STATEMENT OF

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Mr. Chairman, I am pleased to appear before this Committee as you begin work on the First Budget Resolution for fiscal year 1981. My testimony today covers four topics: recent developments in the economy, the economic outlook, budget projections for fiscal years 1980 and 1981, and some general observations about policy options that this Committee may wish to consider.

RECENT ECONOMIC TRENDS

One year ago, most economic forecasters expected a mild recession during 1979, with rising unemployment and persistently high inflation. In 1978, economic growth had been rapid, especially in the fourth quarter. That robust performance seemed unlikely to continue, however, for a number of reasons. The Federal Reserve had just tightened credit conditions, and the high rate of inflation was slowing the growth in real income. Also, the economic expansion had been prolonged by high rates of consumer spending spurred on by a buy-in-advance sentiment to beat inflation, which contributed to record high household debt relative to income. Household spending, especially for housing and durable goods, appeared likely to weaken.

At that time, forecasters in the Administration and at the Congressional Budget Office (CBO) generally agreed with the consensus forecast of slower growth in 1979, although the Administration was somewhat more optimistic than CBO, especially about inflation.

In fact, economic growth did slow significantly last year. Real GNP rose 0.8 percent, well below the 4.8 percent gain in 1978 and about in line with the CBO year-ago midpoint projection of a 1 percent increase. Contrary to most forecasts, however, economic activity declined during the first half of 1979 rather than the second half. In response to the early decline, most forecasters, including CBO, lowered their projections of GNP growth for the remainder of the year. But as events unfolded, there was a mild rebound in the last half of the year. At the end of the year, however, the economy appeared to be faltering again.

Several other economic developments in 1979 were unexpected. Most important, inflation was much higher than projected. Although unpredicted, this development was not mysterious: Nearly all of the acceleration in inflation in 1979 can be attributed to the huge jump in prices of imported oil, resulting from events in Iran, and to rapidly rising housing finance costs, resulting from the Federal Reserve's actions to slow inflation. Less clear, however, is why the unemployment rate rose only slightly despite very weak output growth. The combination of continued employment growth and nearly flat output for the year resulted in a decline of output per worker hour. Economists do not fully understand this decline in productivity--the principal source of rising living standards. Another surprising development late last year was the very low rate of saving out of personal disposable income that helped maintain consumer spending.

The unusual behavior of the unemployment rate and the saving rate in 1979 are a source of considerable uncertainty concerning the future. Most economists now expect sharply rising unemployment and weak consumer demands in 1980, but the economy could be stronger than expected if the uncharacteristic behavior of 1979 carries over into 1980.

TABLE 1. RECENT ECONOMIC TRENDS

Economic Variable	1976:4 to 1977:4	1977:4 to 1978:4	1978:4 to 1979:4
Real GNP (1972 dollars, percent change)	5.7	4.8	0.8
Industrial Production (percent change) a/	5.2	8.0	0.3
Employment Increase (millions)	3.9	3.5	2.0
Consumer Price Index (percent change) a/	6.8	9.0	13.3
Unemployment Rate, Average for the Year (percent)	7.0	6.0	5.8

a/ December to December percent change.

THE CBO FORECAST FOR 1980 AND 1981

Despite the uncertainty, nearly all forecasters agree on one point: a downturn in the economy will occur sometime this year. Of course, there is less consensus on its size and duration. The economic projection prepared by the Congressional Budget Office is summarized in Table 2.

TABLE 2. CBO ECONOMIC PROJECTIONS BASED ON CURRENT LAW

Economic Variable	1978:4 to 1979:4 (actual)	1979:4 to 1980:4	1980:4 to 1981:4
Nominal GNP (percent change)	9.9	5.7 to 9.8	10.2 to 14.4
Real GNP (1972 dollars, percent change)	0.8	-2.3 to -0.3	2.0 to 4.0
Consumer Price Index (percent change)	12.7	8.6 to 10.6	8.3 to 10.3
Unemployment Rate, Average for the Year (percent)	5.8	6.5 to 7.5	7.5 to 8.5

As the table shows:

- o Real gross national product is expected to range from about zero growth to more than a 2 percent decline from the fourth quarter of 1979 to the fourth quarter of 1980. During 1981, growth in real GNP is expected to recover moderately, rising between 2 and 4 percent.

- o The surge in consumer prices is projected to moderate somewhat from the current rate, to a range of 8.6 to 10.6 percent from the fourth quarter of 1979 to the fourth quarter of 1980, and remain at that high level next year.

- o The unemployment rate is forecast to average between 6-1/2 and 7-1/2 percent in 1980, rising another percentage point in 1981.

