Statement of Alice M. Rivlin
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before the
Subcommittee on Forests, Family Farms, and Energy
of the
Committee on Agriculture

U. S. House of Representatives

September 16, 1982

There should be no release of this statement until its delivery, scheduled for 10:00 a.m. (E.D.T), Thursday, September 16, 1982.

Mr. Chairman, the poor performance of the U.S. economy in recent years can be largely attributed to high inflation and restrictive credit conditions. Exceptionally high interest rates aborted the recovery from the 1980 recession and plunged the U.S. economy back into recession beginning in the summer of 1981. The persistence of high interest rates thereafter—an unusual occurrence during a period of declining inflation and reduced economic activity--produced what is perhaps the deepest slump in U.S. postwar history: unemployment was at a record high of 9.8 percent in July and August, and capacity utilization in manufacturing was less than 70 percent in July, near its previous lowest point. One of the major casualties of the combination of recession and high interest rates was residential construction; by some measures, the current housing recession is the worst in the past 30 years.

As indicated in our recent report updating the economic and budget outlook, the CBO expects an economic recovery beginning in the second half of this year, though by historical standards it is projected to be very moderate. The prospect of continued tight monetary policy combined with large federal deficits (with budget policies currently in place) is expected to cause interest rates to remain at levels sufficiently high to retard the expansion of interest-sensitive sectors of the economy such as housing and autos. Without additional budget measures aimed at reducing prospective budget deficits and a relaxation of credit conditions, the sustainability of the recovery is in doubt.

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. The magnitude of the decline in real GNP, however, understates the depth of the current slump because there was a large amount of slack in the economy before the recession began. An upsurge in interest rates arrested the recovery from the 1980 recession when it was only a year old, forcing the economy back into recession starting in the summer of 1981. As a result, the economy has grown very little since the end of 1979, and economic slack in the second quarter of 1982 reached the highest levels of the post-World War II period.

Unemployment is now widespread and is particularly high for some groups of workers. The combination of recession and longer-run structural problems has produced severe economic distress for industries such as steel and automobiles and for some areas of the country, especially the industrial Midwest. Recession, combined with high interest rates, has aggravated problems in housing and agriculture.

Partly because of the depth of the recession, inflation has declined substantially since the beginning of the year. The sharp reduction in inflation, from 8.9 percent during the second half of 1981 to 4.6 percent during the first half of 1982 reflected:

TABLE 1. MAJOR ECONOMIC INDICATORS

	1979	1980	1981	1981 Q2	1981 Q3	1981 Q4	1982 Q1	1982 Q2
Levels (billions of 1972 dollars)								
GNP	1479.4	1474.0	1502.6	1502.2	1510.4	1490.1	1470.7	1475.3
Final Sales	1472.2	1479.0	1493.7	1490.1	1493.9	1485.3	1486.1	1480.6
Inventory Change	7.3	-5.0	9.0	12.1	16.5	4.8	-15.4	-5.3
Disposable Income	1015.7	1018.0	1043.1	1036.6	1048.8	1051.9	1046.9	1056.1
Rates of Change (percent change at annual rates)								
GNP	2.8	-0.4	1.9	-1.5	2.2	-5.3	-5.1	1.3
Consumption	2.7	0.3	1.8	-2.7	2.9	-3.3	2.5	2.0
Business Fixed Investment	7.3	-2.2	3.5	1.1	9.3	0.6	-5.0	-12.3
Residential Investment	-5.2	-20.2	-4.8	-17.4	-31.9	-25.3	-10.2	11.5
Federal Purchases	1.8	4.2	3.7	-3.2	14.8	20.4	-5.5	-15.0
Defense	2.6	4.0	4.9	11.5	7.6	10.1	-7.9	17.7
Nondefense	0.3	4.6	1.3	-27.4	31.6	43.6	-0.9	-57.2
State and Local Purchases	1.1	1.1	-0.8	-4.6	-2.7	-0.8	-1.1	0.0
Exports	15.4	8.9	-0.4	1.0	-4.7	-2.4	-12.7	6.4
Imports	6.1	-0.4	7.2	16.8	11.3	6.0	-17.5	13.0
GNP Deflator	8.6	9.3	9.4	6.8	9.0	8.8	4.3	4.9
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	-7.1
Averages (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	6.9

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

- o Very weak commodity prices, particularly for gasoline and crude oil, but also for agricultural and forestry products;
- o Sluggish final demands;
- o The rise and continued strength of the dollar in foreign exchange markets—in response to relatively high U.S. interest rates—that held down the cost of imported goods; and
- o Lower wage demands, including some reopening of wage contracts, largely as a result of record unemployment rates.

