

**Statement of
James L. Blum
Acting Director and
Assistant Director for Budget Analysis
Congressional Budget Office**

**before the
Committee on the Budget
United States Senate**

February 4, 1988

NOTICE

**This statement is not available
for public release until it is
delivered at 3:00 p.m. (EST),
Thursday, February 4, 1988.**

Mr. Chairman, I am pleased to appear before this Committee to discuss the economic and budget projections of the Congressional Budget Office (CBO). These projections will be described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1989-1993*, which we plan to release on Thursday, February 11.

In the closing days of 1987, the Congress and the Administration negotiated and largely put in place a plan to reduce the budget deficit for 1988 and 1989. At the same time, in the wake of the stock market collapse, signs of some temporary weakness in the economy began to emerge. The Congressional Budget Office now anticipates that the economy will experience a pronounced slowdown in growth in early 1988, but will regain strength in the second half of 1988 and in 1989. On the basis of CBO's economic assumptions and a continuation of current budgetary policies, the federal deficit is projected to rise from \$149 billion in 1987 to \$157 billion in 1988 and \$176 billion in 1989, before dropping to \$167 billion in 1990.

These baseline budget projections assume that revenues, offsetting receipts, and entitlement spending are projected according to the laws now on the statute books. Defense and nondefense discretionary appropriations are assumed to be held constant in real terms. The baseline projections are, therefore, not forecasts of future budgets, which will doubtless include numerous policy changes. This year CBO

has made minor changes in its baseline to make it identical to the budget base as specified in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (P.L. 100-119). We hope that having a single baseline will help focus attention on the fundamentals of the budget situation and reduce any confusion stemming from minor conceptual differences.

THE SHORT-RUN BUDGET SITUATION

On November 16, as required by the Balanced Budget Reaffirmation Act of 1987, CBO reported that the budget deficit for 1988 would be \$180 billion under laws then in effect. It also projected a deficit of \$186 billion in 1989 and \$166 billion in 1990. These estimates were based on CBO's August economic and technical estimating assumptions. How have the budget estimates changed since November?

On November 20, Congressional leaders and the President announced that they had reached a budget agreement covering the next two fiscal years. This agreement, or budget summit, was intended to reduce the deficit by \$30 billion in 1988 and \$46 billion in 1989 from the Balanced Budget Act baseline. The results of the budget summit were almost entirely incorporated in two bills--the continuing resolution of appropriations (P.L. 100-202) and the Omnibus Budget Reconciliation

Act of 1987 (P.L. 100-203)--signed by the President on December 22. These laws reduced the 1988 deficit by an estimated \$34 billion, comprising \$23 billion in lower spending and \$11 billion in additional revenues. The projected deficit reduction will then swell to \$36 billion in 1989 and \$40 billion in 1990, assuming that spending programs subject to annual appropriation action are allowed to grow by only the rate of inflation (see Table 1).

TABLE 1. BASELINE DEFICIT PROJECTIONS FOR 1988-1990
(By fiscal year)

	Actual		Projections		
	1986	1987	1988	1989	1990
In Billions of Dollars					
November 1987					
Base Deficit for					
Balanced Budget Act	221	149	180	186	166
Changes for:					
Enacted legislation	--	--	-34	-36	-40
Updated economic assumptions	--	--	9	21	33
Technical reestimates	--	--	2	6	8
Total changes	--	--	-23	-10	1
February 1988					
Baseline Deficit	221	149	157	176	167
Adjustments for:					
Tax reform	--	22	-10	-16	-4
One-time outlay savings	2	15	6	-3	-3
Total adjustments	2	37	-5	-19	-7
Adjusted Deficit	223	186	152	156	160
As a Percentage of GNP					
Baseline Deficit	5.3	3.4	3.4	3.5	3.1
Adjusted Deficit	5.4	4.2	3.3	3.1	3.0

SOURCE: Congressional Budget Office.

