After rising at an annual rate of 27 percent from September to March, wholesale prices for crude nonfood materials except fuel declined in April and rose only moderately in May. Since materials prices tend to lead business trends, such a slowing is consistent with CBO's projection of an economic downturn this year.

Raw materials prices may have contributed somewhat to the recent acceleration in consumer prices. Overall, however, this impact was relatively small because of the small weight of raw materials in the value of finished products.

Wages. While prices have accelerated sharply this year, there has been little acceleration in wages from the 1978 rate of increase. In the first quarter of this year, the average hourly earnings index increased by about 9.4 percent at an annual rate, as compared with a rate of 8.3 percent over 1978. This rise does not indicate an acceleration in wages; rather, it results from the concentration of the effect of the 1979 minimum wage increase in the first quarter. Last year's first-quarter increase, reflecting a somewhat greater adjustment in the minimum wage, was substantially larger than the gains in the other quarters. In the same way wage measures other than average hourly earnings, such as compensation per hour and the employment cost index, have also shown little acceleration so far this year, as is shown in Table 3.

TABLE 3. SELECTED WAGE MEASURES, 1978-1979: PERCENT CHANGE

Wage Measure	1978:1 a/	1978 b/	1979:1 a/
Compensation per Hour, Private Business Sector	12.2	9.8	11.1
Average Hourly Earnings Index	9.2	8.3	9.4
Employment Cost Index	7.8 c/	7.7 d/	8.2 c/
Collective Bargaining First-Year Settlement, Wage Rates e/	9.3	7.8	9.3

a/ Percent change from previous quarter, annual rate, seasonally adjusted.

b/ Percent change from four quarters earlier.

c/ Three-month percent change ending in March, annual rate, not seasonally adjusted.

d/ Twelve-month percent change ending in December.

e/ Those who received increases; excludes those whose settlements involved no increase in the first year. Not seasonally adjusted.

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

The indicators of future wage behavior are mixed. Factors that would work to hold down the growth in labor costs are the expected higher rate of unemployment later this year and in 1980, the smaller scheduled increases in the minimum wage and in payroll taxes next year, and the success of the Administration's wage-price program. Other influences, however, could cause wage gains to accelerate. Most important among them is the recent rapid increase in the inflation rate, which may put a strong upward pressure on levels of pay.

48-096 0 - 79 - 4

On balance, there is not much likelihood of a significant deceleration of wage gains this year or in 1980. Indeed, if the recent rapid supply-side inflation feeds more fully into labor compensation than CBO now anticipates, wage growth could accelerate substantially in the next year and a half, despite the expected slackening in labor demand.

FINAL SALES

The growth in economic activity has weakened sharply since the end of last year, partly because of the rapid acceleration of inflation. Measured in constant dollars, total final sales increased only slightly in the first quarter, up at an annual rate of 0.1 percent after rising 4.4 percent during 1978 (see Table 4).

TABLE 4. CHANGES IN CONSTANT DOLLAR FINAL SALES AND ITS MAJOR COMPONENTS, 1976-1979: PERCENT CHANGE, AT ANNUAL RATES

	1976:4 to 1977:4	1977:4 to 1978:4	1978:4 to 1979:1
Total Final Sales	4.9	4.4	0.1
Personal Consumption Expenditures	4.8	4.0	0.7
Fixed Investment	11.1	6.4	-1.0
Residential	15.3	0.0	-14.4
Nonresidential	9.1	9.4	5.1
Government Purchases	5.1	1.8	-4.2
Federal	6.3	-1.1 a/	-1.9 a/
State and Local	4.3	3.5	-5.5
Exports	-1.3	16.4	13.1
Imports	10.3	9.3	5.2

a/ The decline in federal purchases results from Commodity Credit Corporation transactions.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Furthermore, the available data suggest a decline in final sales in the April-June period. The preliminary estimate of second-quarter Gross National Product (GNP) will not be released until July 20; on the basis of data currently available, however, CBO calculates that there was little--if any--real growth in the economy during the first half of 1979.

HOUSEHOLD SECTOR

The slowdown in total spending so far this year has been concentrated in the household sector, in both personal consumption and home purchases. The weakness in household demands appears to be caused by four factors:

- Total personal income, after adjustment for inflation, declined during the first five months of the year (see Figure 2). As noted above, this reduction apparently did not result from a slowdown in the growth of labor compensation. Rather, the decrease in real income resulted largely from higher supply-side inflation. In addition, nominal income growth slowed because of the sharp deceleration in employment growth. Total household employment has risen at only a 1.2 percent annual rate since the end of last year, as compared with a 3.6 percent gain for 1978 as a whole.

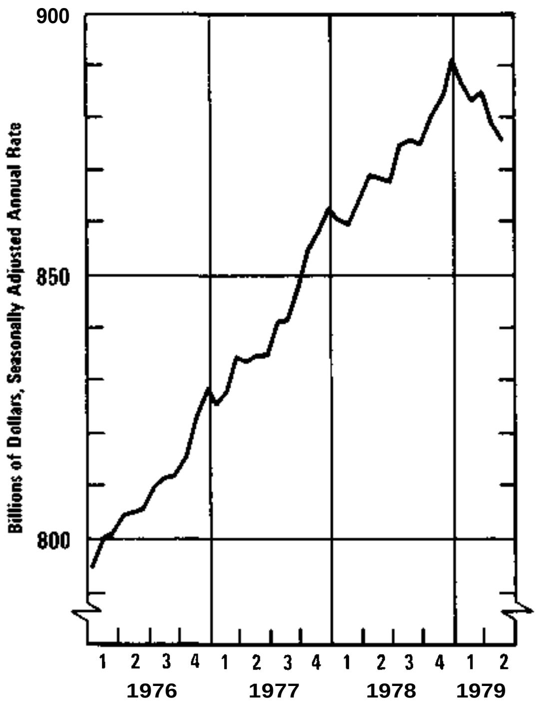
- The ratio of household debt to total disposable income reached a record high last winter, as did the ratio of repayments to income (see Figure 2). The rapid expansion of credit in 1978 makes it unlikely that further debt expansion will provide impetus to consumer spending this year.

- Interest rates have risen rapidly since last fall, apparently dampening home sales.

- Finally, consumer confidence continues to slump (see Figure 2). Consumer pessimism about the future appears rooted in the chronically high inflation and, more recently, in uncertainty about energy supplies. In addition, survey data on current purchase plans suggest that the widespread strategy to buy in advance to beat inflation is giving way to attempts to build precautionary savings. Buying plans for automobiles and houses have declined recently.

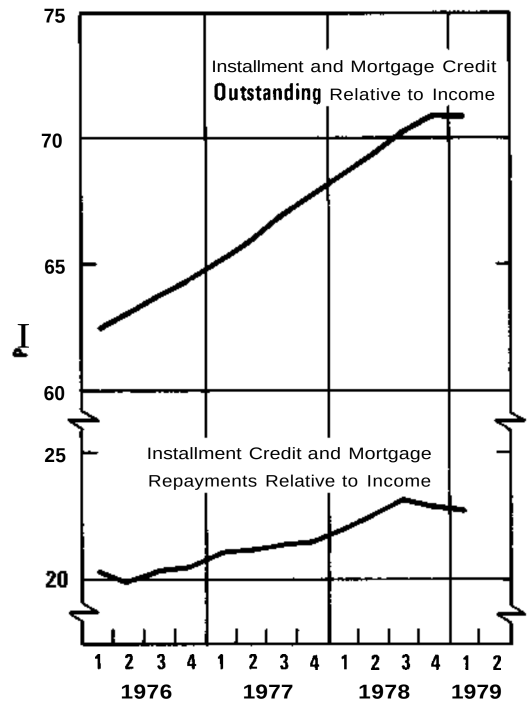
Figure 2.
Household Sector Conditions

Real Personal Income



SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics.

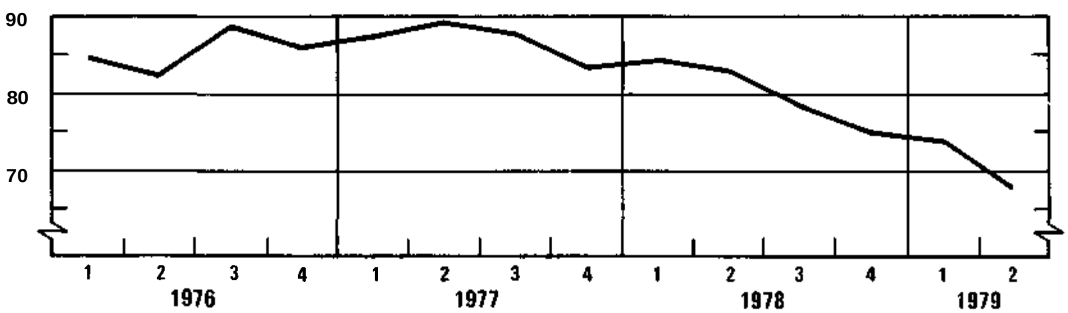
Household Debt and Debt Repayments as a Percent of Disposable Personal Income



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

Index of Consumer Sentiment

Index: 1966 = 100.



SOURCE: University of Michigan, Survey Research Center.

Automobile Sales. Sales of domestically produced automobiles have slumped badly since the end of last year--down nearly 12 percent in the second quarter of 1979 from the final quarter of 1978 (see Figure 3). This is the most rapid decline since the 1973-1975 downturn. As a result, auto inventories reached record high levels in May and apparently continued to rise in June.

The sales weakness and the consequent inventory buildup have been concentrated among larger autos. In addition, since imported autos are weighted toward smaller models, the import share of the market reached a record high level of 24 percent in May.

In part, the weakness in auto sales has been caused by the same factors that have weakened overall retail sales. The decline in constant dollar personal income reduces the ability of a number of households to take on monthly auto payments. Specifically, rapid price inflation for necessities such as food and energy and the slowdown in employment growth have restrained discretionary income growth and provided an incentive to postpone replacing existing autos.

