Statement of
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Mr. Chairman, I am pleased to have the opportunity to testify on the economic and budgetary outlook. As you know, the U.S. economy has been weaker so far this year than most forecasters anticipated. In mid-1984, its growth slowed abruptly and continued at a sluggish pace in the first three quarters of this year. This weak growth has kept unemployment quite high by historical standards, and industrial capacity utilization low. Inflation rates, however, remain at the relatively moderate levels achieved soon after the 1981-1982 recession.

The slowdown this year resulted primarily from a reduction in inventory investment and a further decline in net exports. Although domestic demands remain strong, foreign competition has made heavy inroads in the goods producing sector of the U.S. economy. This deterioration in the competitive position of U.S. producers is related, in part, to the growth in the federal deficit in recent years. The deficit helped to push up interest rates in the United States, thus attracting inflows of international capital that contributed to the rise in the exchange values of the dollar and the resulting decline in net exports.

Massive inflows of foreign capital into the United States and the concomitant rise in our country's external debt have altered the nature of long-run costs of persistent large budget deficits. Without such inflows, enormous borrowing requirements of the federal government would have crowded out private borrowers, thus leading to reduced business investment and lower productivity growth. The end result would have been slower improvement of living standards. Instead, inflows of foreign capital in recent years have mitigated the crowding out effects of federal deficits and their depressing influence on productivity.

Rising external indebtedness of the United States necessitates, however, diverting an increasing share of domestic output toward servicing the external debt. The end result, therefore, will be slower growth of Americans' living standards than what could have been achieved with smaller budget deficits.

Most forecasters, including the Congressional Budget Office (CBO), now expect a speedup in output growth later this year, followed by moderate growth in 1986. The reason for these expectations is a sharp drop in interest rates, partly in response to an expansive monetary policy. Furthermore, the recently enacted Congressional Budget Resolution for Fiscal Year 1986 significantly reduces the size of future budget deficits, leading to expectations of reduced future credit demands and an anticipatory lowering of long-term interest rates. Lower interest rates are likely to encourage growth in interest-sensitive sectors such as residential construction and business investment.

The dollar has also declined recently, thereby improving the prospect for halting the deterioration of net exports next year. Monetary authorities of the five largest industrial countries have recently come to an accord aimed at weakening the dollar on international exchanges, which may further contribute to the improvement in U.S. net exports.

Nevertheless, the economic outlook remains cloudy. Although the Commerce Department's flash report on the economy suggests that growth did accelerate somewhat in the third quarter, so far there are only a few signs of an imminent resumption of robust economic growth. Furthermore, the financial system appears to be coming under increasing stress; the international debt situation is not improving; economic growth in the rest of the world remains lackluster; and protectionist pressures are mounting. On the other hand, final sales still remain relatively strong; oil prices may weaken further; economic performances of the United States and its leading trading partners are likely to converge; and, most important, the Congressional Budget Resolution for Fiscal Years 1986-1989, although leaving deficits high by historical standards, has changed the budgetary outlook for the better. In contrast to CBO's projections last February of deficits rising to the neighborhood of $300 billion by 1990, we now project that, if the resolution is fully implemented, federal deficits will gradually decline from $210 billion this year to $120 billion in 1990.

In a report issued last August entitled The Economic and Budget Outlook: An Update, the Congressional Budget Office (CBO) provided this committee with revised economic and budget estimates. My testimony today will summarize and update that report.

RECENT ECONOMIC DEVELOPMENTS

The economy has recorded only 2.3 percent growth in real gross national product (GNP) over the last year and a sluggish 1.7 percent average increase, at annual rates, for the first three quarters of 1985. Unemployment has held steady for a year at rates slightly above 7 percent (see Table 1).

The slowdown in output growth in the first half of this year resulted from further deterioration in net exports and a decline in inventory accumulation rather than from weak domestic demands. In fact, private demands have been quite strong (see Figure 1). Real final sales to domestic purchasers grew at a 4.6 percent rate during the first half of this year, with consumer spending rising at a strong 5.0 percent rate and business fixed investment at a 6.2 percent rate.