While policymakers were working hard to reduce the deficit, however, a deterioration in the economic outlook was eroding some of their improvements. CBO's updated economic assumptions add \$9 billion to the deficit in 1988, \$21 billion in 1989, and \$33 billion in 1990, compared with the November estimates. In 1988 and 1989, most of these changes result from lower tax revenues brought on by the forecast of a slowdown in economic growth. By 1990, however, the primary factor is a projected increase in interest rates, which adds to the costs of servicing the national debt.

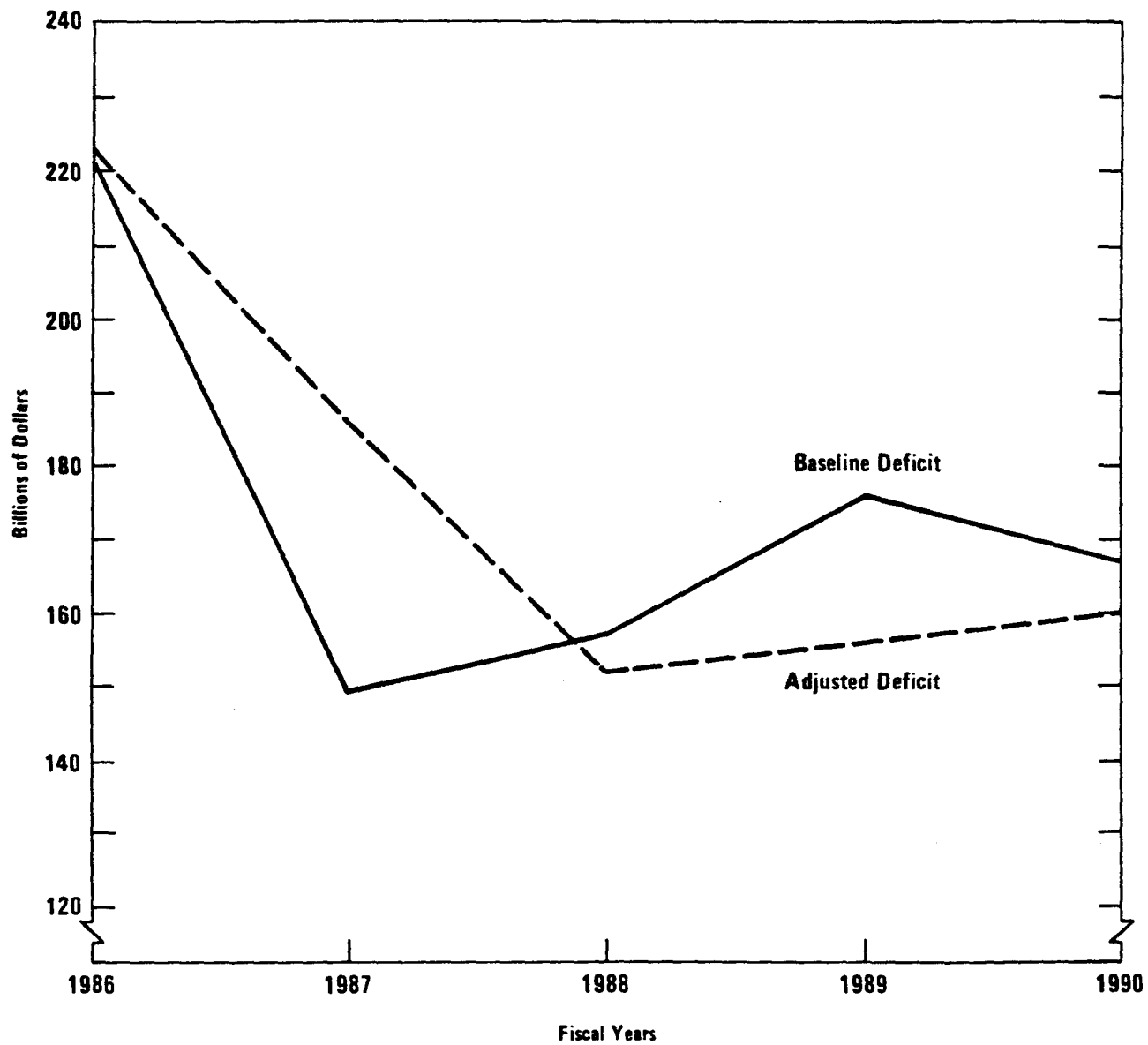
Changes in technical estimating methods and assumptions have increased the projected deficit slightly--by \$2 billion in 1988, \$6 billion in 1989, and \$8 billion in 1990--since CBO's November report. These reestimates result primarily from newly available data that permit a better estimate of the effects of the Tax Reform Act of 1986 (P.L. 99-514). Technical revisions in outlay estimates, while large for some individual programs, are negligible in total in most years.