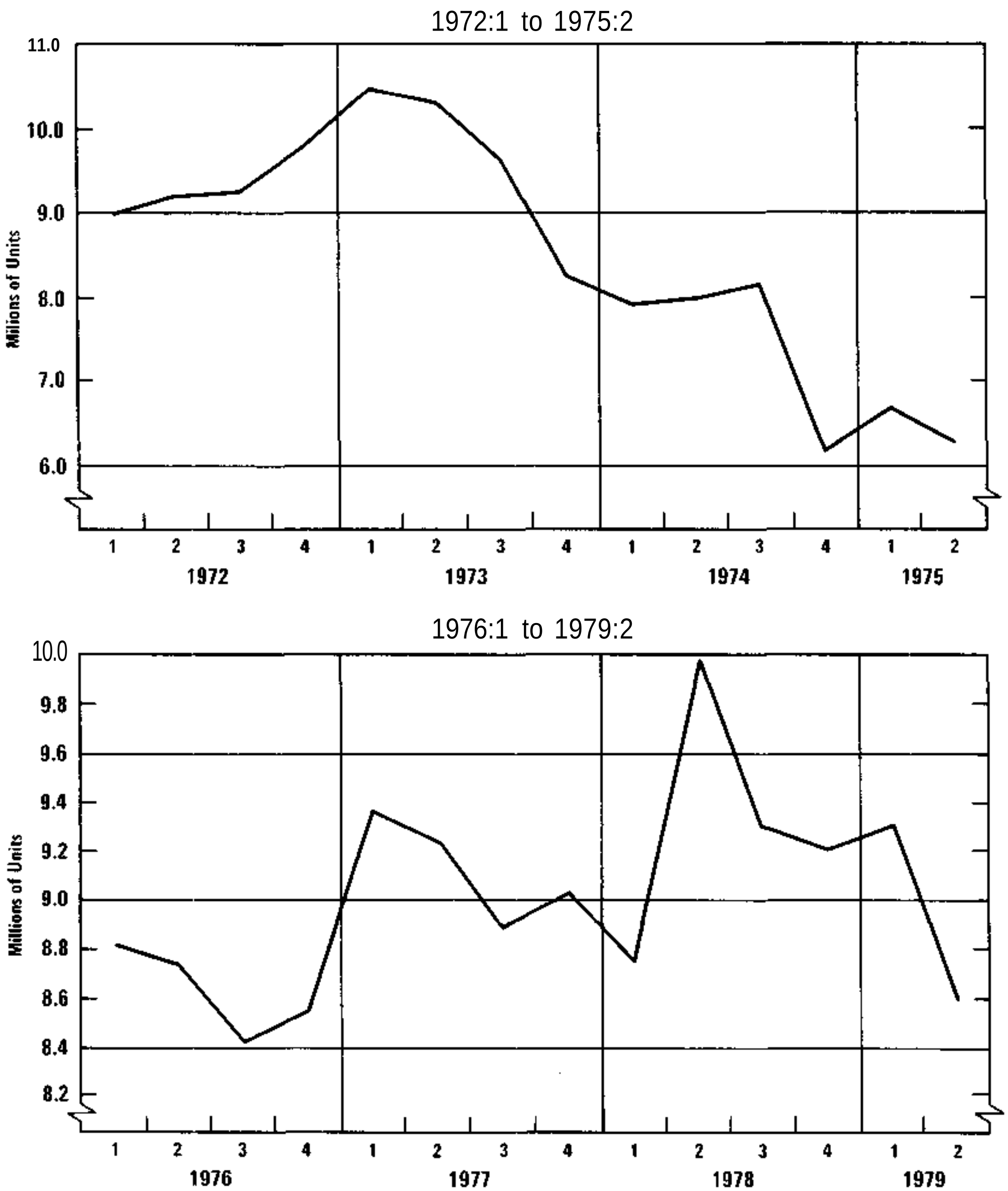
In part, however, the sales deterioration results from the auto industry's particular vulnerability to public uncertainty over energy. The sharp drop in sales of larger models coincided roughly with two other events: long lines at gasoline stations in parts of the country and the rapid increase in gasoline prices (see Table 5). As depressing as the energy situation has been on domestic auto sales, it apparently has had an even greater adverse effect on purchases of recreational vehicles and small trucks.

TABLE 5. INCREASES IN CONSUMER PRICES FOR GASOLINE, DECEMBER 1978-MAY 1979: PERCENT CHANGE, MONTHLY RATE

1978:	1979				
December	January	February	March	April	May
1.7	2.0	2.0	3.8	6.0	5.0

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

Figure 3.
Sales of Domestic Automobiles



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Point for 1979:2 is average of April and May values.

Consumer Spending, Other Than for Autos. Purchases of other consumer goods--though not as weak as auto sales--have also deteriorated, once adjusted for inflation (see Table 6). The data suggest that households have cut back on a wide variety of consumer goods since the end of last year. Large nominal spending gains were recorded by grocery stores and gasoline service stations, but the increases wholly reflect sharply higher prices. More discretionary purchases--general merchandise, furniture, food away from home--also failed to rise as rapidly as prices.

TABLE 6. CHANGES IN RETAIL SALES AND CONSUMER PRICES, SELECTED MARKET CATEGORIES: PERCENT CHANGE FROM DECEMBER 1978 TO MAY 1979

	Retail Sales	Consumer Prices
Total, Excluding Autos	1.5	N.A.
Food at Home	4.4	6.1
Gasoline	10.5	20.1
General Merchandise	1.2	N.A.
Apparel	0.2	2.1
Furniture	3.0 a/	2.3 a/
Eating and Drinking Places	1.4	6.0
Mail-Order Houses	-30.0 a/	N.A.

N.A. = Not available.

a/ Change is from December to April.

SOURCE: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics.

Housing. The final component of household spending, home purchases, has also been weak so far this year. An average of 1.68 million (annual rate) housing units were begun in the first five months of the year, down sharply from the 2.1 million rate late in 1978 (see Figure 4). The sharp drop in the first quarter resulted in part from adverse weather conditions, but the failure of starts to rebound fully in the spring--as well as the 19 percent decline in sales of new single-family homes--suggests that the widely expected slackening of housing activity is underway.

The indications are that housing will weaken further in the coming months. Consumer sentiment surveys reveal that plans to buy a house (the Conference Board Survey) and evaluations of whether it is a good time to buy a house (the University of Michigan Survey) have deteriorated from a year ago (see Table 7). This deterioration does not result from a fundamental lack of demand. It has been estimated that normal household formation would require at least 2 million new housing units a year, and home purchase continues to be a good hedge against inflation. Rather, the slowdown results both from household inability to make higher monthly mortgage payments and, perhaps to a lesser extent, from a shortage of available mortgage funds.

TABLE 7. HOUSE-BUYING ATTITUDES, 1978-1979: PERCENT OF RESPONDENTS

	Plan to Buy House in Next Six Months a/	Now Is Good Time to Buy House b/
1978:1	4.6	55
2	4.0	56
3	3.5	50
4	3.9	45
1979:1	3.5	49
2	3.3	51

a/ The Conference Board Survey.

b/ University of Michigan Consumer Survey.

Figure 4.
Housing Sector

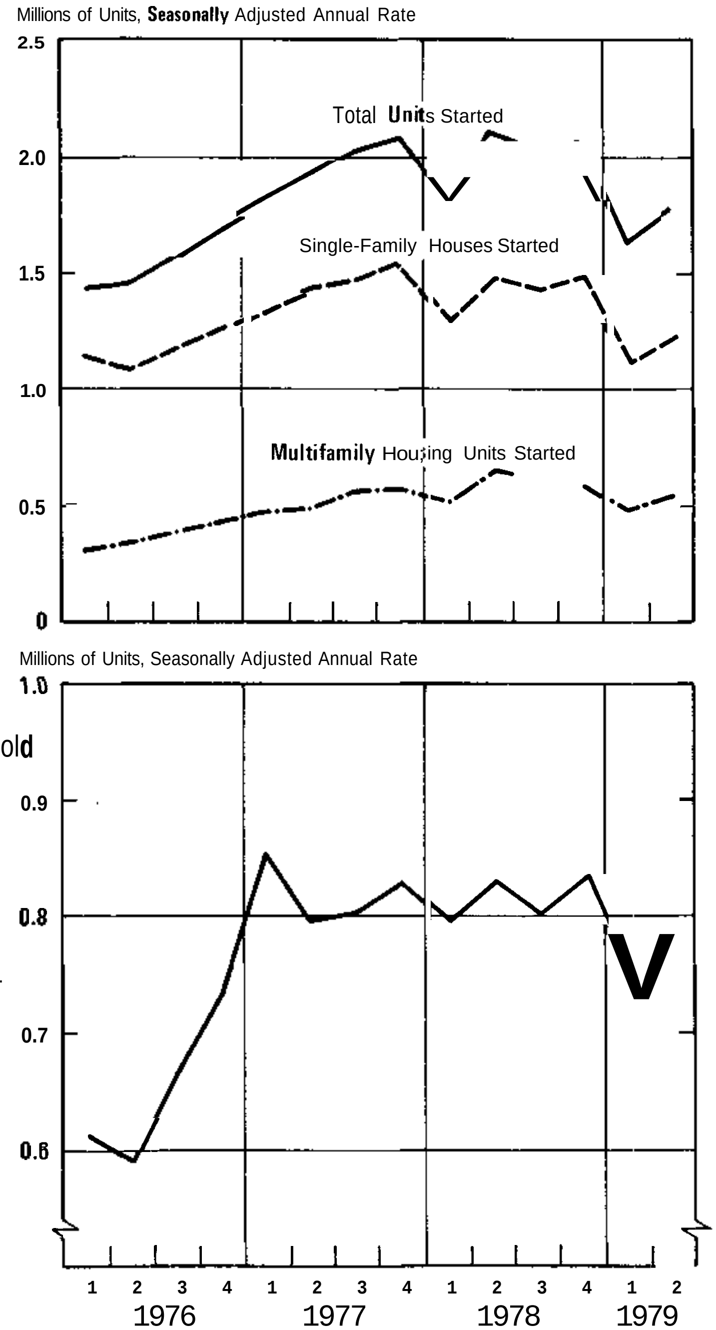
Housing Units Started
(New Privately Owned Units)

NOTE: Point for 1979:2 is average of April and May values.