The divergence between the rate of growth of domestic demand and domestic output is one reflection of the stimulative effects of federal budget deficits and the depressing effects of trade deficits. It is generally understood by now that increased federal deficits have been crucially important in creating record-breaking trade deficits. Data suggest that until mid-1984 the increasing drag on the economy originating in the external sector was more than offset by stimulative effects of strong fiscal expansion. More recently, however, the negative effects of rapidly deteriorating net exports appear to have dominated fiscal policy impacts, thus depressing overall U.S. economic performance and noticeably affecting the composition of the American economy.

As a result of strong domestic demand, those sectors of the economy

TABLE 1. RECENT ECONOMIC INDICATORS

Indicator	1983	1984	1984 III	1984 IV	1985 I	1985 II	1985 III
Real GNP (percent change)	3.7	6.8	1.6	4.3	0.3	1.9	2.8 a/
Real final sales to domestic purchasers	4.4	6.8	2.9	4.3	3.4	5.9	N.A.
Personal consumption expenditures	4.8	5.3	0.7	3.6	5.2	4.8	N.A.
Business fixed investment	2.5	19.8	13.7	8.5	-1.6	14.5	N.A.
Residential investment	41.7	12.2	-4.6	-5.5	5.3	6.4	N.A.
Government purchases	-0.3	3.5	5.4	5.9	0.3	3.7	N.A.
Inventory change (billions of 1972 dollars)	-3.6	24.8	30.6	16.8	19.1	8.3	N.A.
Industrial Production (percent change)	5.9	11.5	6.4	-0.6	2.1	1.4	1.6 a/
Civilian Unemployment Rate	9.6	7.5	7.5	7.2	7.3	7.3	7.2
Consumer Price Index, Urban Consumers (percent change)	3.2	4.3	3.7	3.5	3.3	4.2	2.5 a/
Three-Month Treasury Bill Rate	8.6	9.5	10.3	8.8	8.2	7.5	7.1
Corporate Bond Rate	12.0	12.7	13.0	12.4	12.3	11.6	11.0

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

N.A. = not available.

a. Based on incomplete or preliminary data.

that are relatively immune to foreign competition continued to thrive--namely, most services or defense oriented industries. At the same time, industries producing tradeable goods have suffered a drop in their output. The purchases-based goods component of GNP declined in the first half of this year, suggesting a decline in GNP goods output. Moreover, industrial production rose only at a 1.7 percent annual rate from January through August. Payroll employment data indicate that employment in goods producing industries has declined by 163,000 since the beginning of the year. On the other hand time, employment in service producing industries, which are not threatened significantly by foreign competition, has risen over 1.8 million.

Inflation rates in the first half of this year were about the same as for 1984 as a whole. The Consumer Price Index rose at about a 3.3 percent rate from December to August, while the Producer Price Index for finished goods increased at about a 0.8 percent rate. Factors contributing to the moderate inflation were: the high dollar, which cuts the price of imports and restrains price increases for import competing products; continuing weakness in oil prices; abundant crops and low food prices; and low average wage increases. Given the current slack in the economy and the likelihood of further declines in oil prices, most forecasters do not expect inflation rates to rise significantly above current levels during the next several months.

Both real and nominal interest rates continued to ease through July and remained about flat in the past three months. The three-month Treasury bill rate has fallen three percentage points since last summer, and long-term Treasury bond rates are also down sharply. While the weakened state of the economy undoubtedly was a factor in this decline in rates, it also reflected a more expansive monetary policy and, perhaps, the expectation of reduced future credit demands on the part of the federal government.

Continued moderate inflation, reduced interest rates, and the significant decline in the dollar over the past six months have improved the prospects for a pickup in economic activity. The near-term outlook is, however, very uncertain. Indicators of domestic output are mixed and the outlook for the foreign trade sector is particularly uncertain.

THE CBO ECONOMIC PROJECTION

CBO's economic projection that is used to construct budget estimates consists of: (1) an economic forecast through 1986 that is conditional on specific policy assumptions; and (2) medium-term economic projections through 1990 based on historical growth trends.

