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before the
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United States Senate

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There should be no release of this statement until its delivery, scheduled for 9:30 a.m. (E.D.T.), Tuesday, July 27, 1982.

Mr. Chairman, in my testimony today I will discuss recent economic developments, provide a preliminary Congressional Budget Office (CBO) economic projection, and discuss the implications of this projection for the budget outlook.

Last February, CBO projected fairly vigorous economic growth in the second half of this year because: (1) the inventory adjustment would have run its course; (2) consumer spending would be stimulated by the July tax cut and the Social Security benefit increase; and (3) declining interest rates would encourage a pick-up in sales of housing and other interest-sensitive durable goods. Lower interest rates would also eventually lead to a recovery in investment spending.

CBO still expects the economy to revive in the second half of 1982. However, the failure of interest rates to decline, despite falling inflation, and the unexpected depth of the recession now lead us, as well as most other forecasters, to anticipate a somewhat less robust recovery than seemed likely a few months ago. Moreover, the especially weak performance of investment spending in the recent period, resulting from high interest rates and record economic slack, has created doubts about whether the recovery will prove sustainable with policies currently in place.

Most economic forecasters project moderate growth in output and employment and further progress in reducing inflation during the next few years. In our view, however, the level of uncertainty is much greater than the similarity of forecasts might suggest. Economic policies themselves account for some of the uncertainty. The budget changes enacted during the last year are of such large magnitude, by historical standards, that we cannot confidently predict their economic effects. Moreover, the unusual combination of tight monetary policy, designed to reduce inflation, and expansionary fiscal policy has also contributed to the uncertainty.

Recent Economic Developments

As measured by constant dollar Gross National Product (GNP), the decline in economic activity during the past year exceeded the average decline in postwar recessions. Moreover, there was a large amount of slack in the economy before this recession began. High interest rates aborted the recovery from the 1980 recession when it was less than a year old. As a result, there has been very little economic growth since the end of 1979 and unemployment has recently reached post war record levels. High unemployment is now widespread and some groups have been particularly affected. The combination of recession and longer-run structural problems has produced severe economic distress for some industries, such as steel and automobiles, and for some areas of the country, especially in the industrial Midwest. Recession, combined with high interest rates, has aggravated problems in housing and agriculture.

Last February when CBO published its forecast for the first budget resolution for fiscal year 1983, we expected that the decline in economic activity would be somewhat less severe than the average recession and would end in the spring. Revised GNP data now show that the decline in economic activity was deeper than CBO had projected last winter and, as a result, unemployment rose higher than expected. As Table 1 shows, GNP did turn up in the second quarter, but only because of a reduction in the liquidation of inventories; real final sales, which declined through the second quarter, were weaker than expected. Most of the unanticipated weakness in final sales in the second quarter can be traced to consumer spending.

The depth of the recession has been a major factor in the decline in inflation. For the first six months of 1982, the inflation rate as measured by the GNP deflator was nearly two percentage points lower than projected last January. The sharp reduction in inflation from 8.9 percent during the second half of 1981 to 4.8 percent during the first half of this year reflected:

- o Very weak commodity prices, particularly for gasoline and crude oil;
- o Sluggish final demands;
- o The rise and continued strength of the dollar in foreign exchange markets, which have held down the cost of imported goods; and
- o Lower wage demands, including some reopening of wage contracts, as a result of record unemployment rates.

