Statement of

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before the

Senate Committee on the Budget

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Mr. Chairman and Members of the Committee:

I appreciate this opportunity to discuss the economic outlook and the present status of the federal budget as you prepare for the Second Concurrent Resolution for Fiscal Year 1977.

The Congressional Budget Office recently issued a detailed analysis of current economic conditions and a forecast for 1977 entitled, Sustaining a Balanced Expansion, which, with your permission, Mr. Chairman, I would place in the record.

The essential message of that report is that the present recovery is projected to continue through 1977, but at a slower pace than during the first five quarters of the upturn. As shown in the attached table, real GNP is expected to grow at an annual rate of between 5 and 6.5 percent for the rest of 1976 and between 4.5 and 6.5 percent during 1977. In the first five quarters of recovery, output grew at a 6.7 percent annual rate.

This range of growth projections implies a continuation of the downward trend in the unemployment rate to the 6.9 to 7.3 percent range by the end of this year and to between 5.8 and 6.4 percent by the end of 1977.

The inflation rate is projected to remain in the 5 to 7 percent range during the next six quarters, and an upward movement in short-term interest rates is expected.

In sum, our present forecast is quite similar to the one we prepared last March for your use in framing the First Concurrent Resolution on the Budget.

ECONOMIC PROJECTIONS, 1976 AND 1977

	Actual (preliminary) 1976:II	Projected Range		Projected Growth (annual rate, percent)	
		1976:IV	1977:IV	1976:II to 1976:IV	1976:IV to 1977:IV
GNP, Billions of Current Dollars	1673	1755 to 1785	1965 to 2005	11.5 to 12.5	11.0 to 12.5
GNP, Billions of 1972 Dollars	1260	1290 to 1300	1350 to 1380	5.0 to 6.5	4.5 to 6.5
General Price Index (GNP deflator, 1972 = 100)	133	136 to 138	143 to 147	5.5 to 6.5	5.0 to 7.0
Consumer Price Index (1967 = 100)	169	172 to 175	181 to 186	5.0 to 6.0	4.7 to 6.7
Unemployment Rate (percent)	7.4	6.9 to 7.3	5.8 to 6.4	--	--

SOURCE: United States Congress, Congressional Budget Office, Sustaining A Balanced Expansion, 3 August 1976, p. 13.

Although these projections represent our best estimates of what is most likely to happen, some or all of them may not be realized. I would like to mention several types of developments which could invalidate the forecast and which, therefore, bear careful watching.

First, the projections are based on a number of assumptions: adherence to the First Concurrent Resolution on the Budget; monetary growth slightly above the Federal Reserve's target range; 5 to 6 percent annual growth in exports; a 4 percent average annual increase in farm prices; and an 8 percent average annual rise in fuel prices. Major deviations from these assumptions--for example, substantially higher food prices in 1977--would require a revised forecast.

Second, indications are that the recovery is in a lull. Although it seems likely that this lull is only temporary, and that the recovery has sufficient upward momentum to sustain itself at least through 1977, it is particularly important now to monitor the indicators as they come out. The unemployment rate rose from 7.3 percent in May to 7.5 percent in June to 7.8 percent in July, although the July increase was caused by a sharp jump in the labor force, rather than a slowing in the growth of employment. Retail sales were down in July compared to June and April and housing starts in July were 9 percent below starts in June. The growth in industrial production tapered off to a 0.2 percent increase in July from a 0.4 percent increase in June and a 0.9 percent increase in May.

We believe, however, that this slowing in the recovery is only temporary, and that growth in the fourth quarter will pick up again. There are various indications that both investment and consumption will rebound later this year. For example, new orders for nondefense capital goods rose 14.1 percent in July. Housing permits--an indicator of future housing activity--increased 6 percent in July to the highest level in more than two years. Retail sales, though down in July, were up substantially in the first two weeks of August. The growth in industrial production has been recently slowed by the coal and rubber strikes which now appear to be settled. The July increase in personal income--the largest percentage increase in six months--should further stimulate retail sales and production.

Nonetheless, the current lull does mean that the third quarter growth in constant-dollar GNP is likely to be closer to the 4.3 percent experienced in the second quarter of 1976 than to the more rapid pace of the first quarter of 1976.

Other factors create uncertainty about the forecast. One such area is monetary policy and the future course of interest rates. Typically, interest rates rise during periods of rapid economic growth, but this time they did not. Rather, they stayed almost level during the past year of recovery, and short-term rates currently are slightly lower than they were at the trough of the recession. One explanation for the absence of an upward trend in interest rates during the early phase of the recovery is the slowing of inflation during that period and the consequent reduction of the inflation premium in the rate, as set by financial markets.

If monetary growth continues at a rate slightly above the upper end of the Federal Reserve's target range, we expect short-term interest rates to rise only gradually throughout the forecast period. Such a rise would be consistent with the tendency of interest rates to rise in previous recoveries and we do not foresee a further significant decline in the inflation rate to offset this tendency. Specifically, our forecast shows the three-month Treasury bill rate rising from its current 5.3 percent to 7.1 percent by the end of 1977.

We do not expect interest rates to rise to a level high enough to cause a serious outflow of funds from savings institutions during the next year and a half. This means that housing is not likely to be hampered by a credit squeeze, although housing activity is not likely to increase as fast over the next year and a half as it did early in the recovery.

Although the Federal Reserve targets presently appear consistent with only gradually rising interest rates, given the economic projections in our report, the report simulates a number of alternative monetary scenarios and projects their impact on inflation, unemployment, and growth. A 1 percent increase or decrease in the rate of growth of the supply of money defined to include savings accounts, for instance, is projected to affect nominal GNP by $10 billion in either direction, the unemployment rate by 0.2 percentage points, and the Consumer Price Index by 0.2 percentage points by 1980.