The Forecast for 1985 and 1986

The short-run CBO forecast shown in Table 2 incorporates the following assumptions:

- o Federal budget policies are assumed to be those incorporated in the Congressional Budget Resolution for 1986.
- o CBO's economic forecast of last August assumed that the Federal Reserve would increase the monetary aggregates at rates corresponding to the middle of the target ranges announced by the Federal Reserve in its mid-year report to Congress and that the demand for narrowly defined money balances (M1) would increase

slightly faster than GNP. Since the time of our forecast, the demand for money balances has grown at a surprisingly rapid rate and the Federal Reserve has accommodated this surge. Without this change, it is unlikely that the originally assumed policy would have been consistent with our August economic forecast.

- Food prices are assumed to rise less than prices in general, and oil prices are assumed to decline by about $2.50 per barrel from calendar year 1984 to 1986.

- In its forecast of last August, CBO assumed that the exchange rate of the dollar falls by some 8 percent from its average level in the second quarter of 1985 and remains roughly stable through the forecast period. The recent agreement of the Group of Five depressed the dollar a few percentage points below the level forecast by CBO in August. We now assume that the average value of the dollar in international exchange markets will remain approximately at today's levels.

TABLE 2. THE CBO FORECAST FOR 1985 AND 1986

	Actual		Forecast	
	1983	1984	1985	1986
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	10.4	9.5	7.0	7.8
Real GNP	6.3	5.7	2.6	3.4
Fixed-Weight GNP Deflator	4.0	4.2	4.1	4.3
Consumer Price Index				
Urban consumers	3.3	4.1	3.9	4.8
Calendar Year Average (percent)				
Civilian Unemployment Rate	9.6	7.5	7.2	7.0
Three-Month Treasury Bill Rate	8.6	9.5	7.6	7.4
Corporate Bond Rate				
(Moody's AAA)	12.0	12.7	11.5	10.7

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

With these assumptions and taking into account the economic results of the first half of this year, CBO adjusted the forecast it made last February by lowering the rate of GNP growth for 1985 by about one percentage point and slightly raising it for 1986. Inflation, as measured by the Consumer Price Index (CPI-U), has been about in line with our February forecast. The rate of inflation is expected to be between $3\frac{1}{2}$ percent and 4 percent this year and to accelerate to between $4\frac{1}{2}$ percent and 5 percent in 1986. The increase in CPI-measured inflation from 1985 to 1986 reflects a lagged response to the decline in the dollar and exceptionally low inflation in food prices so far in 1985 (the latter is not expected to be repeated next year). The civilian unemployment rate is projected to decline gradually from current levels. The three-month Treasury bill rate is expected to average about $7\frac{1}{2}$ percent in 1985 and 1986--about two percentage points below last year's average rate. Corporate bond rates are projected to fall about a percentage point in 1985, to $11\frac{1}{2}$ percent, and still further in 1986 to $10\frac{1}{2}$ percent.

Economic Projections for 1987-1990

The medium-term projections, shown in Table 3 and Figure 1, are based on average historical experience. Specifically, the growth rates for real GNP and productivity from the fourth quarter of 1982 (the recession trough) to the fourth quarter of 1990 are assumed to equal their respective average growth rates in the eight-year periods following earlier postwar recessions. Thus, these growth- and interest-rate paths do not necessarily reflect the budget policies incorporated in the Budget Resolution for Fiscal Year 1986. The major characteristics of the 1987-1990 projections are:

- o Real GNP grows smoothly at an average 3.5 percent rate;
- o The unemployment rate declines gradually to 6.3 percent by 1990;
- o Inflation holds at about 4.2 percent, close to current levels; and
- o Interest rates also remain flat at 7.2 percent for the Treasury bill rate and 10.2 percent for the corporate bond rate. The inflation-adjusted Treasury bill rate is assumed to be 3 percent, somewhat lower than the real rate assumed last February.