TABLE 1. MAJOR ECONOMIC INDICATORS

	Calendar Years			Quarters				
				1981			1982	
	1979	1980	1981	II	III	IV	I	II
Billions of 1972 Dollars								
GNP	1479.4	1474.0	1502.6	1502.2	1510.4	1490.1	1470.7	1476.8
Final Sales	1472.2	1479.0	1493.7	1490.1	1493.9	1485.3	1486.1	1483.7
Inventory Change	7.3	-5.0	9.0	12.1	16.5	4.8	-15.4	-6.9
Disposable Income	1015.7	1018.0	1043.1	1036.6	1048.8	1051.9	1046.9	1054.9
Percent Change at an Annual Rate								
GNP	2.8	-0.4	1.9	-1.5	2.2	-5.3	-5.1	1.7
Consumption	2.7	0.3	1.8	-2.7	2.9	-3.3	2.5	3.0
Business Fixed Investment	7.3	-2.2	3.5	1.1	9.3	0.6	-5.0	-8.5
Residential Investment	-5.2	-20.2	-4.8	-17.4	-31.9	-25.3	-10.2	3.3
Federal Purchases	1.8	4.2	3.7	-3.2	14.8	20.4	-5.5	-16.1
Defense	2.6	4.0	4.9	11.5	7.6	10.1	-7.9	7.1
Nondefense	0.3	4.6	1.3	-27.4	31.6	43.6	-0.9	-49.2
State and Local Purchases	1.1	1.1	-0.8	-4.6	-2.7	-0.8	-1.1	0.4
Exports	15.4	8.9	-0.4	1.0	-4.7	-2.4	-12.7	1.8
Imports	6.1	-0.4	7.2	16.8	11.3	6.0	-17.5	7.2
GNP Deflator	8.6	9.3	9.4	6.8	9.0	8.8	4.3	5.3
CPI - Urban Consumers	11.3	13.5	10.3	7.8	11.8	7.7	3.2	4.6
Industrial Production	4.4	-3.6	2.7	1.9	1.3	-16.4	-11.7	-6.9
Percent								
Unemployment Rate	5.8	7.1	7.6	7.4	7.4	8.4	8.8	9.5
3-Month Treasury Bill Rate	10.1	11.4	14.0	14.9	15.1	11.8	12.8	12.4
Capacity Utilization Rate	85.5	79.1	78.5	79.8	79.3	74.8	71.6	70.3
Personal Saving Rate	5.9	5.8	6.4	6.1	6.5	7.5	6.6	6.6

The most unexpected development thus far in 1982 has been the extremely high interest rates (see Table 2). Rates declined quite sharply in the first months of the recession but then rose again in the fall and winter. As a result, many interest rates were higher in the first six months of 1982 than in the fourth quarter of last year, despite the deepening recession and the decline in inflation. Figures 1 and 2 show that both short- and long-term interest rates were at exceedingly high levels compared with earlier recessionary periods. In fact, in recent months interest rates, adjusted for current inflation, reached their highest levels since 1932. These high rates contributed to the record levels of business failures and delayed the recovery in interest-sensitive sectors of the economy. During recent weeks, interest rates have declined moderately, and they are forecast to continue to fall, perhaps irregularly, for the remainder of the year. Whether such a decline does in fact materialize is critical because substantial further interest rate reductions appear to be necessary if the economic recovery is to be sustained.

Although real GNP turned up in the second quarter, it is not clear whether the turning point in economic activity has been reached. The latest data on economic activity give mixed signals. On the positive side, real GNP rose by 1.7 percent at annual rates in the second quarter, according to preliminary estimates, and the Commerce Department's index

TABLE 2. FINANCIAL VARIABLES

	1979	1980	1981	1981 Q_1	1981 Q_2	1981 Q_3	1981 Q_4	1982 Q_1	1982 Q_2
Monetary Growth (percent)									
M1	7.7	6.3	7.0	4.6	9.6	0.2	5.9	10.8	3.2
M2	8.5	8.3	9.8	7.7	12.6	8.6	9.2	10.1	9.7
Total Reserves a/	1.6	5.8	6.5	5.6	4.2	4.0	3.2	8.3	N/A
Interest Rates (percent)									
3-Month Treasury Bill	10.1	11.4	14.0	14.4	14.9	15.1	11.8	12.8	12.4
20-Year Government Bond	9.3	11.4	13.7	12.7	13.5	14.5	14.1	14.3	13.7
Moody's AAA	9.6	11.9	14.2	13.2	14.0	14.9	14.6	15.0	14.5
Mortgage Rate b/	10.9	12.8	14.9	13.9	14.6	15.4	16.1	15.7	15.9
Treasury Borrowing									
Billions of Dollars	37.4	79.2	87.4	128.9	43.4	56.3	120.9	120.0	N/A
Absorption Rate c/	9.5	22.2	22.6	30.9	10.4	15.2	35.0	29.5	N/A

a/ At Federal Reserve member banks.

b/ Effective conventional mortgage rate, all homes, combined lenders.

c/ Percent of all funds raised by nonfinancial institutions, private and public.

SOURCE: Federal Reserve Board, Federal Home Bank Board.