The recent policy actions and economic and technical reestimates have not changed the pattern of the deficit: it fell sharply in 1987, will rise in 1988 and 1989, and will fall again in 1990. This jagged shape is largely the result of the phase-in of the Tax Reform Act of 1986 and of various one-time outlay savings. Tax reform added \$22 billion to revenues in 1987 but reduces tax collections by \$10 billion in 1988 and

\$16 billion in 1989. Asset sales and other one-time spending cuts hold down outlays by \$15 billion in 1987 and \$6 billion in 1988. The 1988 savings result from loan prepayments permitted by the recent appropriation and reconciliation bills. Were it not for these special factors, the pattern of the deficits would be much smoother, as shown in Figure 1. The deficit would have fallen less sharply in 1987--to about \$186 billion--and would then fall further to the range of \$150 billion to \$160 billion, where it would remain for several years.

The baseline deficits of \$176 billion in 1989 and \$167 billion in 1990 are well above the Balanced Budget Reaffirmation Act targets of \$136 billion and \$100 billion. The amount of deficit reduction required in 1989 is limited by law to \$36 billion. Implementing the rest of the budget summit in 1989 would produce about \$3 billion in additional outlay reductions in discretionary appropriations from the 1989 baseline and \$0.4 billion in additional revenues resulting from further increases in IRS enforcement resources. But even with these further savings, another \$32 billion in deficit reduction would still be required. (Asset sales of \$3.5 billion, although required by the budget summit, may not be counted as savings under the terms of the Balanced Budget Reaffirmation Act.) If the Office of Management and Budget (OMB) comes up with similar estimates this summer, across-the-board cuts would be required of roughly 9 percent in defense programs and 13 percent in nondefense programs from their baseline levels.

Figure 1.
Deficit Adjusted for Tax Reform Act
and One-Time Savings



SOURCE: Congressional Budget Office.

These cuts could be avoided if OMB's estimate of the deficit were within \$10 billion of the target--that is, less than \$146 billion. While using more favorable economic assumptions could reduce the projected deficit to that level, relying on this approach to get through the 1989 budget year would make the 1990 deficit reduction task that much harder. Taking no action this year beyond that required by the budget summit would leave the 1990 deficit around \$160 billion, according to CBO's current estimates. With a 1990 deficit target of \$100 billion, the excess deficit would be \$60 billion, almost double the amount of deficit reduction achieved in the first year of the summit.

THE SHORT-TERM ECONOMIC OUTLOOK

Just as the budget summit agreement for 1988 and 1989 was prompted by the stock market collapse of October 19, so will budgetary developments for 1988 and 1989 be driven by the economic aftermath of the crash. The drop in share values wiped out hundreds of billions of dollars of consumer wealth and, as measured by the most widely watched indexes of consumer sentiment, weakened confidence in the prospects for the economy. Excluding automobiles, real personal consumption fell at a 1 percent rate in the fourth quarter of 1987--the first decline since 1981.

As a result of the weakness in consumption, business piled up unsold inventories throughout 1987, but especially in the fourth quarter. CBO expects that the attempt to reduce inventory accumulation will act as a drag on the economy in early 1988. Real federal purchases of goods and services are also expected to fall, reflecting successive years of budgetary stringency.

Some brighter signs, however, suggest that the economy will avoid a recession. Real net exports have started to improve as a result of three years of dollar depreciation, and net exports are likely to be the major engine of growth in 1988 and 1989. Because the saving rate has already increased substantially, further declines in consumption are not anticipated.