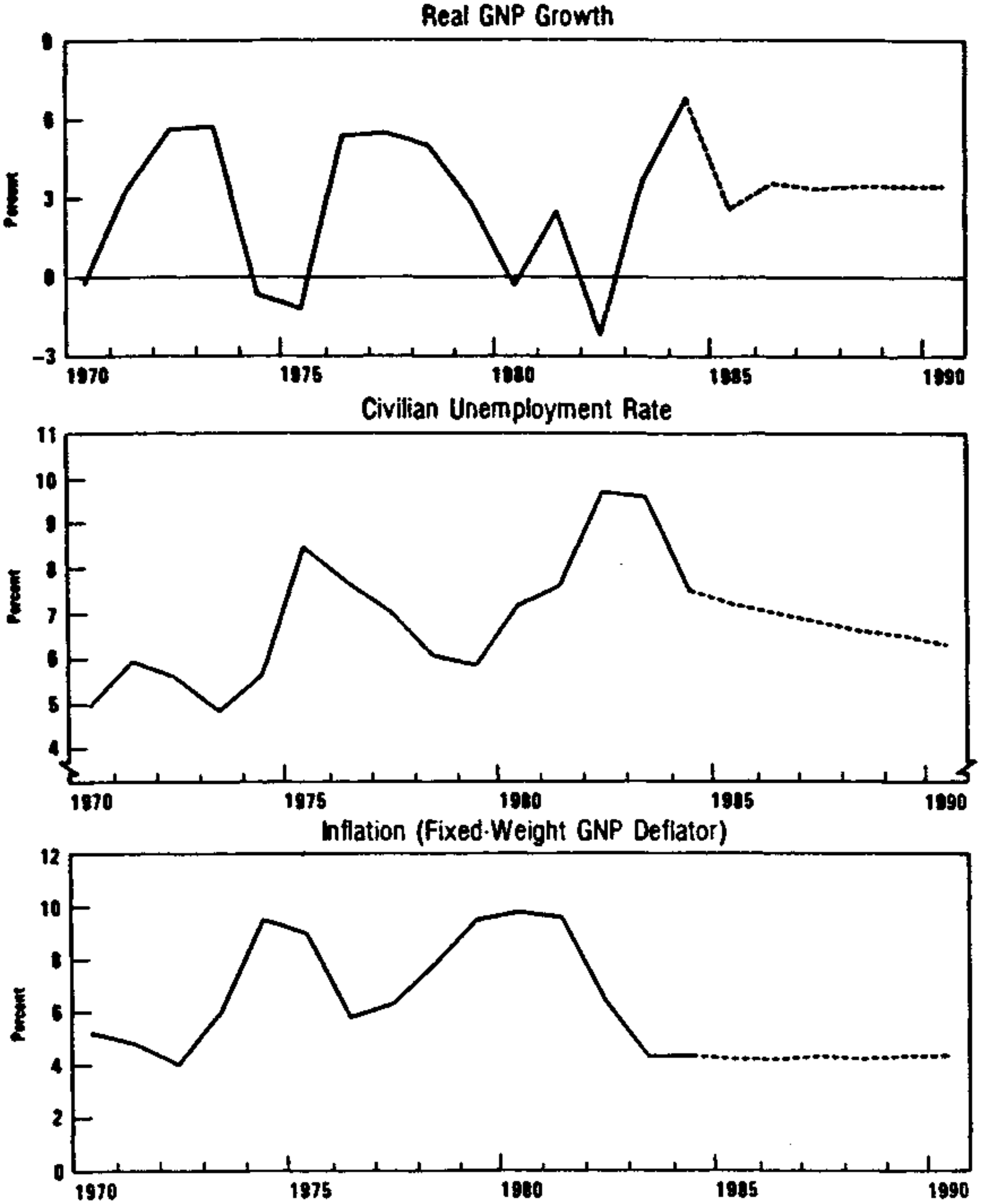
TABLE 3. ECONOMIC ASSUMPTIONS

Economic Variable	Actual 1984	1985	1986	1987	1988	1989	1990
Economic Assumptions (By calendar year)							
Real GNP (percent change)	6.8	2.6	3.6	3.4	3.5	3.5	3.5
CPI-U (percent change)	4.3	3.7	4.5	4.4	4.2	4.2	4.2
Civilian Unemployment Rate	7.5	7.2	7.0	6.8	6.6	6.5	6.3
Three-Month Treasury Bill Rate	9.5	7.6	7.4	7.2	7.2	7.2	7.2

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

Figure 1.

Major Economic Assumptions



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

UNCERTAINTY IN THE FORECAST

At present, the greatest uncertainty appears to be related to the following factors: condition of financial institutions, mounting protectionist pressures, behavior of the dollar, and changes in world oil prices.