FIGURE 1

Three-Month Treasury Bill Rate
Around Peak Quarters
Adjusted for Current Underlying Inflation

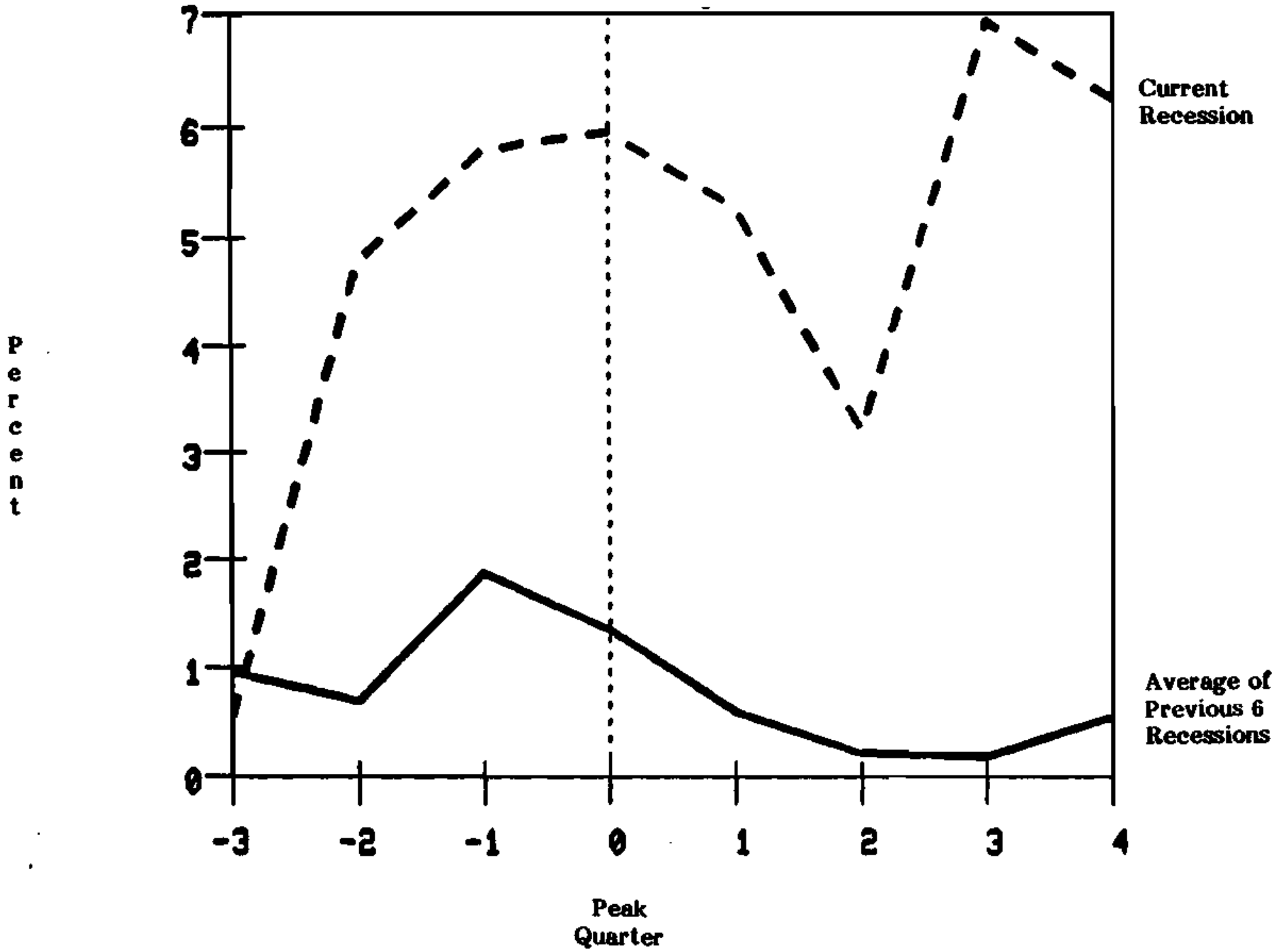
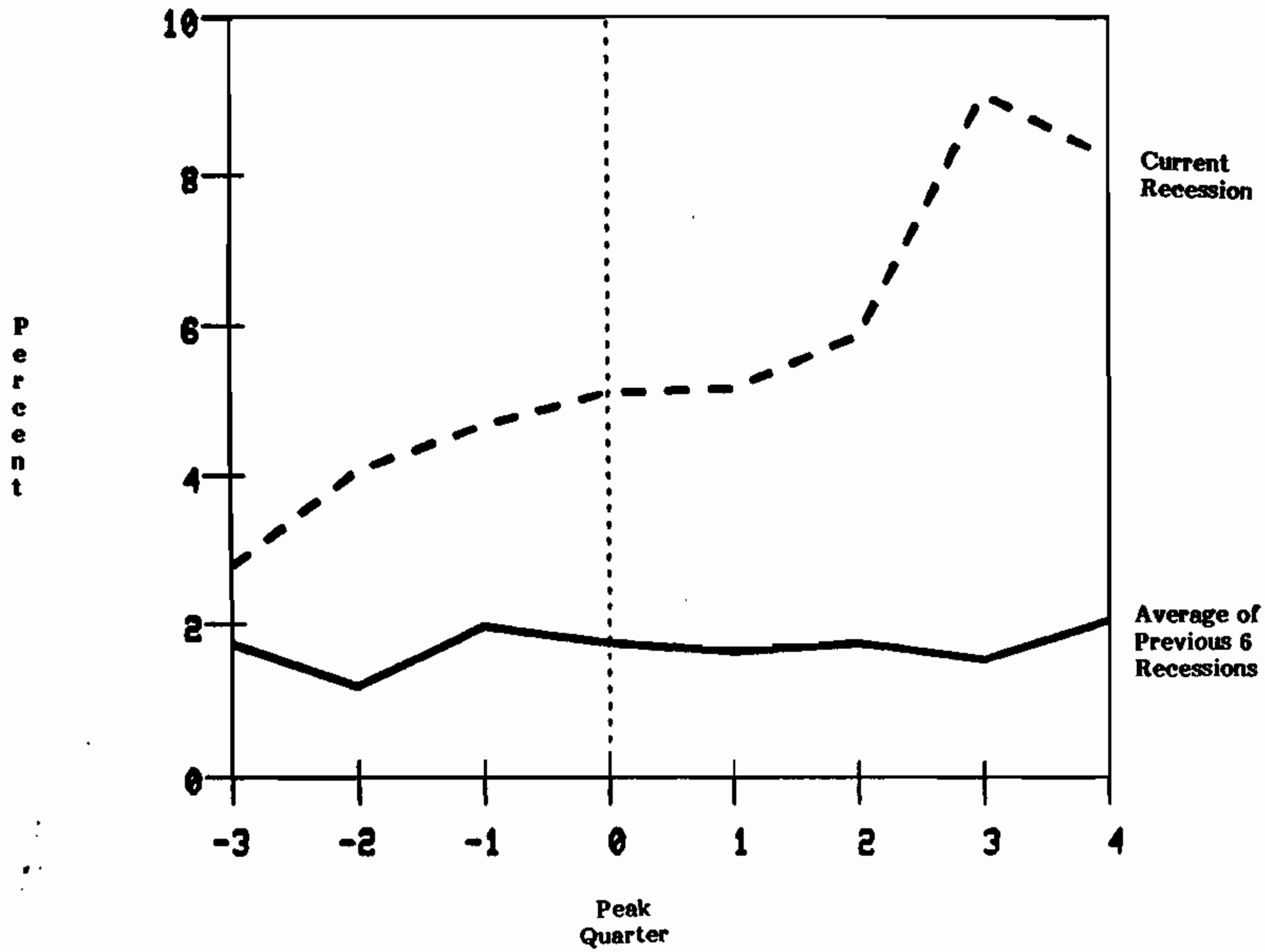