The financial crisis was the impetus for a major shift in monetary policy. From the Louvre accord in February 1987 through October, the Federal Reserve's stated aims were to support the value of the dollar and to dampen inflationary expectations. In pursuing these aims, the Federal Reserve was forced to keep up interest rates. After the crash, however, it permitted interest rates to fall even at the cost of a depreciating dollar. This situation is likely to create inflationary pressures by the end of 1988 that will cause the central bank to shift back to a less accommodating stance.

CBO's short-run economic forecast for 1988 and 1989 is shown in Table 2. In addition to the monetary policy just described, the forecast assumes that federal fiscal policies are consistent with CBO's baseline revenue and outlay projections. The immediate outlook for the economy is substantially weaker than CBO expected in August. With a sluggish first half, real gross national product (GNP) is expected to grow by only 1.8 percent in 1988 (measured from fourth quarter to fourth quarter). The unemployment rate will average 6.2 percent for 1988 as a whole, the same as the previous year. In 1989, growth is expected to return to a 2.6 percent rate, roughly the same as that assumed in CBO's summer projections and only slightly lower than in the last three years, and unemployment should drop back. Consumer price inflation, which totaled 4.4 percent in 1987, is expected to reach 4.9 percent in 1988 and 4.8 percent in 1989. The GNP deflator is expected to increase more slowly than the Consumer Price Index, since the step-up in inflation is driven mainly by import prices, which do not add to the GNP deflator.

TABLE 2. CBO, ADMINISTRATION, AND CONSENSUS FORECASTS FOR 1988 AND 1989 (By calendar year)

	Actual	Forecast	
	1987	1988	1989
Fourth Quarter to Fourth Quarter (Percent change)			
Real Gross National Product			
CBO	3.8	1.8	2.6
Administration	3.8	2.4	3.5
Consensus	3.8	1.8	2.0
GNP Deflator			
CBO	3.3	3.9	4.2
Administration	3.3	3.9	3.7
Consensus	3.3	3.8	4.3
Consumer Price Index (CPI-U)			
CBO	4.4	4.9	4.8
Administration	4.4	4.3	3.9
Consensus	4.4	4.2	4.8
Calendar-Year Average (Percent)			
Three-Month Treasury Bill Rate			
CBO	5.8	6.2	6.7
Administration	5.8	5.3	5.2
Consensus	5.8	6.0	6.5
Ten-Year Government Note Rate			
CBO	8.4	9.3	9.5
Administration	8.4	8.0	7.4
Consensus <u>a/</u>	8.4	9.0	9.1
Civilian Unemployment Rate			
CBO	6.2	6.2	6.1
Administration <u>b/</u>	6.1	5.8	5.6
Consensus	6.2	6.2	6.3

SOURCE: Congressional Budget Office, February 1988 economic forecast; Council of Economic Advisers press release, December 23, 1987; Blue Chip Economic Indicators, January 10, 1988 (revised).

- a. Averages are calculated by using CBO's projection of the difference between the corporate bond rate and the 10-year government note rate.
- b. The Administration's projection is for the total labor force, including armed forces residing in the United States. In recent years, this rate has tended to be 0.1 to 0.2 percentage points below the civilian unemployment rate.

As a result of the slow real growth and the Federal Reserve's accommodative stance in the first half of 1988, there will be little immediate pressure on interest rates. Later in the year, the three-month Treasury bill rate should begin to rise in response to the higher inflation rate. For the year as a whole, CBO projects that the bill rate will average 6.2 percent. Ten-year government note yields will rise even more sharply, averaging 9.3 percent for the year, as they incorporate expectations of still greater inflation in the future resulting from the accommodative monetary policy. In 1989, the resumption of growth and the Federal Reserve's anticipated tightening will cause short-term real interest rates to continue rising. Long-term rates in 1989, however, are projected to be relatively flat.