New Single-Family Houses Sold

NOTE: Point for 1979:2 is April value.

SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Housing and Urban Development.



Between December and May, home purchase prices increased at an 11 percent annual rate, while financing costs were up at a 25 percent rate. As shown in Table 8, using a qualification rule often used by lenders, the annual income needed to qualify for a mortgage on a median-priced house has been rising rapidly, up more than 40 percent in just two years. The University of Michigan survey found that 52 percent of the respondents cited high home prices and high mortgage rates as reasons for thinking that now is not a good time to buy a house, up from 49 percent in the fourth quarter of 1978.

TABLE 8. ANNUAL INCOME LEVEL NEEDED TO QUALIFY FOR MORTGAGE, 1977-1979: BY HALF YEARS

	1977:I	1977:II	1978:I	1978:II	1979:I a/
Qualifying Income Level	$14,700	$15,600	$17,200	$19,100	$21,200

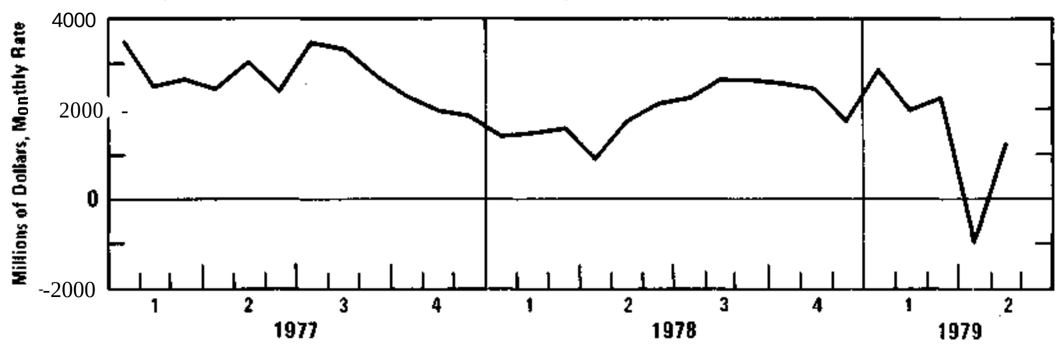
NOTE: Figures are based on a 20 percent down payment, the median house price, and the effective interest rate for a 30-year mortgage on a new one-family home, using the rule that the monthly payment (principal and interest) should not exceed 25 percent of gross monthly income.

a/ Estimate.

SOURCES: Federal Home Loan Bank Board; U.S. Department of Commerce, Bureau of the Census; U.S. Department of Housing and Urban Development.

Conditions influencing the supply of mortgage funds also suggest contraction. Until recently, funds were generally available except in some areas with usury ceilings on the maximum mortgage interest rate that can be charged. Since mid-March, however, savings and loan associations--the main source of mortgage funds--have apparently experienced some difficulty in attracting funds. In April, thrift institutions had net withdrawals of deposits, although the data show some rebound in May (see Figure 5). In mid-March, federal regulations were changed to reduce the maximum interest rate that thrifts can pay on $10,000 six-month certificates by 1/4 percentage point and to prohibit compounding of interest. 3/ Given the erratic recent behavior of deposits at thrifts, more data are needed to determine to what degree this change will result in a squeeze on mortgage funds available later in the year. In addition, borrowing from the Federal Home Loan Bank Board--which was relied on heavily by thrifts during the second half of 1978 as a source of loanable funds--appears unlikely to provide a similar increase in loanable funds this year.

Figure 5.
Net Savings Inflow at Insured Savings and Loan Associations



SOURCE: Federal Home Loan Bank Board.
NOTE: Last point plotted is May. Data are seasonally adjusted by the Congressional Budget Office.

Largely because of these various problems, mortgage loan commitments held and mortgage loans closed are down so far in 1979, after showing substantial strength toward the end of last year (see Table 9).

3/ The 1/4 percentage point reduction holds when the 26-week Treasury bill rate is 9 percent or higher.

TABLE 9. MORTGAGE LOAN COMMITMENTS AND CLOSINGS AT SAVINGS AND LOAN ASSOCIATIONS, 1978-1979: IN MILLIONS OF DOLLARS, QUARTERLY RATES

	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2 a/
Commitments	66,513	63,255	63,789	66,699	61,927	62,444
Closings	29,352	26,505	25,929	29,157	25,390	25,835

NOTE: Data are seasonally adjusted by CBO.

a/ Estimated from April and May data.

SOURCE: Federal Home Loan Bank Board.

BUSINESS SECTOR

In contrast to the household sector, the business sector contributed to real growth in the first quarter of this year. Indeed, without the increased outlays for plant and equipment and for higher inventories, total economic activity in the first quarter would have been below that in the final quarter of 1978.

Business Fixed Investment. The need for additional capacity to meet rising demand spurred business spending for plant and equipment last year, and the momentum carried over into the early months of 1979 (see Table 10). Spending for durable equipment rose at a 9.9 percent annual rate in the first quarter, as compared with the 7.3 percent gain during all of 1978. Although outlays for the other component of business fixed investment--structures--declined early this year, unusually harsh winter weather hindered the construction industry in general; and business construction rebounded in March and April as the weather improved. Spending for industrial building in the three months ending in April was 10 percent above that in the preceding three-month period.

Indicators of near-term business fixed investment have become mixed recently. On the plus side, a number of indicators remain at relatively high levels, including the backlog of orders,

TABLE 10. BUSINESS FIXED INVESTMENT, 1975-1979: PERCENT CHANGE IN CONSTANT DOLLAR VALUES

	1975:4 to 1976:4	1976:4 to 1977:4	1977:4 to 1978:4	1978:4 to 1979:1 a/
Nonresidential Fixed Investment, Total	8.6	9.1	9.4	4.9
Structures	3.0	7.0	13.9	-4.9
Producers' Durable Equipment, Total	11.4	10.1	7.3	9.9
Autos, Trucks and Buses	21.5	27.0	12.2	6.8
Other Machinery and Equipment	8.3	4.2	7.3	11.1

a/ Compound annual rate of change.

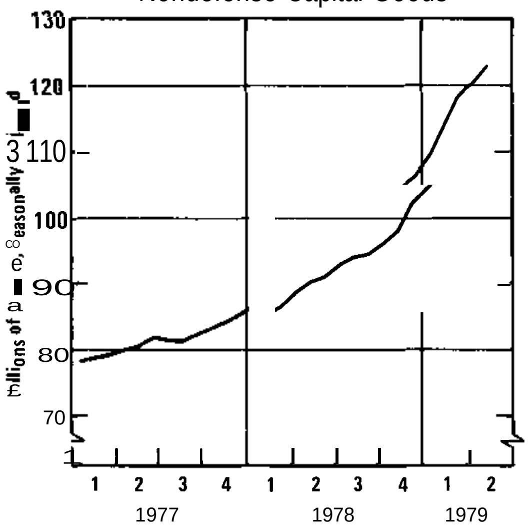
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

new bookings for nondefense capital goods, nonresidential construction contracts, and manufacturers' capital appropriations (see Figure 6) . And the Commerce Department's spring survey of anticipated plant and equipment expenditures, taken in April and May, found a planned spending increase for 1979 of 12.7 percent, 1.4 percentage points above the planned increase reported three months earlier. Once adjusted for inflation, such spending would imply about a 4 1/2 percent increase in survey-based business investment this year--somewhat below the gain in 1978.

On the negative side, some indicators have been showing weakness lately. Most notably, as shown in Figure 6, new orders for nondefense capital goods dropped sharply in April and by May were 12 percent below the advanced March level. This series tends to lead actual capital spending by three to six months. In addition, manufacturing capacity utilization has been edging down this

Figure 6.
Indicators of Business Spending

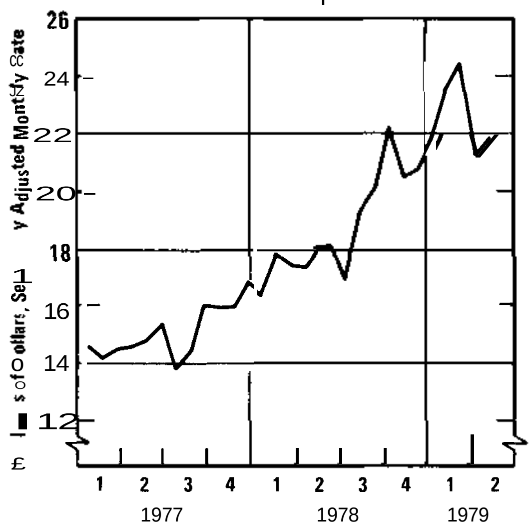
Unfilled Orders for Nondefense Capital Goods



SOURCE: *U.S.* Department of Commerce, Bureau of the Census.

NOTE: Last point plotted is May.

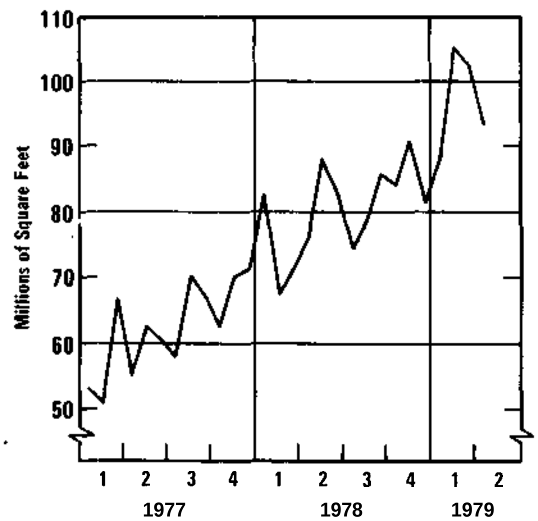
New Orders for Nondefense Capital Goods



SOURCE: U.S. Department of Commerce, Bureau of the Census.

NOTE: Last point plotted is May.