FIGURE 2

AAA Corporate Bond Rate

Around Peak Quarters

Adjusted For Current Underlying Inflation



of leading indicators has risen for three consecutive months—usually a sign of imminent upturn. Real consumer spending and residential construction were up and the inventory liquidation slowed in the second quarter—all positive signs for future output. Unemployment insurance claims have also declined for more than a month. On the other hand, the economy seemed to weaken in June and many important economic indicators, such as industrial production, still show no evidence of recovery. Moreover, the decline in business investment accelerated in the second quarter and weak orders for capital goods suggest that excess capacity and the record high real interest rates will have an adverse effect on business investment for several more months.

The most positive sign of recovery is the rise in real disposable income (by about 3 percent at annual rates) in the second quarter and the expected sharp rise this quarter as a result of the personal income tax cut. Because of these developments, consumer spending should turn up significantly in the months ahead. However, high interest rates and recently enacted tax incentives for saving could restrain the recovery in consumer spending during the months ahead.

The CBO Forecast

Although CBO has not yet assimilated the extensive revisions in GNP released last week, we have prepared a preliminary economic forecast, shown in Table 3. This forecast shows moderate growth in real GNP during the second half of this year, continuing at a rate of more than 3½ percent during 1983. The unemployment rate is expected to begin a gradual decline later this year, resulting in an average annual unemployment rate of 9.3 percent this year and 8.8 percent in 1983.

Inflation, as measured by the GNP deflator, is expected to accelerate from the very low 4.8 percent average annual quarterly rate in the first half of this year to about 7 percent in the last six months of the year. Two of the factors accounting for this rise in the second half of 1982 are the usual temporary acceleration due to the concentration of federal pay raises in the fourth quarter of the year and the effect of recent increases in oil prices. Next year the inflation rate is expected to decline to about 6.3 percent on a fourth-quarter-to-fourth-quarter basis. Both long- and short-term interest rates are projected to trend down during the forecast period, although short-term rates are expected to move up somewhat in 1983 as the recovery progresses. Our projection shows an average annual rate for three-month Treasury bills of about 12 percent this year and 11 percent in 1983.

The CBO forecast is based upon the assumption that the policies of the first resolution for fiscal year 1983 will be carried out. In regard to monetary policy, the CBO forecast assumes that M1 will grow at the upper end of the Federal Reserve's target range of 5.5 percent during the next

TABLE 3. COMPARISON OF THE PRELIMINARY CBO FORECAST AND THE ECONOMIC ASSUMPTIONS OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1983

Economic Variables	Actual[a/]	Projected	
	1980:4 to 1981:4	1981:4 to 1982:4	1982:4 to 1983:4
Nominal GNP (percent change)			
CBO	9.6	6.8	10.1
Resolution	9.8	8.6	11.6
Real GNP (percent change)			
CBO	0.7	0.7	3.6
Resolution	0.9	1.6	4.4
GNP Implicit Price Deflator (percent change)			
CBO	8.9	6.0	6.3
Resolution	8.9	6.9	6.9
Unemployment Rate (percent, calendar year average)			
CBO	7.6	9.3	8.8
Resolution	7.6	9.1	8.4
Three-Month Treasury Bill Rate (percent, calendar year average)			
CBO	14.0	12.0	11.1
Resolution	14.0	12.0	10.7

a/ The difference between CBO and Resolution figures reflects the recent revision in historical GNP accounts.

one and a half years. The forecast of inflation assumes that food prices will rise about 5 percent this year and 6½ percent next year. World oil prices are assumed to show no significant change through 1983.

The projected economic recovery is characterized by: (1) a pick-up in consumer expenditures, particularly for durable goods; (2) a further increase in residential construction, though the level remains very depressed; (3) an end to the inventory liquidation before year-end; (4) continued rapid growth in defense purchases; and (5) further declines in business investment spending this year followed by an upturn during 1983. The recovery results from:

- The current low level of inventories.
- The two reductions in personal income taxes that provide a considerable boost to real disposable income and personal consumption expenditures and the cuts in business taxes. The tax cuts are quite large, and lower projected inflation increases the real value of both the individual income tax cuts and the expanded business depreciation allowances.
- A projected decline in interest rates that is expected to set free pent-up demands for interest-sensitive durable goods. Moderate consumer debt burdens suggest that the consumer spending rebound could be sizable. The CBO forecast, however, does not foresee an easing of credit conditions sufficient to permit a rapid recovery in residential construction or in business investment during the forecast period.

Compared with the economic assumptions adopted for the first resolution, also shown in Table 3, the updated CBO forecast shows slightly less growth and lower inflation, a result of actual developments since the first resolution forecast was made. Although the differences are small and easily within the usual range of forecast error, such small differences in economic assumptions can have significant consequences for budget estimates.

Risks in the Forecast

At present, the major source of uncertainty appears to be the behavior of interest rates. The outlook for interest rates is particularly clouded because there does not appear to be a completely satisfactory explanation for the high rates of the past year.

The widely accepted explanation for the exceedingly high long-term rates experienced during recent months is that investors anticipate that a resurgence of inflation and/or high federal deficits will place upward pressure on rates in years to come. The high short-term rates are not so easily explained. Most economists would expect that declining inflation and a recession would lead to weak credit demands and declining interest rates, providing Federal Reserve policies were unchanged. Thus, analysts were suprised by the rise in short-term rates in the first half of 1982, especially given the increased growth in the money supply during the period. The apparent reason for this rise was that the demand for money was uncharacteristically strong. According to Federal Reserve spokesmen, much of the growth in M_1 money reflected the desire of individuals to increase liquid balances for precautionary purposes—money to hold, not to spend. Economists did not anticipate this development because deposits included in M_1 generally pay lower interest rates than other liquid assets, such as money market mutual funds. By permitting money aggregates to grow above target for much of the last seven months, the Federal Reserve partially accommodated this increased demand for liquidity, but apparently not sufficiently to prevent rates from rising.