The steep decline in economic activity through the first half of 1982 resulted largely from the persistently high interest rates (see Table 2). Interest rates declined quite sharply in the first months of the recession, as many forecasters had predicted, but rose again unexpectedly in the fall and winter. 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 declining inflation. Figure 1 shows that real interest rates have been considerably higher during the current recession than the average for earlier recessionary periods. In fact, during the first half of 1982, interest rates adjusted for current inflation reached their highest levels since 1932.

No completely satisfactory explanation exists for the behavior of interest rates in the past year. The persistence of high long-term rates is generally attributed to investors' fear that inflation and/or large federal deficits would place upward pressure on rates in years to come. The volatility of interest rates is also thought to have increased the uncertainty

TABLE 2. FINANCIAL INDICATORS

	1979	1980	1981	1981 Q1	1981 Q2	1981 Q3	1981 Q4	1982 Q1	1982 Q2
Monetary Growth (percent, annual rates)									
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	2.1
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

SOURCES: Federal Reserve Board; Federal Home Loan Bank Board.

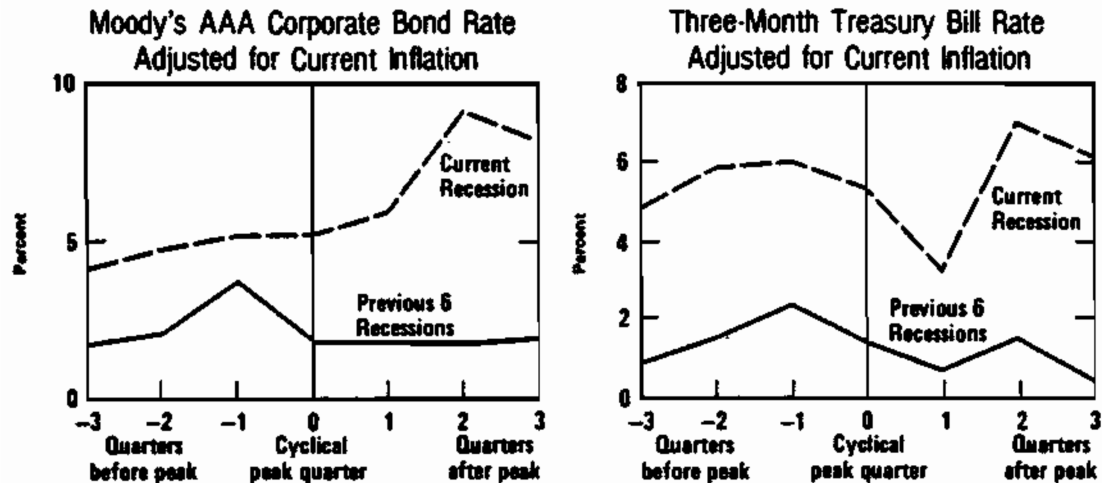
[a] At Federal Reserve member banks.

[b] Effective conventional mortgage rate, all homes, combined lenders.

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

Figure 1.

Interest Rates in Recessions, Adjusted for Inflation



NOTE: Adjustment for current inflation uses a measure of underlying inflation based on the CPI for the current quarter.

SOURCES: Federal Reserve Board; Bureau of Labor Statistics.

premium in long-term rates. The high short-term rates that prevailed until recently are not so easily explained, because declining inflation and a recession are usually associated with declining interest rates. One reason for high short-term rates in the first half of 1982 was the strength of the demand for money, which was partly responsible for money growth above Federal Reserve targets. Apparently, much of the growth in M1 reflected a desire to increase liquid balances for precautionary purposes—money to hold, not to spend—despite higher yields on other liquid assets, such as

money market mutual funds.[1] By permitting money aggregates to grow above target for much of the December-to-May period, the Federal Reserve partially accommodated this demand for liquidity, but not sufficiently to prevent short-term rates from rising. High short-term rates also appear to have put upward pressure on long rates. In any case, the high long- and short-term rates made the recession deeper, contributed to the record levels of business failures, and delayed the recovery in interest-sensitive sectors of the economy.