This outlook for the economy depends on the success of the Federal Reserve in supplying the economy with enough credit to avoid a recession, without reigniting inflation or undermining the dollar. It also assumes that the long-awaited improvement in net exports has finally arrived and will accelerate in 1988. On the other hand, the economy could prove stronger than CBO forecasts if we have overestimated the extent of consumer retrenchment.

CBO foresees less rapid real growth and higher interest rates during the next two years than does the Administration, as shown in Table 2. Compared with private-sector forecasters, however, CBO's

growth forecast is about average for 1988 and is actually above the average for 1989. CBO's interest rates are slightly above the consensus, as a result both of stronger 1989 growth and the continued fall of the dollar. While we do not have all the details of the Administration's forecast, it appears that using their economic assumptions would lower the 1989 baseline deficit by about \$25 billion to \$30 billion. The differences between the CBO and consensus forecasts, however, are sufficiently small that they would have little effect on the budget estimates.

LONGER-RUN BASELINE PROJECTIONS

Beyond 1989, CBO's economic assumptions are not a forecast of future conditions but are projections based on historical trends. The projections do not include business cycles. They assume that the economy's long-term growth depends largely on the growth of the labor force and that output per worker will grow at about the same rate it has in recent years. CBO's five-year economic projections and the corresponding baseline budget projections are presented in Table 3.

In the projections, real GNP grows at an average annual rate of about 2.7 percent from 1989 to 1993, while the civilian unemployment

TABLE 3. BASELINE BUDGET PROJECTIONS
AND UNDERLYING ASSUMPTIONS

	Actual 1987	1988	1989	1990	1991	1992	1993
Budget Projections (By fiscal year, in billions of dollars) <u>a/</u>							
Revenues	854	897	953	1,036	1,112	1,181	1,262
Outlays	1,003	1,055	1,129	1,203	1,270	1,332	1,396
Deficit	149	157	176	167	158	151	134
Economic Assumptions (By calendar year)							
Nominal GNP Growth (percent change)	5.9	5.8	6.8	6.8	6.8	6.9	6.9
Real GNP Growth (percent change)	2.9	2.3	2.6	2.6	2.6	2.7	2.7
Implicit GNP Deflator (percent change)	3.0	3.4	4.1	4.1	4.1	4.1	4.1
CPI-W <u>b/</u> (percent change)	3.6	4.5	4.9	4.6	4.4	4.4	4.4
Civilian Unemployment Rate (percent)	6.2	6.2	6.1	6.0	5.9	5.9	5.8
Three-Month Treasury Bill Rate (percent)	5.8	6.2	6.7	6.6	6.4	6.1	5.9
Ten-Year Government Note Rate (percent)	8.4	9.3	9.5	9.0	8.4	7.8	7.4

SOURCE: Congressional Budget Office.

a. The baseline estimates include Social Security, which is off-budget.