In regard to financial conditions, two sources of uncertainty now appear paramount. First, the historical relationship between certain monetary aggregates and economic activity appears to be shifting. In the last four years, there have been two periods of unexpected and unprecedented decline in money velocity (the ratio of GNP to money); the most recent decline occurred in the first three quarters of this year. This instability in money velocity makes it much more difficult for outside forecasters and the Federal Reserve to predict the effects of its policy on the economy.

Second, the failure rate of domestic financial institutions is very high. Many farm banks have experienced serious difficulties and the Farm Credit System has come under increasing strain as a result of the deteriorating quality of its assets. Increasingly poor quality of assets has also become the most pressing problem for many savings institutions. In addition these institutions remain vulnerable to rising interest costs because of a mismatch in the maturities of their assets and liabilities. Debt-burdened developing countries are also vulnerable to a rise in interest rates. A widespread failure of financial institutions or an inability of foreign debtors to service their debt could create serious economic uncertainty, perhaps having significant budgetary implications, and could force the Federal Reserve to relax its anti-inflationary policy stance.

Escalation of protectionist pressures around the world could have incalculable consequences for the American and the world economies. Should they trigger a cascade of retaliatory and counter-retaliatory measures, the outcome would be a sharp contraction of international trade accompanied by a pronounced slowdown in economic growth.

The economic outlook would be significantly affected by an abrupt shift in the dollar exchange rate. If the international value of the dollar were to rise, despite the stated commitments of the five largest industrial countries to weaken it, the U.S. foreign trade position would be likely to keep deteriorating, perhaps even jeopardizing further expansion. On the other hand, if the dollar were to fall sharply, inflation in the United States would be higher, but the U.S. trade position would become stronger.

A major drop in oil prices would also have a significant effect on the economic situation. Indeed, some forecasters expect that oil prices will decline more sharply than assumed by CBO. Such a decline would have a favorable effect on both inflation and economic growth in the United States and other oil importing countries.

Many analysts predict a decline in the value of the dollar as well as in energy prices. If this should happen, the deflationary effects of falling energy prices would tend to offset the inflationary effects of a falling dollar. But the effects on real activity might be reinforcing--both tending to increase domestic output.

THE BUDGETARY OUTLOOK

The budgetary outlook has changed dramatically since the beginning of the year as the result of the new Congressional budget plan for fiscal years 1986-1988. Assuming that this plan is implemented fully, and extrapolating its policies through 1990, CBO projects that federal deficits would fall from $210 billion this year to $175 billion in 1986, $143 billion in 1988, and $120 billion in 1990. The decline in the deficit appears even larger in relation to the size of the economy. Under CBO's economic assumptions, the deficit will shrink from 5.5 percent of the gross national product in 1985 to 2.1 percent by 1990, the lowest level experienced since 1979.

These budget projections are in sharp contrast to those that we made in February in our annual report to the Budget Committees. At that time, CBO was projecting deficits rising to the neighborhood of $300 billion by 1990 and remaining above 5 percent of GNP throughout the projection period. While some have expressed disappointment that the Congress did not go further in its plan to reduce the deficit and while it is true that much remains to be done, I believe that implementing the budget resolution would, nevertheless, represent significant progress. Given our assumptions, one of its most important outcomes is that the resolution would halt the rapid escalation of federal debt relative to GNP. According to our estimates, the debt-to-GNP ratio would peak at 41.7 percent in 1987 and then decline to 40.2 percent by the end of 1990, as shown in Figure 2. This should help to

TABLE 4. THE BUDGET OUTLOOK WITH POLICIES OF THE 1986 BUDGET RESOLUTION (By fiscal year)

	1984 Actual	1985 Estimate	CBO Projection 1986	1987	1988	CBO Extrapolation 1989	1990
			In Billions of Dollars				
Revenues	666	737	790	858	939	1,013	1,094
Outlays	852	946	965	1,021	1,082	1,145	1,214
Deficit	185	210	175	163	143	132	120
Debt Held by the Public	1,313	1,522	1,701	1,861	2,002	2,133	2,252
			As a Percent of GNP				
Revenues	18.6	19.2	19.1	19.2	19.5	19.5	19.5
Outlays	23.8	24.6	23.3	22.9	22.5	22.1	21.7
Deficit	5.2	5.5	4.2	3.7	3.0	2.5	2.1
Debt Held by the Public	36.7	39.6	41.1	41.7	41.6	41.1	40.2