To summarize, although many uncertainties apply, the First Concurrent Resolution on the Fiscal 1977 Budget implies a fiscal strategy which, if coupled with only moderate increases in interest rates and smaller increases in food and fuel prices than were experienced in the 1973-75 period, will most likely result in a continued, but slower, recovery through 1977. This will leave both the measured unemployment and inflation rates in the 6 percent range at the end of that year. Industrial capacity will not, in general, be strained by such a recovery.

If implemented, the Resolution will provide more fiscal stimulus than the proposed Administration budget. However, it is slightly more restrictive than the 1976 budget. The high employment deficit, about $10 billion at an annual rate during the first half of calendar 1976, will move close to zero by the end of 1977. The actual federal deficit will also be much smaller in fiscal year 1977 than in fiscal 1976.

Fiscal Policy Alternatives

Although major changes in fiscal policy are not under active consideration at the present time, we have analyzed the possible effect of small departures from the First Concurrent Resolution for Fiscal 1977.

One such departure would be a sustained veto of much of the proposed public employment legislation. Specifically, elimination of $5.6 billion in outlays on public employment is estimated to reduce employment by 400,000 by the end of calendar year 1977. Unemployment would be about 0.3 percentage points higher than in the baseline forecast. Although the impact on prices is likely to be negligible in the short-run, the inflation rate might be reduced by about 0.3 percentage points by 1980.

An expansionary alternative that would add an additional $10 billion in outlays to the First Concurrent Resolution was also analyzed. An added $10 billion in outlays would reduce the unemployment rate by about 0.2 percentage points by the end of 1977, and add about 0.2 percentage points to the inflation rate by 1980.

Status of the Federal Budget

One of the key assumptions underlying our present economic forecast is adherence to the spending and revenue targets of the First Concurrent Resolution for Fiscal Year 1977. The latest budget scorekeeping figures are contained in this week's Senate Budget Scorekeeping Report which was issued Monday, August 23. Based on this Report, it appears that the assumption is valid, although both Congressional action and economic developments can still influence the actual outlays and revenues for fiscal year 1977. Key points in the Report are summarized in the Budget Summary Table I would like to submit.

The First Concurrent Resolution set an outlay target of $413.3 billion for fiscal year 1977. As of August 23, CBO estimates that action completed by the Congress, or underway in the Senate, would produce outlays of $394.6 billion. In addition, the Senate scorekeeping report shows that another $19.7 billion in estimated outlays may result from appropriations and other spending actions that have not yet been considered by the Senate. Therefore, total potential outlays for fiscal year 1977 would be $414.3 billion, or $1.0 billion more than contemplated in the First Concurrent Resolution.

FY 1977 BUDGET SUMMARY
(In billions of dollars)

	1st. Con. Res. target	Current Status[1]	Potential Status[2]
Revenues	362.5	360.2	360.6
Outlays	413.3	394.6	414.3
Deficit	-50.8	-34.4	-53.7
Budget authority	454.2	416.1	447.7

Source: Senate Budget Scorekeeping Report No. 77-5, August 23,1976

[1] Current status consists of action that has been completed by the Congress or is underway in the Senate.

[2] Potential status consists of action to date plus possible congressional action on revenue or spending legislation that is not yet reported in the Senate. This includes all formal budget requests by the President that have not yet been considered by the Senate, plus other items that in the judgment of the Senate Budget Committee staff may require funding later in the fiscal year.

The potential outlay estimate of \$414.3 billion includes the latest Congressional Budget Office estimates of spending that will result from current actions of Congress as well as from programs such as social security benefits and interest on the public debt that do not require current action by the Congress. CBO updates each week the Senate scorekeeping figures to account for current legislative action, and periodically revises the figures to reflect nonlegislative actions, such as changes in economic assumptions or in program spending patterns. These periodic reviews of nonlegislative changes in spending estimates are timed to follow the Office of Management and Budget's quarterly review of budget estimates. Thus, the August 23 Senate scorekeeping figures incorporate CBO spending reestimates resulting from the OMB July 16 mid-session budget review and also our own analyses of factors affecting budget cost estimates, including insofar as possible, analysis of the effects of actual fiscal year 1976 spending on the fiscal year 1977 estimates. Details on these CBO reestimates have been provided to the Committee staff and I understand they will be summarized in the staff markup documents for the Second Concurrent Resolution.

On the revenue side, however, it appears likely that fiscal year 1977 revenue will be somewhat below the First Concurrrent Resolution target level. The key assumptions in the First Concurrent Resolution target of \$362.5 billion were: (1) that extension of the December 1975 temporary tax reductions would result in a \$17.3 billion loss, and (2) that enactment of tax reform legislation would produce a \$2.0 billion net increase in revenues. The second of these assumptions is unlikely to be fulfilled. Estimated overall revenue collections for fiscal year 1977 under current law do remain unchanged at $377.8 billion, and the Senate-passed tax bill does extend the December 1975 temporary tax reductions through the end of calendar year 1977. However, other provisions would reduce revenues in fiscal year 1977 by $300 million instead of providing an increase of $2.0 billion. As a result, if the Senate-passed bill were to prevail in conference, and the unemployment insurance tax rate is increased (as passed by the House in H.R. 10210), fiscal year 1977 revenue would total $360.6 billion, or $1.9 billion less than the First Concurrent Resolution target.

Thus, the current Senate budget scorekeeping report shows the potential deficit for fiscal year 1977 as $53.7 billion compared to $50.8 billion contained in the First Concurrent Resolution. This appears to be a realistic estimate and we do not believe there are grounds for predicting a deficit substantially above the First Concurrent Resolution target, either on the basis of the economic outlook or anticipated legislative action.