High interest rates have had dire effects on the housing industry (see Figure 2). By most measures, the current housing slump is the worst in the past three decades. Housing starts have remained below one million units at an annual rate for over a year—far longer than in any other postwar recession (see Figure 3). Housing starts did move above the one million annual rate level in July, but all the increase occurred in the multi-family category; single-family starts actually declined. Moreover, it is not clear how much of the increase in multi-family starts was associated with new construction activity; apparently, a large portion of the increase reflected ground-breaking by builders to meet the October deadline for previously committed federally assisted rental projects. Nor had there been any

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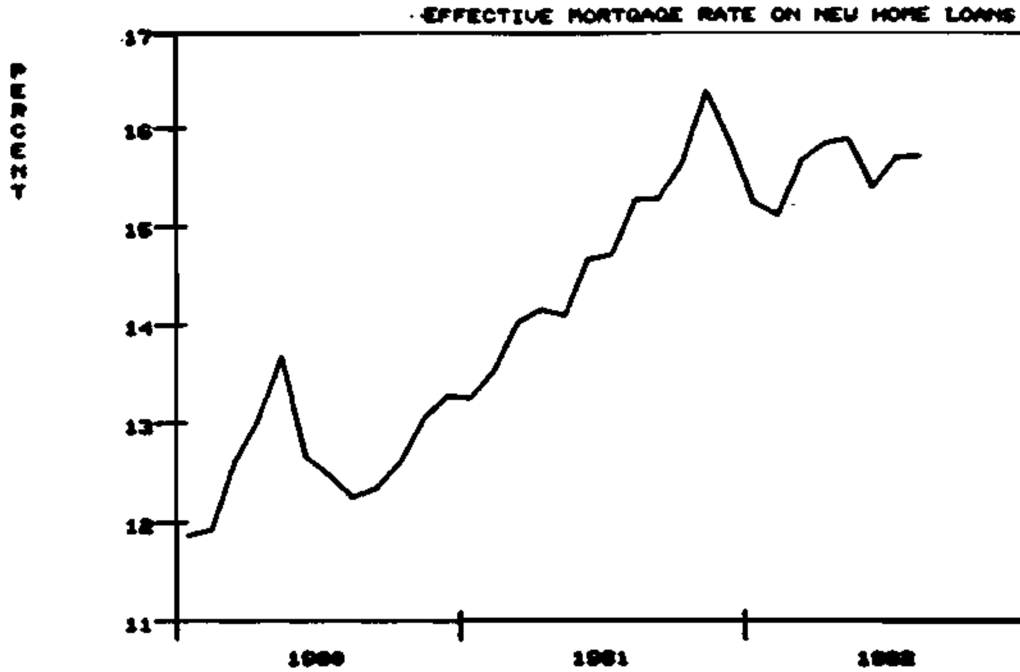
1 M1, the most widely watched monetary aggregate, consists mainly of currency in circulation plus travelers' checks plus checkable deposits at commercial banks and thrift institutions.