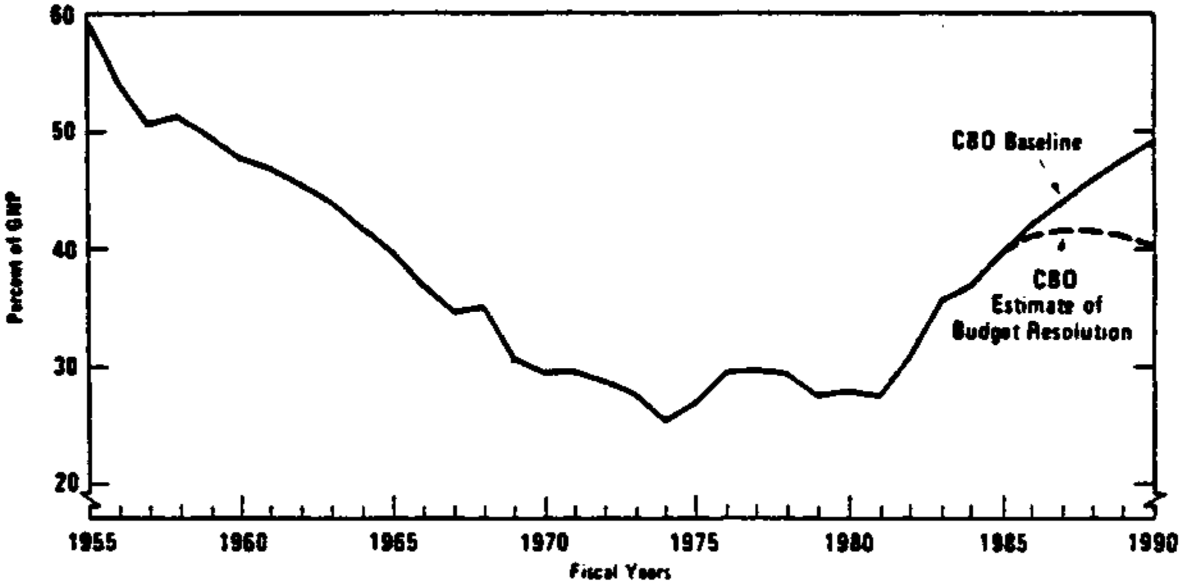
SOURCE: Congressional Budget Office.

ease pressures on interest rates and have favorable effects for both the economy and the budget.

The projected improvement in the deficit and debt picture does not mean, however, that all fiscal problems will disappear. The remaining deficits are still high by historical standards. Furthermore, publicly held federal debt would grow by nearly 50 percent during the next five years, requiring a larger share of the budget to be allocated to debt service costs. Finally, these projections depend critically on the Congress following

Figure 2.

Federal Debt Held by the Public



SOURCE: Congressional Budget Office
[a]Extrapolated by CBO in 1989 and 1990

through with legislative actions necessary to implement the budget resolution policies, and the economy performing as assumed by CBO. In other words, the resolution does not provide any insurance against things going wrong.

Policy Changes

The budget resolution relies almost entirely on spending reductions to achieve lower deficits. Only very small revenue increases from projected baseline levels are contemplated. Table 5 summarizes the deficit reductions in the budget resolution in terms of changes from CBO's updated baseline projections.

TABLE 5. POLICY CHANGES IN THE 1986 BUDGET RESOLUTION AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	CBO Projection			CBO Extrapolation	
	1986	1987	1988	1989	1990
CBO Baseline Deficit a/	212	229	243	264	285
Deficit Reductions as estimated by CBO					
Revenue increases b/	-3	-5	-8	-11	-11
National defense	-11	-25	-41	-57	-74
Entitlements	-7	-13	-18	-19	-20
Nondefense discretionary	-11	-20	-24	-24	-26
Offsetting receipts	-4	c/	c/	-1	-1
Net interest	-1	-3	-10	-20	-33
Total reductions	-37	-66	-100	-132	-164
Deficit in Budget Resolution as Estimated by CBO	175	163	143	132	120

a. CBO February 1985 baseline, as updated in August.
b. Revenue increases appear as negative numbers because they reduce the deficit.
c. Less than $500 million.