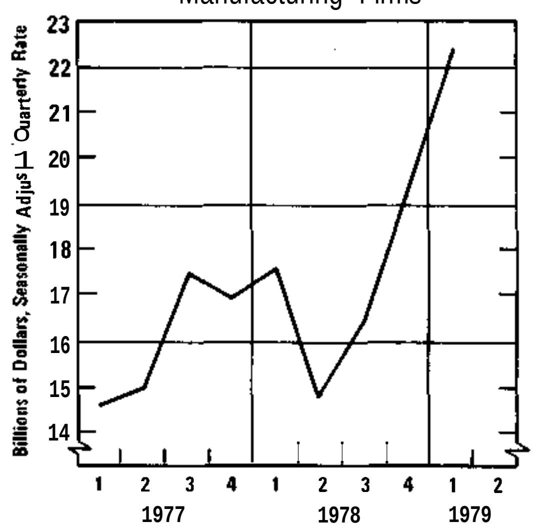
Nonresidential Construction Contracts



SOURCE: McGraw-Hill Information Systems Company.

NOTE: Last point plotted is April.

Newly Approved Capital Appropriations, Manufacturing Firms



SOURCE: The Conference Board.

year and will continue to decline if household spending remains weak (see Table 11). Excess capacity removes a significant impetus to business fixed investment.

TABLE 11. MANUFACTURING CAPACITY UTILIZATION, 1978-1979: PERCENT, SEASONALLY ADJUSTED

	1978:1	1978:2	1978:3	1978:4	1979:1	1979:2 a/
Total Manufacturing	82.1	84.0	85.0	85.9	86.1	85.2
Primary processing	83.8	86.3	87.8	89.0	88.2	87.4
Advanced processing	81.1	82.7	83.5	84.1	84.9	83.9

a/ Data for April and May only.

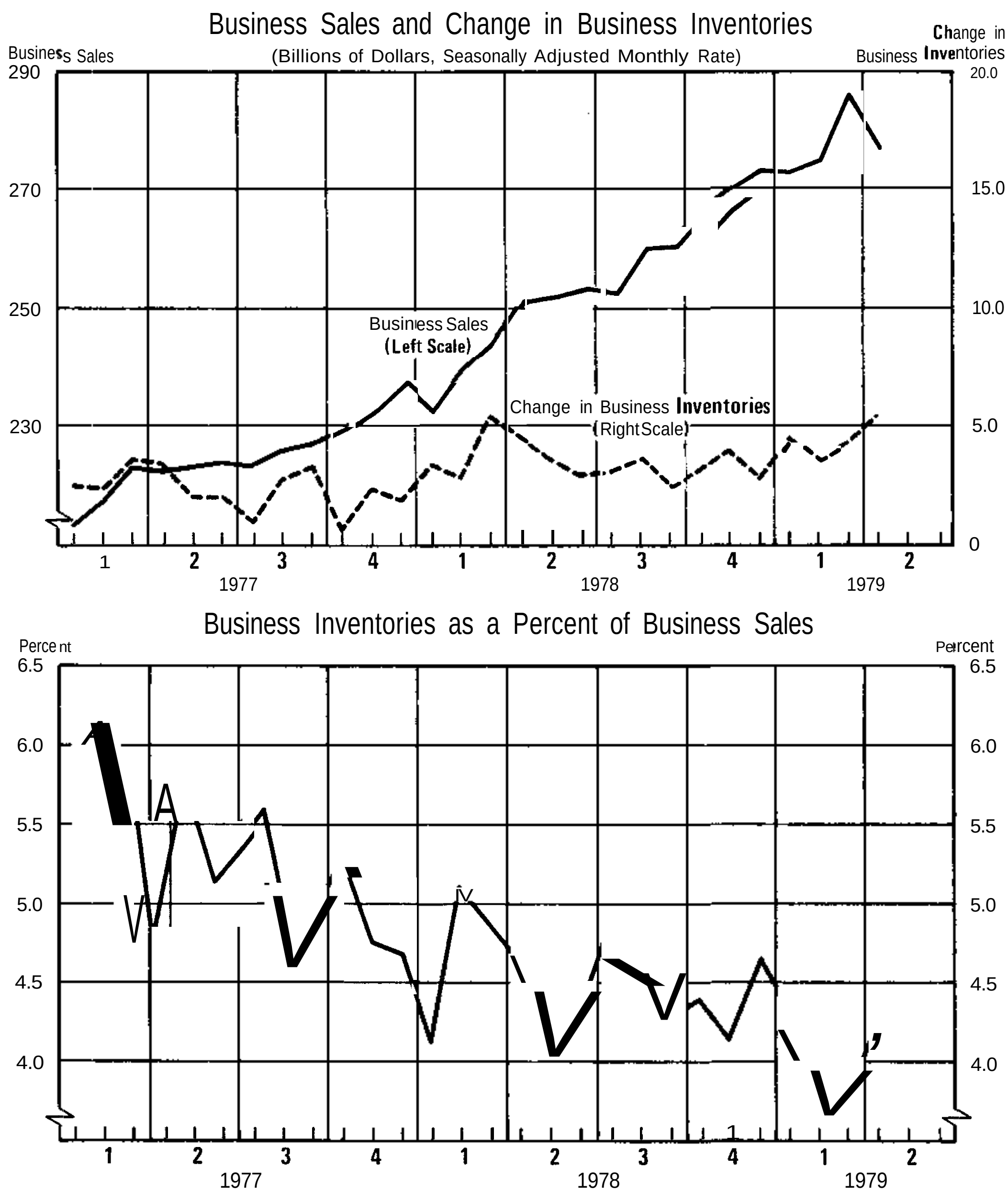
SOURCE: Board of Governors of the Federal Reserve System.

Inventory Investment. Business inventories typically begin to rise relative to sales around a peak in the business cycle. This is because producers usually maintain production levels for a period following a decline in demand, which leads to an unintended inventory accumulation.

The ratio of inventories to final sales increased early this year as business stocks began to build at a quickened pace (see Figure 7). By historical standards, the overall inventory-to-sales ratio has remained low. But this ratio has been trending down for some time now, and the recent buildup may signal some unintended accumulation because of weak final sales. Such unplanned increases are important because they eventually lead to cutbacks in production and employment.

To be sure, the inventory increase so far this year was not wholly unplanned. High levels of capacity utilization, rapid inflation, slower deliveries of ordered goods, and the greater risk of strikes interrupting normal delivery patterns have led

Figure 7.
Business Sales and Inventories



Source: U.S. Department of Commerce, Bureau of the Census.
Note: Last point plotted is April.

many firms to desire increased stocks. But the slowdown in household spending this year has been greater than generally anticipated and has left producers in some markets, especially automobiles, with higher inventories than desired. As described earlier, weak auto sales have resulted in record high stocks of unsold cars in May and little likelihood of any improvement in June.

Despite autos and a few other product areas, however, the inventory picture in the first four months of 1979 remains generally consistent with cautious business behavior which attempts to avoid serious imbalances between stocks and sales. Although low inventory-to-sales ratios are no guarantee against near-term future unintended accumulations, there is little evidence of the type of overordering for inventory building that occurred in 1973-1974 and contributed to the severity of the last recession.

INTERNATIONAL SECTOR

Growth of exports relative to imports strengthened over the last two quarters and may continue as a source of strength in the coming months (see Figure 8) . The U.S. balance of manufactured goods showed gradual but continued improvement over the past year, partly because of the depreciation of the dollar. After falling sharply toward the end of 1978, the exchange value of the dollar rose during the first months of 1979. Its value, however, remained below its 1978 high and should still help export growth relative to import growth through the next year.

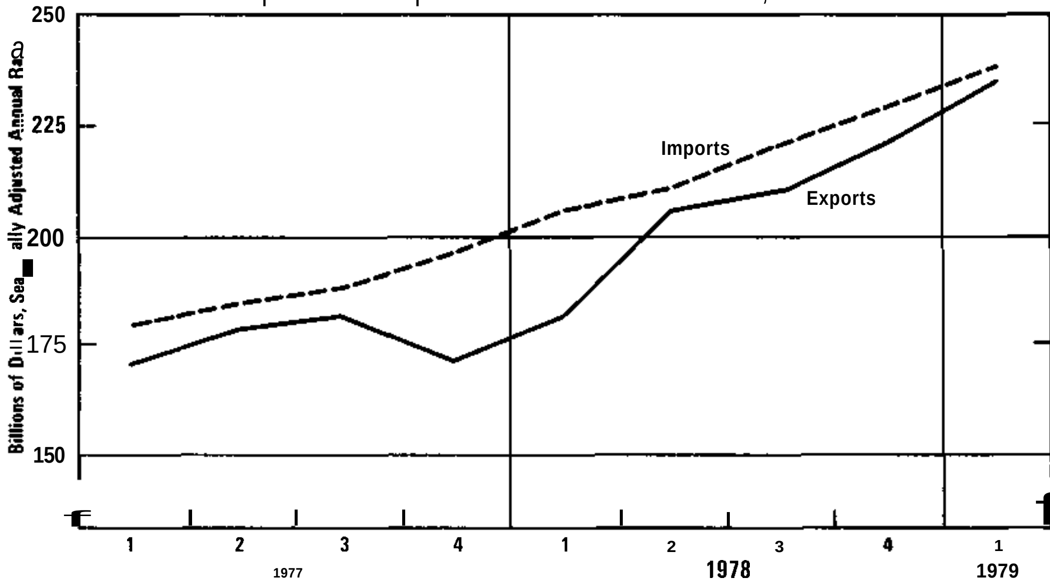
These trends toward a larger net export balance and the economic stimulus it would provide could be overwhelmed by the impact of higher prices of petroleum imports. Domestic petroleum production is not expected to increase significantly in the near future; thus, reliance on imported petroleum products will continue. Current gasoline shortages in some areas and fears about shortages of heating oil next winter have led the Administration to encourage purchases of crude oil and petroleum products in the spot market in spite of record high prices.