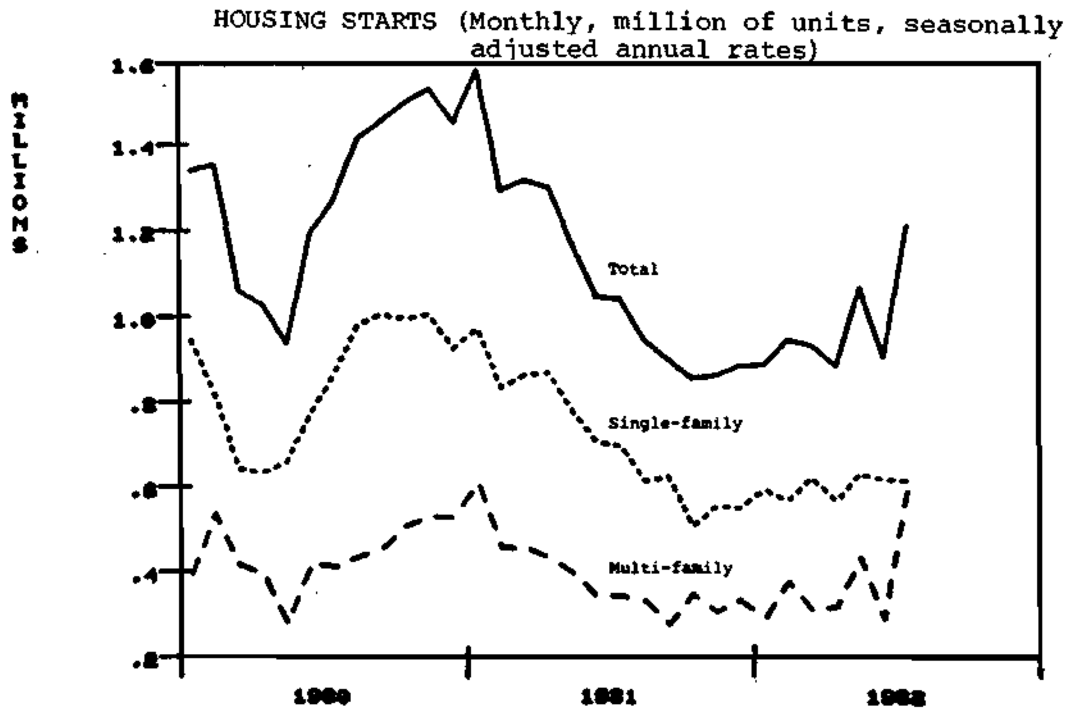
Figure 2.



Source: Federal Home Loan Bank Board.

Figure 3.

HOUSING STARTS (Monthly, million of units, seasonally adjusted annual rates)



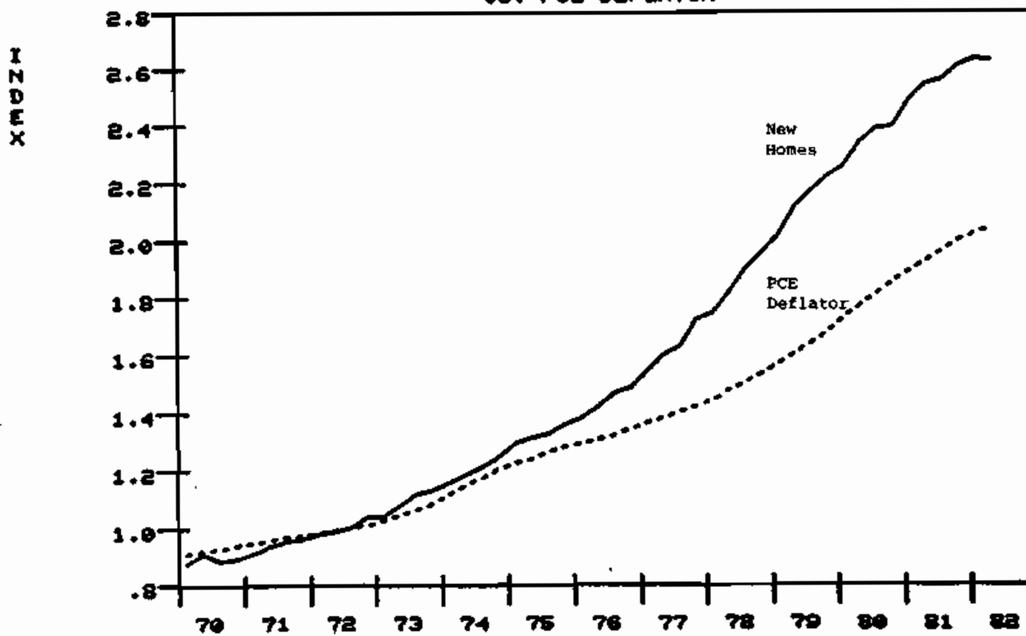
Source: U.S. Department of Commerce, Bureau of the Census.

upturn in sales of newly built homes through July. While recent reductions in mortgage interest rates are encouraging, no clear-cut signs of a broad-based recovery in housing have appeared to date.