Unfortunately, this explanation does not provide much information for projecting the future because we do not know whether the increased demand for liquidity is permanent or will soon be reversed. There is some reason to think that precautionary demand could decline as the economic recovery proceeds, but this cannot be predicted with confidence on the basis of past experience. If precautionary demand declines, short-term interest rates may fall quickly without an increase in money growth targets. Otherwise short-term rates might remain quite high under current monetary policy.

If past cyclical changes in interest rates are a guide to the future, the decline in short-term rates could be quite large. Between its August 1981 peak and June of this year, the three-month Treasury bill rate declined about $3\frac{1}{2}$ percentage points, reversing nearly half of the previous cyclical rise. During past declines, however, the bill rate fell by between $1\frac{1}{4}$ and 2/3 times the earlier rise. If this historical pattern is repeated, the bill rate might decline further by two to seven percentage points from the June levels, a decline that could set in motion a vigorous recovery. Most forecasters, however, believe that such a large decline in rates is unlikely in view of monetary policy targets and the projected magnitude of Treasury borrowing.

The Budget Outlook

Turning now to the budget outlook, CBO has not undertaken a comprehensive review of budget estimates pending receipt of the Administration's midsession review. Nevertheless, I can make a few comments on the status of the fiscal year 1982 budget and the implications of our preliminary economic forecast for the 1983 budget.

Based on actual tax collections through June, it now appears that fiscal year 1982 revenues will be in the range of $620 to $625 billion, or $3 to $8 billion below the revised second budget resolution estimate. Outlays will be close to the resolution level of $734 billion, based on actual spending trends to date. Primarily because of lower revenues, the budget deficit for 1982 will probably exceed the resolution target of $106 billion by several billion dollars.

While the preliminary CBO forecast for fiscal year 1983 is only marginally different from the economic assumptions used for the first budget resolution, these marginal differences could result in surprisingly large budget reestimates, particularly for revenues. The lower than expected revenue base for 1982, combined with the slightly lower real growth and lower inflation for 1983 in the CBO forecast, imply appreciably lower revenues than estimated for the first resolution. The impact of the CBO forecast on outlays is smaller, as the effects of lower inflation offset to some extent the effects of higher unemployment and interest rates. The net effect of these reestimates could be to add $25 to $35 billion to the 1983 budget deficit, almost all of it on the revenue side.

For the longer run, the CBO forecast also implies higher budget deficits than projected for the first budget resolution. The principal reason would be lower revenues resulting from somewhat lower real growth and lower inflation than assumed for the resolution. Outlays would be only marginally higher. The net result could be to increase budget deficits by about $40 to $55 billion for 1984 and $50 to $65 billion for 1985.

There is a great deal of uncertainty about the economic and budget outlook. It is certainly possible that the economy could recover more rapidly than projected by CBO because of easier credit conditions. Lower interest rates could provide a large boost to residential construction, business investment, and other interest-sensitive durable goods. Under this scenario, real output could expand more rapidly than we now project. Assuming that inflation does not respond quickly to stronger demands, the implications of the budget would be higher revenues and somewhat lower outlays.

On the other hand, if interest rates continue at high levels, the projected economic recovery would be severely limited. This low-growth scenario would result in even lower revenues, higher outlays, and significantly higher deficits.

Conclusion

The CBO still expects a recovery in the second half of this year and continued reduction of inflationary pressures. Recent economic trends, however, have led us to project more moderate growth and less inflation than we anticipated last February. Both of these changes in the economic outlook lead to estimates of larger budget deficits. This illustrates the sensitivity of the federal budget to changes in economic conditions. Even the relatively small changes in the economic outlook now forecast by CBO could have substantial effects on budget estimates. At best, budget deficits will continue to be a problem for the foreseeable future, even with the tax changes and spending reductions assumed for the first budget resolution. Further tax changes and additional spending reductions could be required again next year to achieve the longer-run deficit targets specified by the budget resolution.