STATE AND LOCAL GOVERNMENT SECTOR

An important measure of the impact of state and local governments on the overall U.S. economy is the size of their combined surplus or deficit. The budget balance of state and local governments (National Income Accounts basis) declined by $1.3 billion

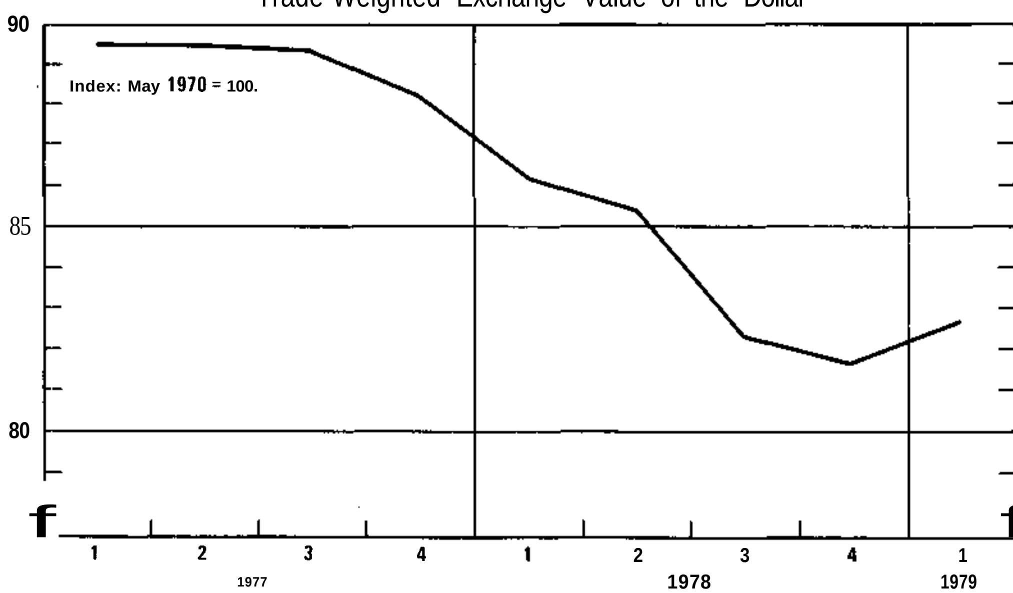
Figure 8.
International Sector

Imports and Exports of Goods and Services, NIA Basis



SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Trade-Weighted Exchange Value of the Dollar



SOURCE: Morgan Guaranty Trust Company.

in the first quarter of 1979, despite a growth of only 1.4 percent, at an annual rate, in weather-depressed total outlays by this sector (see Table 12). The decline in this balance reflected both a fall in nominal personal tax revenues and a reduced level of federal grants. Excluding social insurance trust fund accounts, state and local government surpluses fell by $2.1 billion to a level of $3.8 billion. The decline continued a general movement toward reduction that began in the second quarter of 1978. This drop reflected measures to reduce property tax burdens--most notably Proposition 13 in California.

TABLE 12. STATE AND LOCAL GOVERNMENT RECEIPTS AND EXPENDITURES, 1977-1979: IN BILLIONS OF DOLLARS, NIA BASIS, SEASONALLY ADJUSTED ANNUAL RATES

	Calendar Year 1977	Calendar Year 1978	1978:I a/	1978:II a/	1978:4 b/	1979:1 b/
Total Surplus	29.6	28.4	30.7	26.1	28.8	27.5
Social Insurance Trust Fund Surplus	18.0	21.2	20.2	22.3	22.9	23.7
Remaining Budget Surplus	11.5	7.2	10.5	3.9	5.9	3.8
Total Spending	266.7	299.8	291.0	308.6	311.3	312.4
(Percent change)	(8.3)	(12.5)	(11.4)	(12.5)	(7.4)	(1.4)
Purchases	248.9	280.2	271.4	288.9	292.0	294.0
(Percent Change)	(8.4)	(12.6)	(11.9)	(13.3)	(9.0)	(2.7)
Total Receipts	296.2	328.1	321.6	334.7	340.1	339.9
(Percent Change)	(11.0)	(10.8)	(11.3)	(8.3)	(13.9)	(-0.2)
Receipts Excluding Grants	228.8	251.2	246.7	255.8	259.8	262.9
(Percent Change)	(11.4)	(9.8)	(11.2)	(7.5)	(13.5)	(4.9)
Grants	67.4	76.9	74.9	78.9	80.3	77.0
(Percent Change)	(10.2)	(14.1)	(11.3)	(11.0)	(15.3)	(-15.5)

a/ Half year.

b/ Quarter.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Federal grants, a major source of funds to state and local governments, declined by 15.5 percent in the first quarter of this year, roughly offsetting the 15.3 percent increase in grants in the fourth quarter of 1978 that included a one-time $2.2 billion retroactive payment of social service grants. During 1978, federal grants to state and local governments rose by 14.1 percent, largely reflecting substantial increases in outlays for public service employment and public works programs. Under current policy assumptions that include cuts in public service employment grants, a cessation of countercyclical revenue sharing, and a spend-out of remaining budget authority for public works programs, CBO estimates that federal grants will grow by only 1 percent in 1979, followed by a rise of 4.7 percent in 1980. The slower growth in grants coupled with measures to reduce state and local tax burdens likely will dampen the growth in state and local spending.

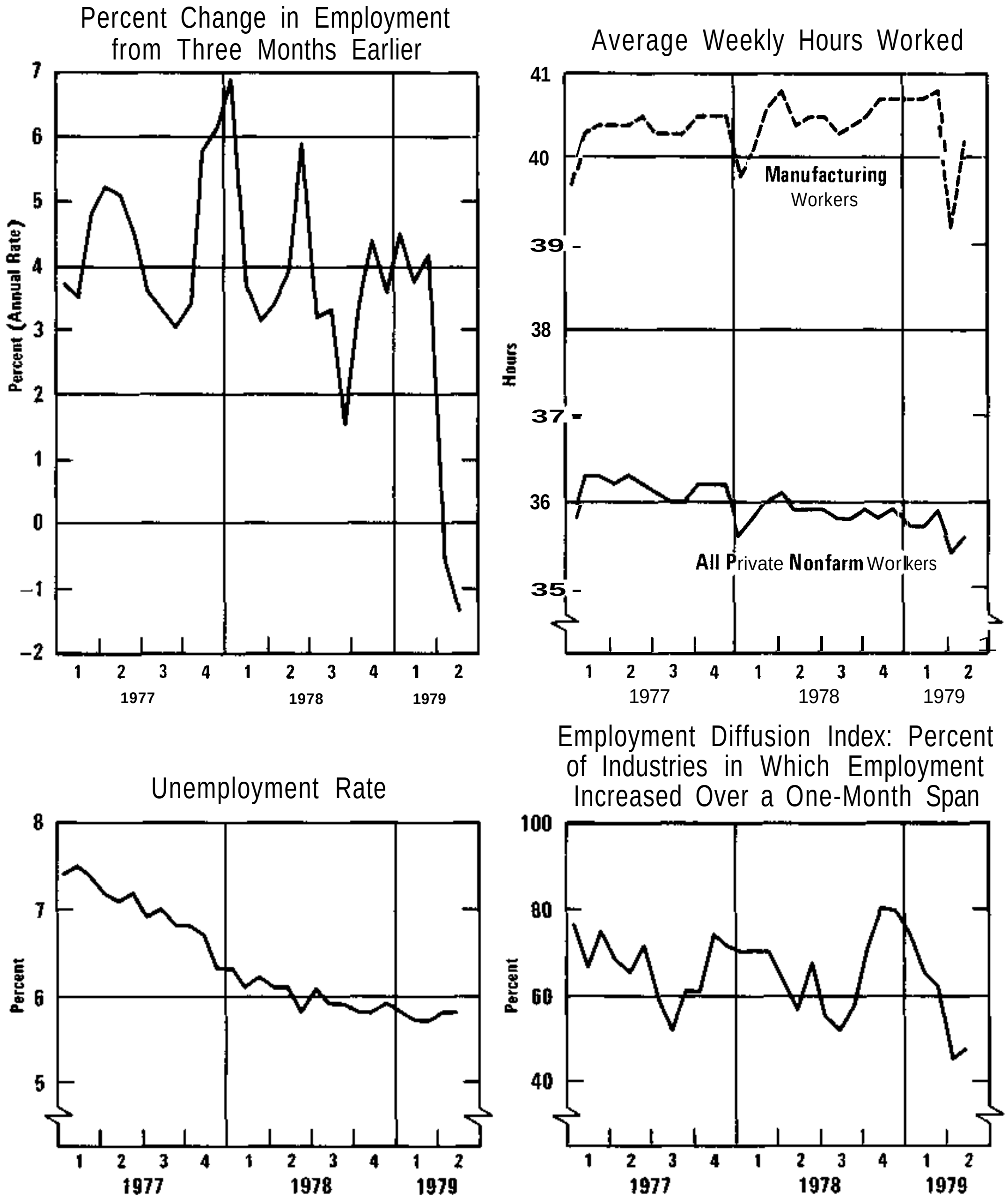
EMPLOYMENT AND UNEMPLOYMENT

Labor market data at midyear show significantly less strength than they did at the end of 1978 (see Figure 9) . Total household employment increased at only a 1.2 percent annual rate during the first five months of the year, down sharply from last year's pace of 4.3 percent and below the growth rate of the population aged 16 and over. In May, only 48 percent of 172 industries reported job gains, as compared with 76 percent last December; except for April, which was depressed by the Teamsters' strike, this was the lowest monthly level in nearly three years. Furthermore, average weekly hours--perhaps the best lead indicator of labor market developments--have fallen so far this year. The average workweek of production or nonsupervisory workers in the private sector dropped to 35.6 hours in May--0.3 hour below December and, excluding the strike-depressed April figure, the lowest level in more than a year. The factory workweek also has been falling and was down to 40.2 hours in May--0.5 hour below December.

The principal exception to the trend toward weakening has been the unemployment rate. As shown in Figure 9, the jobless rate in May was estimated at 5.8 percent--the tenth consecutive month in which unemployment has hovered between 5.7 and 5.9 percent. Since layoffs tend to lag a downturn in final sales, it is not surprising that the jobless rate had not increased by May.