One reason for the poor current performance of housing is that both house prices and mortgage interest rates have risen rapidly over the past decade, pushing mortgage payments to very high levels relative to incomes. Figure 4 shows the rapid increase in house prices relative to other prices, which has meant that houses purchased in the early 1970s with the low interest rates then prevalent have been very good investments. As Figure 5 makes clear, however, a house that could have been bought in the early 1970s with a commitment of 10 to 15 percent of monthly income for conventional mortgage payments now requires a commitment of more than 30 percent of monthly income. Thus, it is now far more difficult for new buyers to enter the housing market. And new purchases may well not appreciate as rapidly as those bought ten years ago.

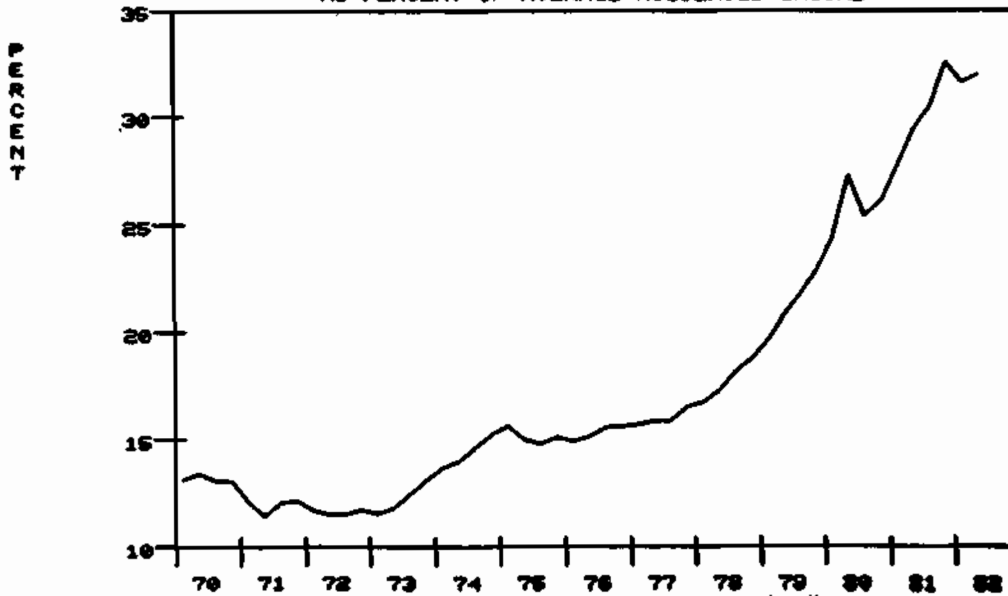
During recent weeks, short-term interest rates have declined substantially. Long-term rates, including mortgage rates, have started down, and they are forecast to continue to fall, perhaps irregularly, for remainder of the year. The extent to which they fall will be critical for the economy--especially for housing; sizable further reductions in long-term interest rates, in particular, appear to be necessary if the recovery is to be sustained.

Figure 4.



Sources: U.S. Department of Commerce, Bureaus of Economic Analysis and of the Census.

Figure 5.



Source: CBO calculation.

Explanation: The monthly mortgage payment was computed assuming purchase of a house with the same characteristics as the average house bought in 1977 financed by a conventional 30-year mortgage with 25% downpayment.

THE ECONOMIC OUTLOOK

The recession appears to have bottomed out, but as yet it is not clear that the recovery has begun; the latest data on economic activity give mixed signals. On the positive side, real GNP rose by 1.3 percent at an annual rate in the second quarter, because of a slowdown in the rate of inventory liquidation, and the Commerce Department's index of leading indicators rose between the first and the second quarters, usually a sign of imminent upturn. Real consumer spending and residential construction were up, and durable goods orders began to increase in July—all positive signs for future output. Another promising sign is the dramatic decline in short-term interest rates, and the more modest but still significant fall in long-term rates since July.