The largest spending reductions compared with earlier policy are for national defense--$11 billion in 1986, $41 billion in 1988, and $74 billion in 1990. The budget resolution allows defense budget authority to keep pace with inflation in 1986, and provides for real increases of about 2 percent a year thereafter under CBO economic assumptions. Spending for entitlement programs--notably Medicare, general revenue sharing, and farm price supports--is to be reduced by $7 billion in 1986, $18 billion in 1988, and

$20 billion by 1990. Proposed reductions in nondefense discretionary spending amount to $11 billion in 1986, $24 billion in 1988, and $26 billion in 1990. Finally, net interest outlays are lowered by $1 billion in 1986, $10 billion in 1988, and $33 billion in 1990 because of the reductions in projected deficits.

It is too early to tell how successful the Congress will be in implementing the budget resolution policy changes. The resolution contained reconciliation instructions to various House and Senate committees to prepare legislation to achieve $75 billion in deficit reductions in 1986-1988. These instructions cover about half of the assumed revenue increases and virtually all of the reductions in spending for entitlements and other mandatory programs.

Even larger savings are to be achieved through the authorization-appropriation process. Based on action taken to date, it would appear that 1986 appropriations for national defense and nondefense discretionary programs generally will be in line with the budget resolution targets. The most notable achievements to date has been the action on the defense authorization bill and the agreement by the Administration to the budget resolution spending targets for defense programs.

CBO Reestimates of the Budget Resolution

Under CBO economic and technical assumptions, the deficits that would result under the policies in the budget resolution are higher than the targets specified in the resolution itself. Most of the increases in the deficit estimates are the result of using different economic assumptions. The resolution uses the economic assumptions of the Administration's February budget. CBO's latest economic forecast and longer-run assumptions project lower levels of nominal gross national product and taxable incomes than assumed for the budget resolution. This difference results in somewhat lower revenues than estimated in the resolution, by a total of $35 billion over the 1986-1988 period (see Table 6). CBO has reestimated outlays for various benefit programs, primarily because of differences in assumed rates of inflation. Finally, CBO estimate lower net interest outlays in 1986 and 1987 and higher outlays in 1988 as the result of different interest rate assumptions.

Most of the technical reestimates of the budget resolution reflect changes in baseline spending or revenue trends that have become evident during the past six months. These recent developments are not reflected in the resolution, which is generally based on CBO's February technical estimating assumptions. On the spending side, the biggest change is an increase in the cost of farm price supports that could offset the proposed savings to be achieved through legislative action.

Alternative Economic Assumptions

The CBO reestimates of the budget resolution help to demonstrate how sensitive the budget is to changes in the economy. Because of the uncertainty and risks surrounding the latest CBO economic forecast and longer-run assumptions, we have also prepared high and low paths for

TABLE 6.	CBO REESTIMATES OF THE BUDGET RESOLUTION (By fiscal year, in billions of dollars)		
	1986	1987	1988
Deficit in Budget Resolution	172	155	113
CBO Economic Reestimates:			
Revenues	2	11	23
Benefit programs	-2	-1	a/
Net interest (rates)	-4	-5	3
Subtotal	-4	5	25
CBO Technical Reestimates	6	3	3
Debt Service Effect of Reestimates	a/	1	2
Total reestimates	3	9	30
Deficit in Budget Resolution as Estimated by CBO	175	163	143

a. Less than $500 million.

economic growth to illustrate further the sensitivity of budget estimates to economic conditions. These alternative paths are summarized in Table 7.

The high path assumes growth equal to that of the strongest eight-year recovery in the postwar period--that experienced in the 1960s--resulting in a growth rate from 1984 through 1990 that is about 1.2 percent higher than in the CBO economic assumptions. Because of the very rapid growth, inflation and interest rates rise rapidly in the out-years. The low path assumes growth from the end of 1984 to the end of 1990, averaging 1.2 percentage point less