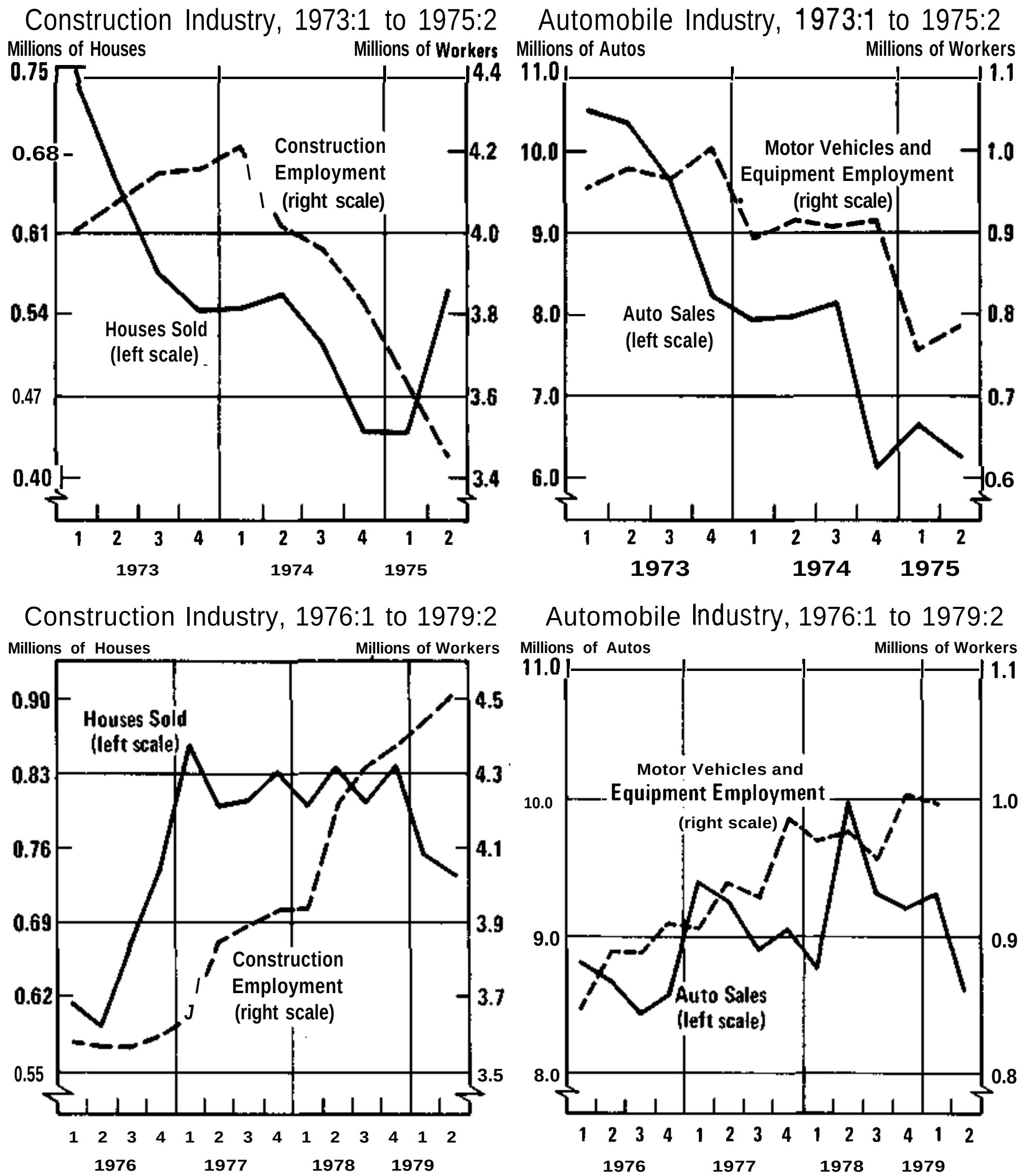
It would be surprising if the unemployment rate did not rise in the coming months. Production growth is expected to be weak,

Figure 9.
Labor Market Conditions



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.
NOTE: Last point plotted is May.

Figure 10.
Construction and Automobile Industries



NOTE: Point for 1979:2 is average of April and May values.

NOTE: Point for 1979:2 is average of April and May values for sales and is April value for employment.

SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Labor, Bureau of Labor Statistics.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics.

restraining employment, while the normal rise in the labor force is likely to be augmented by persons seeking to add to inflation-eroded family incomes. In addition, a number of sectors appear poised for a reduction of employment. Figure 10 shows the employment-sales situation in two critical industries, automobiles and construction, and suggests that substantial layoffs could occur in each industry if final demands for their products remain weak. And the impact of such cutbacks would be widely felt. It is estimated that one job in either industry is associated with 1 1/2 to 1 3/4 jobs in directly related industries.

CHAPTER II. POLICY DEVELOPMENTS AND THE ECONOMIC OUTLOOK

The performance of both prices and output since January has been considerably worse than CBO forecast last January. Consumer prices, after rising at 6.8 percent in 1977 and 9.0 percent in 1978, accelerated to a 13.4 percent annual rate during the first five months of 1979. The rapid rise in consumer prices appears to have hastened the downturn in final demands. The economy has shown little growth since last winter, and many forecasters believe the United States is already in a recession. GNP data for the second quarter are not yet available, but a sharp decline in real final sales is likely. Output probably exceeded sales so that a buildup of inventories may have limited the impact of the decline on total real growth. Although the future path of output is highly uncertain, CBO believes that the most likely outcome is a significant decline in real activity during 1979 and, following some moderation of inflation, a weak recovery in 1980.

RECENT POLICY DEVELOPMENTS

Both monetary and fiscal policy have shifted in a restrictive direction during the past year, contributing to the economic slowdown. Such policy shifts affect real activity much earlier than they affect prices. The response of monetary and fiscal policy to current developments will play an important role in the course of the economy over the forecast period.

Federal Fiscal Policy

In accordance with its desire for fiscal restraint in order to control inflation, the Congress now plans a reduction in the rate of increase in federal spending in fiscal year 1980. The first concurrent budget resolution for fiscal year 1980 calls for outlays of $532 billion, only 7.6 percent above the 1979 resolution figure (see Table 13). The budget resolution included both no tax cut and a $10 billion decline in the federal deficit, to a $23 billion level in 1980. The projected deficits for fiscal years 1979 and 1980 are considerably smaller than those recorded in the three preceding fiscal years, when the deficits totaled $66.4 billion, $45.0 billion, and $48.8 billion, respectively.

TABLE 13. FEDERAL BUDGET ESTIMATES UNDER CURRENT POLICY ASSUMPTIONS, FISCAL YEARS 1978-1980: IN BILLIONS OF DOLLARS

		1979		1980	
	1978 (actual)	Second Budget Resolution Revised	CBO Forecast Assumption	First Budget Resolution	CBO Forecast Assumption
Receipts	402.0	461	467	509	519
Outlays	450.8	494.45	495	532	540
(Percent Change)	(12.2)	(9.6)	(9.8)	(7.6)	(9.1)
Deficit	48.8	33.45	28	23	21

CBO's forecast assumptions for the federal budget, also shown in Table 13, call for higher revenues than specified for the latest budget resolution, primarily reflecting an unexpectedly high level of personal income tax collections so far this year. CBO's outlay assumptions now include an $8.0 billion overrun in spending in fiscal year 1980 relative to the first concurrent resolution. The overrun reflects higher estimates of outlays for national defense, interest, and various transfer payments such as unemployment insurance and Social Security. Largely as a result of higher defense procurement outlays, spending in the current fiscal year is also expected to exceed the target of the second concurrent resolution for fiscal year 1979. These projected overruns contrast with the shortfalls experienced earlier with the new budget process. 1/

1/ Throughout the history of the new budget process, actual spending levels have been below the levels specified in the budget resolutions. The earlier shortfalls in spending (relative to the final budget resolutions) amounted to $10.1 billion in fiscal year 1976, $7.8 billion in the transition quarter (July 1 through September 30, 1976), $7.3 billion in fiscal year 1977, and $8.4 billion in fiscal year 1978.

The Fiscal Policy Impact on the Economy. The federal budget recently has become restrictive in its impact on the economy. The growth in federal expenditures during the first half of 1979 has been considerably less than the rate of inflation. The stimulative impact of the $13 billion cut in personal income taxes last January has been offset by increased Social Security taxes and fiscal drag--the increase in effective tax rates brought about by the interaction of the progressive tax structure and nominal income growth. The reduction in business taxes last January, amounting to about $6 billion at annual rates and mainly reflecting a reduction in corporate income tax rates, is not expected to have a major effect on the economy during its first year of enactment.

Given current policy budget assumptions, fiscal policy shifts sharply toward restraint in the projected period. As shown in Table 14, the full-employment budget swings toward surplus by nearly $54 billion from fiscal year 1978 to fiscal year 1980. The projected movement toward restraint is attributable to a

TABLE 14. FEDERAL DEFICITS AND FULL-EMPLOYMENT BUDGET MEASURES, FISCAL YEARS 1977-1980: IN BILLIONS OF DOLLARS, NIA BASIS

Fiscal Year	Federal Deficit (NIA basis)	Change in Full-Employment Deficit or Surplus	Full-Employment Expenditures	Full-Employment Receipts	Ratio of Full-Employment Spending to Potential GNP (percent)
1977	-46.7	+4.9	401.4	392.7	20.6
1978	-36.8	+4.1	446.0	441.4	20.7
1979	-22.6	+20.3	492.7	508.3	20.3
1980	-16.9	+33.6	530.2	579.4	19.3

SOURCES: Historical data--U.S. Department of Commerce, Bureau of Economic Analysis. Projected and full-employment data--Congressional Budget Office.

rapid growth in personal income taxes measured at full-employment levels, and to reduced growth in spending. The slower growth in spending is reflected in the ratio of full-employment expenditures to potential GNP, which is projected (on a current policy basis) to decline to 19.3 percent by fiscal year 1980, more than a full percentage point below the rate experienced in the 1977-1978 period.

The changing composition of federal spending also suggests less fiscal stimulus. In fiscal years 1979 and 1980, federal purchases and grants are expected to decline as a percent of total expenditures (NIA basis), while interest payments and transfers to persons increase (see Table 15). Since purchases are believed to have a quicker and larger impact on the economy than most other forms of outlays, this compositional change in the budget will tend to reduce its overall impact.