On the negative side, industrial production continued to fall in August. The decline in business investment accelerated in the second quarter, and continued weak orders for capital goods (despite an increase in July) suggest that excess capacity and high real interest rates will adversely affect business investment for several more months. In fact, the Commerce Department's survey of capital spending plans taken in July and August shows that investment intentions have been revised downward sharply for the remainder of 1982. The backlog of unfilled orders has not yet started to increase. Auto sales were very depressed in June and July and showed no signs of recovery in August, despite dealer incentives and

lower interest rates. Retail sales, excluding autos, did not increase in August. A flagging consumer sector was also suggested by the University of Michigan's index of consumer sentiment, which declined for a third consecutive month in July and remained flat in August, despite the 10 percent tax cut that came into effect in July.

Nevertheless, we expect that consumer spending will turn up in the months ahead, following a 3 percent (annual rate) rise in the second quarter and another sharp rise in real disposable income this quarter as a result of the personal income tax cut and the increase in Social Security benefits. (Tax incentives for saving, however, may partially offset the effects of higher consumer income.) The recent sharp drop in interest rates will also contribute to the recovery, providing that the decline in short-term rates is sustained and that long-term rates follow.

The CBO Forecast

The current CBO forecast, shown in Table 3, shows moderate growth in economic activity during the second half of this year and next year and continued moderation of inflation. The unemployment rate should begin to decline gradually later this year, resulting in an average annual unemployment rate of 8.8 to 9.3 percent in 1983. In contrast to the recent trend, short-term interest rates are expected to move up temporarily in 1983 as the recovery progresses. Long-term interest rates, on the other hand, are

TABLE 3. THE CBO FORECAST

Economic Variables	Actual 1981	Projected 1982	Projected 1983
	Fourth Quarter to Fourth Quarter (percent change)		
Nominal GNP	9.6	4.7 to 8.7	8.3 to 12.3
Real GNP	0.7	-0.3 to 1.7	2.7 to 4.7
GNP Implicit Price Deflator	8.9	4.9 to 6.9	5.3 to 7.3
	Calendar Year Average (percent)		
Unemployment Rate	7.6	8.8 to 9.8	8.3 to 9.3
3-Month Treasury Bill Rate	14.0	10.0 to 12.0	9.3 to 11.3
Mortgage Rate [a]	14.7	14.3 to 16.3	11.8 to 13.8
Housing Starts (thousands of units)	1,100	800 to 1,200	1,200 to 1,600

NOTE: Projections are based on preliminary GNP figures for the second quarter of 1982.

a Effective rate on mortgages by all major lenders for purchase of newly built homes.

projected to trend down during the forecast period. According to the CBO forecast, the average annual effective rate on mortgages for new homes will fall to near 15 percent this year, and to near 13 percent in 1983.

Although these projected reductions in mortgage rates are expected to improve housing activity, the CBO does not foresee an easing of credit conditions sufficient to permit a full recovery in residential construction during the forecast period. Indeed, housing starts are expected to average only about 1.2 million to 1.6 million units in 1983, well below the typical full recovery rate of 2.2 million units.

A number of important assumptions underlie the current CBO forecast.

- o The tax and spending policies of the first budget resolution for fiscal year 1983 are assumed to be carried out. Outlays, on a unified budget basis, are assumed to total $788 billion in fiscal year 1983, an increase of 7.5 percent over fiscal year 1982.
- o M1 is assumed to grow at the upper end of the Federal Reserve's target range of 5.5 percent through 1983.
- o Food prices are assumed to rise about 5 percent this year and 6½ percent next year.
- o World oil prices, denominated in dollars, are assumed to rise at a near zero rate in both 1982 and 1983.

Although the first budget resolution for fiscal year 1983, adopted by the Congress last June, significantly reduced projected deficits, they still remain quite high. The unified federal budget deficit is now projected to rise from $112 billion in fiscal year 1982 to $155 billion in fiscal year 1983. Treasury borrowing will exceed these projected deficit levels because of the prospective deficits of off-budget agencies, totaling $18 billion a year.

Uncertainty in the Forecast

At present, the major source of uncertainty about the forecast appears to be the behavior of interest rates.