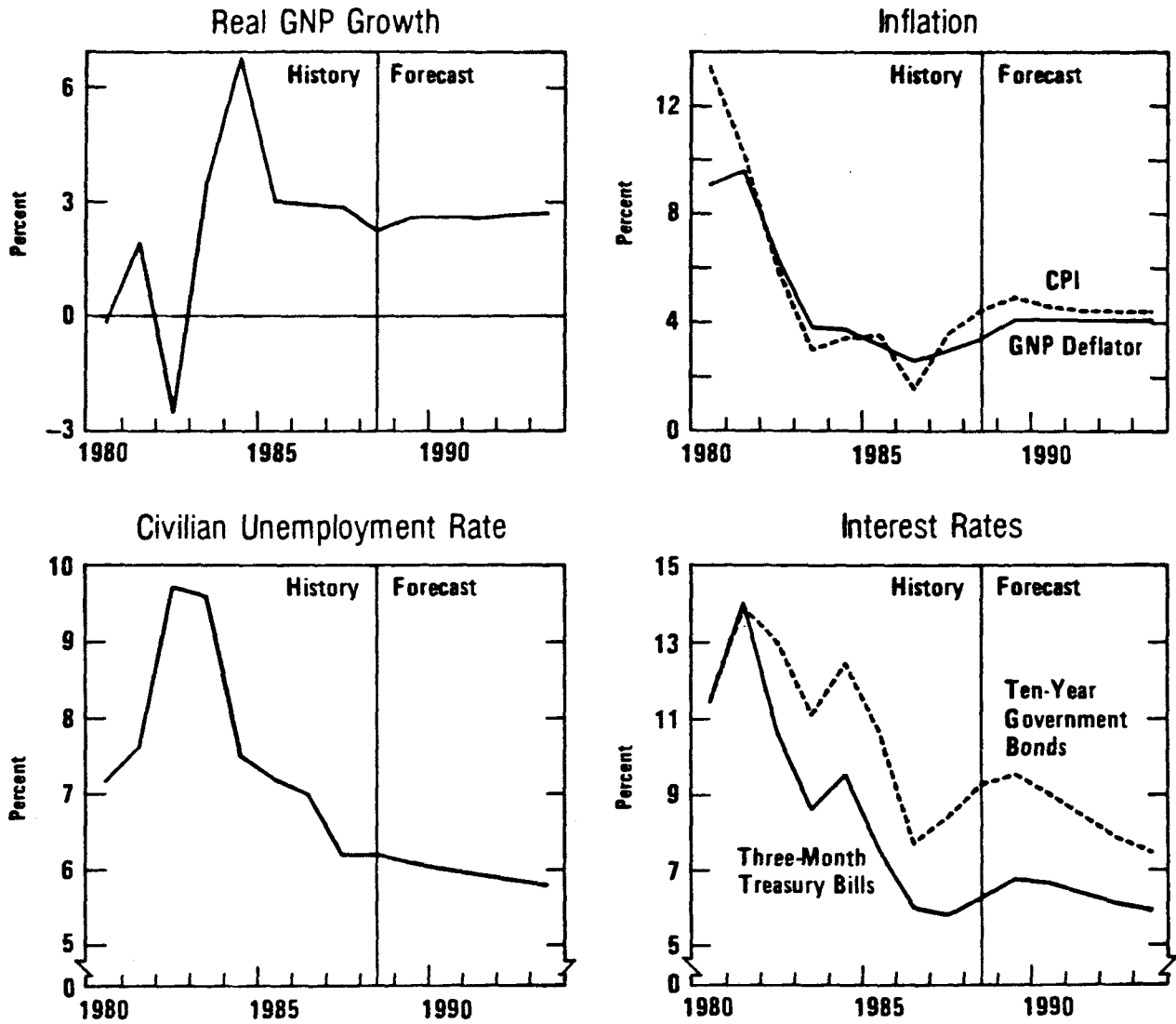
b. Consumer Price Index for urban wage earners and clerical workers.

rate falls to about 5.8 percent (see Figure 2). As measured by the GNP deflator, inflation stays at 4 percent, close to the postwar average. Consumer price inflation is slightly higher, however, because of further declines in the dollar and increases in import prices over the medium term. After 1989, real interest rates decline to levels consistent with their average since exchange rates began floating in 1971.

In such an environment of continued real economic growth, the baseline deficit is projected to decline slowly from \$176 billion in 1989 to \$134 billion in 1993. The deficit shrinks because revenues are boosted by both inflation and real growth, while outlays rise only slightly faster than the rate of inflation. Compared with the size of the nation's economy, the baseline deficit falls from 3.1 percent of the gross national product in 1990 to 2.1 percent in 1993.

In our new report, we have attempted to quantify the uncertainty inherent in these long-term economic and budget projections. The approach we used is an extension of our analysis in last summer's report of the accuracy of budget-year estimates. We find that there are about two chances in three that the level of real GNP in 1993 will turn out to be within 7 percent of its projected value, or that the average real growth rate between 1987 and 1993 will be between 1.6 percent and 3.6 percent. As a result, there is a two-in-three chance that the 1993 deficit will be within \$125 billion of its projected value of \$134 billion.

Figure 2.
Major Economic Assumptions



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

This large degree of uncertainty illustrates the point made earlier that the longer-run projections should be viewed only as a general indicator of budgetary trends and not as a forecast of future budgets.