TABLE 15. TRENDS IN THE GROWTH OF FEDERAL SPENDING AND ITS COMPOSITION, FISCAL YEARS 1976-1980: IN BILLIONS OF DOLLARS, NIA BASIS

	1976	1977	1978	1979 a/	1980 a/
Federal Expenditures	371.5	412.0	450.6	496.3	544.6
Purchases	126.2	140.7	151.1	164.7	177.5
Transfers to Persons	153.5	166.4	178.4	198.6	227.3
Grants to States and Local Governments	57.5	66.2	74.6	77.9	79.9
Net Interest Payments	25.2	28.4	33.7	40.6	44.5
Other b/	9.1	10.3	12.8	14.5	15.4
Federal Spending as a Percentage of GNP	22.9	22.5	22.1	21.7	21.8
Budget Components as a Percentage of Total Federal Spending					
Purchases	34.0	34.2	33.5	33.2	32.6
Transfers to Persons	41.3	40.4	39.6	40.0	41.7
Grants to States and Local Governments	15.5	16.1	16.6	15.7	14.7
Net Interest Payments	6.8	6.9	7.5	8.2	8.2
Other b/	2.4	2.5	2.8	2.9	2.8

a/ Fiscal year estimates are averages of the quarterly CBO forecast assumptions.

b/ Includes transfers to foreigners, subsidies less current surpluses of government enterprises, and wage accruals less disbursements.

SOURCES: Historical data--U.S. Department of Commerce, Bureau of Economic Analysis. Projected data--Congressional Budget Office.

Monetary Policy and Financial Developments

The tightening of monetary policy in 1978--including a. full 3 percentage point rise in the key federal funds rate over the April-December period--was a major element in CBO's earlier forecast of a downturn in late 1979. That forecast assumed that the growth in the broadly defined money aggregate, M2, would be at the upper end of the Federal Reserve target range during the first; half of 1979 and that the Federal Reserve would continue to raise interest rates gradually through the first half of the year. In fact, money aggregate growth has been very weak for most of this period, while the Federal Reserve has maintained the federal funds rate within 1/4 percentage point of the 10 percent level achieved in the last quarter of 1978. Thus, by one measure (money aggregates) monetary policy was tighter than forecast by CBO, while by another measure (interest rates) it was easier than expected.

Although interest rate behavior and money aggregate growth have been different than assumed, the effect of monetary policy on the economy seems to have been nearly as expected. Housing starts in particular appear to have reacted to high mortgage rates and reduced availability of funds. However, the weakness in the economy during the first half of 1979 occurred sooner than expected, hastened as well as deepened by factors other than monetary policy--adverse weather, the gasoline shortage, and the inflation-related decline in real incomes.

Recent Money Growth--What Does It Mean? Over the period from October 1978 to May 1979, the narrowly defined money stock, M1, and the more broadly defined money stock, M2, grew annual rates of 1.6 percent and 4.7 percent, respectively (see Table 16). In contrast, for the first three quarters of 1978, M1 and M2 grew at rates higher than 8 percent a year. This was one of the sharpest decelerations in money growth in the postwar period. Sharp reductions in money growth, particularly when corrected for inflation, have been quite reliable leading indicators of recessions in the past.

Some analysts and policymakers believe, however, that this particular deceleration is of less macroeconomic significance than previous ones. In their view, this slowing has been caused by a voluntary shift of funds out of demand deposits into interest-bearing, but otherwise close, substitutes for money. They point to such recent financial market developments as negotiable order of withdrawal (NOW) accounts in New York and New England, credit union share drafts, telephone transfers between demand and savings

TABLE 16. INTEREST RATES AND ANNUAL GROWTH RATES OF SELECTED MONETARY AGGREGATES, CALENDAR YEARS 1976-1979

	Annual Rate of Growth		Interest Rates		
	M1 a/	M2 b/	Corporate AAA Bonds	Conventional Mortgages for New Homes	Federal Funds Rate
1976:1	4.7	10.9	8.56	8.95	4.83
1976:2	6.5	10.3	8.53	8.93	5.20
1976:3	4.2	9.1	8.46	9.02	5.28
1976:4	7.7	13.2	8.18	9.07	4.88
1977:1	7.6	11.4	8.03	9.00	4.66
1977:2	7.6	9.3	8.01	8.96	5.16
1977:3	8.9	10.4	7.95	9.02	5.82
1977:4	7.5	8.1	8.10	9.08	6.51
1978:1	6.9	7.2	8.45	9.20	6.76
1978:2	9.5	8.7	8.67	9.38	7.28
1978:3	8.1	10.1	8.75	9.67	8.10
1978:4	4.2	7.8	9.03	9.91	9.58
1979:1	-2.1	1.8	9.29	10.23	10.07
1979:2	N.A.	N.A.	9.39	10.48 (May)	10.18
October 1978 thru May 1979	1.6	4.7			

a/ M1: Coin, currency, and demand deposits held by the nonbank public; seasonally adjusted data.

b/ M2: M1 plus time and savings deposits at commercial banks other than negotiable certificates of deposit issued in denominations of $100,000 or more; seasonally adjusted data.

SOURCES: Board of Governors of the Federal Reserve System; Moody's Investor Services; Federal Home Loan Bank Board.

deposits, six-month money market certificates (MMC's), automatic transfer services (ATS) from savings to transaction accounts, and money market mutual funds (MMMF's). If these changes induce holders of demand deposits to economize on their money holdings but to behave in all other respects as if they were still holding money, the monetary deceleration may not signal a reduction in aggregate demand.

Without doubt, these regulatory and institutional changes have had some effect on the observed growth of money aggregates during the past year. Nevertheless, in view of the timing of these changes, the behavior of other money aggregate measures, and the fact that some of the new instruments are not close substitutes for money, CBO's judgment is that the monetary slowing was an important sign of the anticipated decline in economic activity.

Credit Conditions. Although record high interest rates have undoubtedly had a significant impact on the economy, the availability of consumer installment credit and business loans does not appear to have been severely restricted before April of this year. In regard to housing finance, the six-month MMC's, introduced in June 1978, were widely credited with having insulated the housing market from monetary stringency. Because savers were permitted a rate on MMC's equal to the Treasury bill rate, incentives were lacking for savers to switch their funds from mortgage-financing thrifts to the money market.

In March of this year, however, the federal financial regulatory agencies made several changes in the rules governing the issue of MMC's. First, compounding of interest on these instruments was prohibited. Second, the 1/4 percentage point differential on MMC's between thrifts and banks was eliminated for periods when the Treasury bill rate is above 9 percent. 2/ Partly as a result

---

2/ Before the rule change, savings banks, savings and loan associations, and credit unions were permitted to pay 1/4 percentage point above the bill rate, while banks were restricted to the rate itself. On MMC's issued after March 15, thrifts are also subject to the ceiling of the actual bill rate when that rate is above 9 percent. The effect of these rule changes was to reduce marginally the attractiveness of MMC's in general and of thrift-issued MMC's in particular.

of this regulatory change, commercial banks immediately began to capture a larger proportion of deposits in the form of six-month certificates. Net savings inflows at thrift institutions in the April-May period were weak, although all of the decline cannot be attributed to the regulatory change. Some forecasters expect that continued high money market rates and institutional limits on the ability of thrifts to offer competitive rates will cause the mortgage market to tighten further.

THE CBO FORECAST

The CBO forecast, summarized in Table 17, calls for real activity to decline in the second half of this year. Growth in real GNP over the four quarters of 1979 is projected to be in the range of from 0 to minus 2 percent--one of the milder postwar recessions. Despite an expected deceleration in the rate of increase of the Consumer Price Index during the second half of this year, consumer prices are expected to rise from 9.9 to 11.9 percent over the four quarters of 1979. Reflecting the weakness in real activity, the unemployment rate will rise slowly through the year, reaching the 6.4 to 7.4 percent range by the fourth quarter.

In 1980, real activity is projected to advance at a rate of from 1.9 to 3.9 percent--by historical standards, a weak recovery. Inflation is projected to decelerate slightly to a range of from 7.9 to 9.9 percent in 1980. The projected rebound in economic activity is weak, however, and the unemployment rate is expected to rise further in early 1980, remaining above 7 percent through the end of the year.

Basic Assumptions of the Forecast

Policy Assumptions. The CBO forecast is based on the following assumptions about monetary and fiscal policy over the forecast period:

- Current policy outlays of $495 billion in fiscal year 1979 and $540 billion in fiscal year 1980; no tax law changes other than those included in the first budget resolution.

- Monetary policy remaining relatively restrictive through 1979, with interest rates declining as a result of weak demands. A shift to easier monetary policy is assumed thereafter in response to rising unemployment rates.

TABLE 17. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1979 AND 1980

Economic Variable	Levels			Rate of Change (percent)		
	1978:4 (actual)	1979:4	1980:4	1977:4 to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 19890:4
GNP (billions of current dollars)	2215	2351 to 2443	2584 to 2789	13.1	6.2 to 10.3	9.9 to 14.1
Real GNP (billions of 1972 dollars)	1415	1386 to 1415	1412 to 1469	4.4	-2.0 to 0.0	1.9 to 3.9
General Price Index (GNP deflator, 1972=100)	157	170 to 173	183 to 190	8.3	8.4 to 10.4	7.9 to 9.9
Consumer Price Index (1967=100)	202	222 to 226	240 to 249	9.0	9.9 to 11.9	7.9 to 9.9
Unemployment Rate (percent)	5.8	6.4 to 7.4	6.7 to 7.7	--	--	--

The easing of monetary policy is assumed to involve an increase in the M2 target range. This reflects testimony of Chairman Miller that it would be preferable to increase money aggregate growth in response to a recession rather than enact stimulative fiscal measures. 3/

Food and Energy Assumptions. The outlook for food and energy prices, while subject to a good deal of uncertainty, is nevertheless an important component in the forecast. The food component of retail prices is expected to rise nearly 11 percent over the four quarters of 1979 and at an 8 percent rate in 1980. The energy component of the Consumer Price Index is expected to rise by about 30 percent over the four quarters of 1979 and at a 12 to 15 percent pace in 1980.

The Reasons for the Downturn

The persistence and recent acceleration of inflation induced by supply conditions is at the heart of the forecast downturn in the economy. Such inflation reduces the real income and wealth of consumers and, in combination with restrictive fiscal and monetary policies, provides a severe drag on economic activity.