TABLE 7. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1985	1986	1987	1988	1989	1990
Economic Projections (By calendar year)						
Real GNP (percent change, year over year)						
High-growth alternative	2.9	4.8	4.8	4.8	4.8	4.8
CBO economic assumptions	2.6	3.6	3.4	3.5	3.5	3.5
Low-growth alternative	2.5	1.8	-3.0	3.6	3.9	3.7
CPI-U (percent change, year over year)						
High-growth alternative	3.7	4.4	5.1	6.1	7.4	9.0
CBO economic assumptions	3.7	4.5	4.4	4.2	4.2	4.2
Low-growth alternative	3.7	4.3	3.4	2.7	2.4	2.3
Civilian Unemployment Rate (percent, annual average)						
High-growth alternative	7.2	6.7	6.2	5.7	5.3	4.9
CBO economic assumptions	7.2	7.0	6.8	6.6	6.5	6.3
Low-growth alternative	7.3	7.6	10.0	9.6	9.1	8.7
Three-Month Treasury Bill Rate (percent, annual average)						
High-growth alternative	7.2	6.7	8.1	9.6	10.9	12.7
CBO economic assumptions	7.6	7.4	7.2	7.2	7.2	7.2
Low-growth alternative	7.9	7.8	6.5	6.1	6.3	6.5
Budget Projections (By fiscal year, in billions of dollars) a/						
Deficit (-) or Surplus						
High-growth alternative	-210	-155	-117	-67	-10	72
CBO economic assumptions	-210	-175	-163	-143	-132	-120
Low-growth alternative	-210	-200	-259	-272	-256	-252

SOURCE: Congressional Budget Office.

a. CBO estimates based on the policies of the Congressional Budget Resolution for Fiscal Year 1986.

than in the CBO economic assumptions. The low path incorporates a recession beginning in mid-1986 that is equal in length and depth to the 1973-1975 recession. The weaker growth results in somewhat lower inflation and lower interest rates than in the CBO economic assumptions.

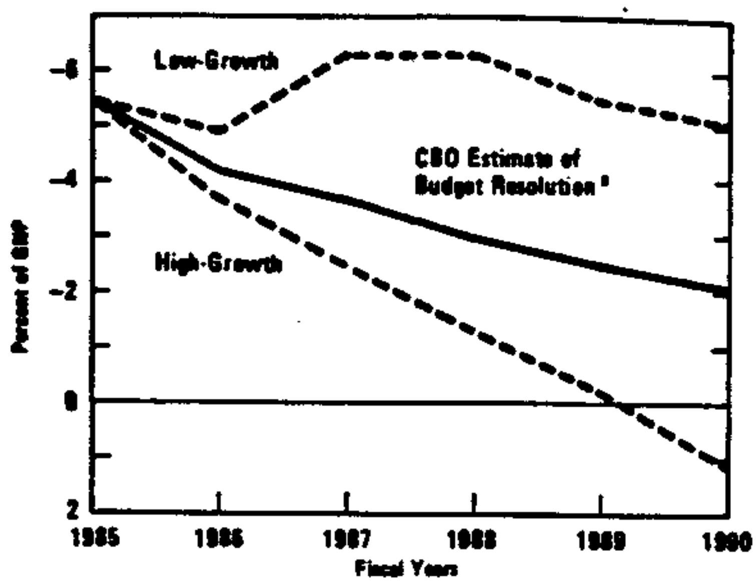
The high-growth and low-growth economic assumptions, when applied to the same budget policies (those of the Budget Resolution for Fiscal Year 1986), lead to alternative budget projections, shown at the bottom of Table 7. In the high-growth case, the deficit drops swiftly--both in dollar terms and as a percent of GNP (see Figure 3). It is nearly in balance in fiscal year 1989 and shows a surplus of about 1 percent of GNP in 1990. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1988, the budget deficit is nearly $130 billion above the CBO estimates. Nevertheless, these alternative paths are only illustrative; they represent extremes in that the probability of exceeding the high path or falling short of the low path is extremely small. CBO economic assumptions remain, in CBO's judgment, a more reasonable basis for budget projections than either of the alternatives.

CONCLUSION

Assuming that the budget resolution policies are implemented, I believe the Congress has made considerable progress in cutting back government spending and deficits. Unfortunately, deficits still remain high and much

Figure 3

Federal Deficit Under Alternative Economic Assumptions



SOURCE: Congressional Budget Office.

[a] Extrapolated by CBO in 1989 and 1990.

remains to be done. The current projections show no room to respond easily to unexpected claims on the budget such as those that might result from an international crisis, a badly performing economy, or an emergency in our credit system.