Short-Term Rates. Although the sizable short-term interest rate declines in recent weeks are widely viewed as a positive sign, they do not in themselves guarantee a robust recovery during the next few months. To the extent that the reduced rates reflect either a reversal of the recent increase in money demand or an easier Federal Reserve policy, or both, lower real interest rates will prevail and strengthen the rebound from the current recesssion. On the other hand, if the interest rate declines merely reflect financial market perceptions that the recovery will be weaker than previously anticipated, there is less reason for optimism. Unfortunately, it is still too early to tell which of these alternative explanations is correct. In addition, there is no way to predict whether the demand for money will weaken in the months ahead, thereby permitting lower interest rates consistent with the Federal Reserve's current money aggregate targets.

Long-Term Rates. The outlook for long-term rates depends on whether present trends in inflation, together with the recently enacted budget measures, will convince the financial markets that inflation will continue to decrease in coming years. A decline in long rates, relative to inflation, would greatly improve the prospects for a recovery in residential construction and business investment, and for sustained economic growth.

CBO'S Medium-Term Projections

The economic assumptions used by the CBO for the purpose of estimating federal budget totals for 1984 and 1985 are highlighted in Table 4. These assumptions show continued moderation in inflationary pressures and moderate economic growth, partly as a result of a continued Federal Reserve policy of monetary restraint. The unemployment rate edges down slowly, but remains very high by historical standards. Short-term interest rates, as measured by the three-month Treasury bill rate, also continue to trend downward. Nevertheless, despite the projected improvement in the performance of the economy, the federal budget deficit on a unified budget basis remains very large with policies currently in place, averaging around $152 billion in both fiscal years 1984 and 1985.

TABLE 4. CBO BASELINE ECONOMIC ASSUMPTIONS (By calendar year)

Economic Variable	1982	1983	1984	1985
Real GNP (percent change, year over year)	-1.3	3.6	3.7	3.7
GNP Deflator (percent change, year over year)	6.6	6.4	6.1	5.6
Unemployment Rate (percent, annual average)	9.3	8.8	8.2	7.8
3-Month Treasury Bills (percent, annual average)	11.0	10.3	10.0	8.9

SOURCE: Congressional Budget Office.

The Monetary-Fiscal Policy Dilemma

The projected weakness of the economic recovery in 1982 and 1983, and the continuation of only moderate real growth in 1984 and 1985, result directly from the high real interest rates that are expected to prevail through 1985. With policies now in place, U.S. Treasury borrowing during fiscal years 1983-1985 is expected to be well above the record levels of 1982. In combination with a restrictive monetary policy, high levels of Treasury borrowing are expected to keep real interest rates higher than otherwise, thereby crowding out some private borrowing normally associated with a cyclical recovery. Thus, given present federal budget policies, the most serious obstacle to a strong sustained recovery appears to be a possible clash between the Federal Reserve's anti-inflationary monetary policy and an expansive fiscal policy.

Many economists believe that a shift in the policy mix toward somewhat more rapid money growth and less fiscal stimulus would result in lower interest rates and a shift in the composition of output toward more investment including residential investment. If successful, a policy shift of this kind would stimulate activity in areas that have been operating at very low levels, and would enhance the longer-run growth prospects of the economy. Such a strategy is not without risks. Some people, for example, feel that a change to a less restrictive monetary policy would heighten expectations of inflation to a greater extent than a more restrictive fiscal policy would lower inflationary expectation. The resultant increase in the

expected rate of inflation would push up long-term rates and slow the recovery. Unfortunately, economists are not certain how expectations are formed, how policies affect expectations, and how changes in expectations affect the economy.

CONCLUSION

The CBO expects a recovery in the second half of this year and continued reduction in inflationary pressures. Long-term interest rates have declined recently. If the decline continues, the impact on housing and investment spending will be favorable. However, fiscal policy changes over the past two years have led to projections of deficits that remain high even as the economy recovers from the current recession. These high projected deficits, along with expected tight credit conditions, are a potent force that may prevent interest rates from declining by enough to generate a rapid recovery. Without policy change, it is unlikely that residential construction will return to previous trend levels in the next few years. Efforts to reduce the deficit along the lines contemplated by the budget resolution, particularly if combined with a less restrictive monetary policy, would reduce real interest rates and stimulate growth in housing.