Consumer Pessimism. Indeed, the recent evidence suggests that the support provided by consumers in this long period of growth may have already come to an end.

- Real disposable income, after adjustment for the growth in employment, turned down in the first quarter--despite the tax cut--and is not expected to increase in the second quarter.

- Consumer surveys suggest that consumers have reduced "advance" buying of durable goods as a hedge against future inflation. This may reflect reduced income growth

---

3/ See Statement of Honorable G. William Miller, Chairman, Board of Governors, Federal Reserve System, in Outlook and Budget Levels for Fiscal Years 1979 and 1980, Part I, Hearings before the House Committee on the Budget, 96:1 (1979), p. 35; and First Concurrent Resolution on the Budget--Fiscal Year 1980, Volume I, Hearings before the Senate Committee on the Budget, 96:1 (1979), p. 175.

as well as the fact that price increases for durable goods have not kept pace with the overall rate of inflation.

- o The rapid rise in gasoline prices at the pump and the long lines in some areas have damaged consumer confidence and weakened the demand for larger new domestic autos.

- o The demand for housing has already weakened, reflecting historically high mortgage rates and some tightening of credit availability.

- o Some consumers will reduce borrowing and repay debts as the weakness in the economy becomes apparent.

CBO expects that the weakness in household demands will result in an unintended buildup in inventories, followed by modest cuts in production and employment.

Interest Rates. Assuming that the projected downturn is mild and inflation remains high, the downward pressures on interest rates from weakened credit demands will not be very large. Moreover, because inflation will still be a problem for policymakers, it is unlikely that the Federal Reserve's target interest rate (the federal funds rate) will be reduced sharply before unemployment reaches high levels. Also, the program to support the foreign exchange value of the dollar announced last October implies a desire to keep rates high relative to interest rates in other countries in order to discourage capital outflows and encourage inflows.

The CBO forecast considers current interest rates to be at peak levels and expects some gradual easing of credit conditions over the balance of 1979 and into early 1980. This drop is expected to amount to nearly 150 basis points for most short-term interest rates and nearly 50 basis points for longer-term rates.

The Persistence of Inflation and Its Impact on Wages and Incomes. As discussed earlier, the rate of inflation is expected to decelerate somewhat in the second half of this year from its present pace. Some slowdown in food prices is anticipated this year, and the weakness of the economy is expected to take some steam out of prices. In 1980, no food and energy "shocks" are assumed, although energy prices are expected to continue to rise faster than the overall rate of inflation. The scheduled increases in the minimum wage and in Social Security taxes are smaller in 1980 than they were in 1979--taking some upward pressure off wages and compensation. Finally, productivity, after performing poorly throughout 1979, is expected to rebound somewhat as growth resumes in 1980. All of these factors should help to lessen some of the upward pressure in prices in 1980. Gains in compensation, however, will remain at near double-digit rates as wage earners attempt to catch up for the deterioration of real income growth brought about by inflation.

The Reasons for the Recovery in 1980

The basic reasons for the recovery are the following:

- Business management of inventories has been cautious in recent years and the current slowdown in final demand should lead to a quick correction, which will end by the end of 1980;
- The rate of inflation is expected to decelerate in the second half of 1979--setting the stage for a recovery in real incomes--and to slow slightly further in 1980;
- Interest rates have peaked at current levels and are expected to move slowly downward into the early stage of the recovery;
- Housing starts are expected to turn up in line with strong underlying demand and improved mortgage credit conditions;
- Retail sales of durable goods should rebound after a long period of decline, in response to gains in residential construction, replacement needs, and improvement in inflation;
- Despite the slowdown in the domestic economy, the demand for exports should remain strong throughout 1980 because of the relative strength of the economies of the major U.S. trading partners; and
- Monetary policy is expected to accommodate the expansion.

Uncertainties in the Forecast

There is a great deal of uncertainty in the economic outlook. But most of the uncertainty works in the direction of higher inflation and weaker growth than forecast by CBO. Briefly, some of the major developments that could adversely affect the economy include:

- o A larger than expected rise in OPEC prices, or poor farm crops that boost consumer prices above the projected levels;
- o Serious domestic shortages in crude oil and refined petroleum products;
- o Labor strikes later this year;
- o A sharp drop in the international exchange value of the dollar;
- o A more restrictive monetary policy in 1980 that prevents the projected recovery in housing construction; and
- o Reductions in employment that are as large and as difficult to explain as the increases experienced during 1978.

Some of these sources of uncertainty are discussed below.

A Significant Shortage of Crude Oil and Refined Products. A shortage of oil remains a significant possibility. The CBO forecast assumes that, while energy prices continue to rise at more than the overall rate of inflation throughout the forecast, shortages of either crude or refined oil products will not significantly reduce industrial output, transportation, and leisure activities.

A shortfall in oil and related products large enough to affect the production and transportation network of the economy would have serious ramifications for the forecast. Shortages would lead to uncertainty, disrupted production, quick jumps in prices, and stockpiling of scarce commodities.

Two private forecasting firms have estimated the impact of hypothetical shortfalls in crude oil imports using their econometric models of the economy. 4/ These studies suggest that a shortfall of oil imports on the order of 500,000 barrels a day could reduce real GNP by around 0.5 percent in the first year, accompanied by a rise in the unemployment rate of 0.1 to 0.2 percent and an increase in the Consumer Price Index of about 0.4 percent. Crude oil prices are assumed to rise in response to such a shortfall. If the shortfall were to continue for a long period of time, the gap in imported oil would be gradually reduced by a drop in domestic demand (as the economy weakened and conservation measures were adopted) and by the development of alternative sources of energy (primarily coal). A very small increase in domestic oil production might also be expected.

If the shortfall were much larger than 500,000 barrels a day, however, the effect on real output, prices, and employment would be much more severe. A doubling of the shortfall, say to 1 million barrels a day, would more than double the estimated impact on the economy because of the effects on production.

Strikes. Some analysts believe that a strike by the United Auto Workers (UAW) on September 15 is likely. Both Data Resources, Inc. (DRI), and Wharton Econometric Forecasting Associates have estimated the effect of such a strike against General Motors for 45 and 90 days, respectively. The DRI estimates show real GNP lower by 0.2 percent in the third and fourth quarters but with a speedy snap-back in 1980. The unemployment rate is estimated to rise by 0.1 percent for one quarter only. The Wharton estimates differ from those of DRI in the fourth quarter because they assume a longer strike. Real GNP is estimated to decline by an additional 0.9 percent in the fourth quarter and the unemployment rate to increase by 0.2 percentage points. In addition, recovery from the strike takes a little longer.

Monetary Policy. While the Federal Reserve has announced a preference for easier monetary policy rather than fiscal stimulus in dealing with a serious downturn, there is no certainty that it will apply monetary stimulus. The authorities may decide

---

4/ Estimates made with the Data Resources, Inc., quarterly model appear in the February and May issues of The Data Resources Review. The Wharton Econometric Forecasting Associates model was used to estimate the effects of production cutbacks; see Congressional Budget Office, The Economic Impact of Oil Import Reductions (December 1978).

to give priority to anti-inflationary policies. Moreover, if an easier policy would threaten the exchange value of the dollar, the Federal Reserve may feel that it cannot ease monetary policy.

Employment. The strong and unanticipated growth in employment experienced recently adds another element of uncertainty to the forecast. Some analysts have argued that a significant part of the recent growth in employment represents labor hoarding by businesses faced with uncertainty about the long-term outlook. If this is true, and if the hoarding seems unnecessary, then the unemployment rate may rise more than forecast by CBO.

IMPLICATIONS FOR FISCAL POLICY

In accordance with the desire of the Congress to reduce inflation, the budget resolution enacted last spring called for a restrictive fiscal policy in 1980. It is now evident that inflation is an even more serious problem and the economy already weaker than projected before the enactment of that resolution. In the past, the prospect of rising unemployment might have brought forth widespread support for a tax cut or other fiscal stimulus. But in the present situation, persistent high rates of inflation raise serious questions about such policies. If the unemployment rate does not rise substantially--and there can be no assurance that it will--fiscal stimulus would only aggravate the problem of inflation. There is also a risk in doing nothing; if action is delayed too long, the unemployment rate could rise to unacceptable levels before fiscal stimulus could take effect.

Unfortunately, the future course of the economy is very uncertain and we do not know whether unemployment will rise sufficiently to warrant fiscal stimulus. Given this uncertainty and the fact that the unemployment rate has not yet begun to rise, one option is for the Congress and the Administration to develop a contingency budget plan that could be implemented quickly, in coordination with monetary policy, should the economic situation deteriorate significantly.

An appropriate contingency plan would not be easy to formulate. First, given the high rates of inflation, the decision concerning what unemployment rate would call for fiscal action necessarily involves a value judgment, about which there would be considerable controversy. Second, the design of a contingency policy should be tailored as much as possible to the expected duration and severity of a downturn. If, for example, there is a mild recession that lasts only a few quarters and is followed by a substantial rebound, the Congress may desire to continue current policy because the delayed effect of fiscal stimulus could aggravate inflationary pressures. (The major impact on employment and output of most types of fiscal stimulus occurs more than a year after implementation.) If, on the other hand, the recession drives the unemployment rate up to unacceptable levels for a prolonged period, fiscal stimulus could reduce unemployment without making inflation significantly worse.

Lastly, the policy chosen should reflect the fact that fiscal measures vary in their effectiveness. Ideally, measures undertaken only for economic stabilization would have a relatively quick effect, would reduce both unemployment and inflation, would generate a large impact on employment per dollar spent, and would not result in a permanent increase in the size of government. Very few measures satisfy such criteria. Most types of stimulus reduce unemployment but also increase inflationary pressures. CBO analysis has indicated that a decrease in the payroll tax could meet the criteria of reducing both inflation and unemployment over a span of a few years. Business income tax cuts might also be effective, though their major impact is thought to be even more delayed.

While decisions on stabilization policy are indeed important for the economic outlook, monetary and fiscal policy alone may not be adequate to deal satisfactorily with an environment of high inflation and rising unemployment. The Congress may want to place increased emphasis on developing longer-run policies to encourage price stability, productivity, and economic growth.

O