The CBO forecast is based on two assumptions about economic policy:

- o First, federal spending and tax policies for fiscal years 1980 and 1981 are assumed to be those now specified in current law. Federal outlays are assumed to total $560 billion in fiscal year 1980 and $609 billion in fiscal year 1981. No tax cuts are assumed; the previously legislated increases in Social Security taxes scheduled for 1981 are assumed to take place.

- o **Second,** the Federal Reserve is assumed to pursue a relatively restrictive monetary policy, with money growth over the projection period near the midpoint of the announced target range. As a result, only a small decline in short-term interest rates is expected during the next six months.

Reasons for the Downturn

The fundamental causes of the sharp economic slowdown last year were increased OPEC oil prices, record high interest rates, and generally high inflation. These factors continued to depress real income growth and household spending as the year came to a close. The dramatic tightening of credit conditions last October by the Federal Reserve has not been in place long enough to have had a major effect on the pace of economic activity. This more restrictive monetary policy will likely have a depressing effect on residential construction this spring. The projected weakness in this sector is consistent with the recent slide in home sales and the drop in housing starts toward the end of the year.

Another sector that experienced weak sales toward the end of 1979 is automobiles. As a result, the domestic auto industry has sharply cut back car assemblies for the current quarter, and a significant recovery in auto output is not expected until next summer or later.

The accumulating problems in housing and autos are significant for the overall outlook. These two sectors account for a significant portion of total domestic output and, when secondary effects on suppliers and producers of related products are included, the overall impact on the economy is expected to be quite large.

Retail sales other than autos are also projected to be weak in 1980, because of lagging real income growth, heavy debt burdens, and already depleted savings. This is unlikely to be offset by increased real consumer spending financed by further reductions in saving rates. On the contrary, **CBO--along** with most other **forecasters--is** projecting a small increase in the saving rate by the end of 1981.

A deep recession is not expected in 1980, since the projected slowness in household spending seems likely to be offset in part by the behavior of other sectors. First, most indicators of future business spending suggest that this sector will not be as weak in 1980 as in most past recessions. Second, net exports are expected to be a source of growth during this year. A domestic economy in a recession will demand fewer imports, while somewhat stronger foreign economic growth is expected to bolster the demand for U.S. exports. Finally, and most important, the available data indicate that the ratio of inventories to sales has remained at a relatively low level. Consequently, a severe curtailment of production to trim unwanted inventories does not seem likely.

Reasons for the Weak Recovery

CBO's forecast for 1981 indicates a less robust recovery than the typical postwar upswing. The major reasons, aside from the shallowness of the recession, are threefold: First, high inflation is expected to continue to sap the purchasing power of rising money incomes. Second, high inflation and the international condition of the dollar are expected to continue placing upward pressure on short-term interest rates. Third, a sizable braking effect on the economy will come from the Social Security tax increases scheduled for next year as well as from the fiscal drag resulting from the combination of inflation and the progressive income tax structure, which pushes taxpayers into higher tax brackets.

BUDGET PROJECTIONS

CBO now estimates that federal spending growth will accelerate in 1980 and that the budget deficit could exceed the second concurrent resolution by $10 billion or more, depending on final Congressional action on the pending windfall profits tax (see Table 3). The growth in federal outlays above the resolution ceiling for 1980 can be attributed largely to higher interest costs ($5 billion), higher inflation ($2 billion), and higher farm price supports resulting from the recent grain embargo and a larger than expected corn crop ($4 billion). There is little difference in the outlook for 1980 revenues from the second resolution estimates.

For fiscal year 1981, the CBO budget projections show a decline in the budget deficit as revenue growth accelerates with the expected recovery and spending growth declines with lower inflation and interest rates. We are now preparing an Analysis of the President's Budgetary Proposals for Fiscal Year 1981 for the House Committee on Appropriations, and will make that report available to this Committee when it is completed.

TABLE 3. ACTUAL AND PROJECTED FEDERAL BUDGET TOTALS, FISCAL YEARS 1978-1981 (Billions of dollars, Unified Budget basis)

	1978 Actual	1979 Actual	1980 2nd Budget Resolution	1980 CBO Current Law Estimate	1981 CBO Current Law Estimate
Receipts	402.0	465.9	517.8 a/	516 b/	582 b/
Outlays	450.8	493.7	547.6	560 c/	609 d/
(Percent Change)	(11.9)	(9.5)	(10.9)	(13.4)	(8.8)
Budget Balance	-48.8	-27.7	-29.8	-44	-27

a/ Includes $2.4 billion for a windfall profits tax.

b/ Does not include any receipts from a windfall profits tax or the Administration's cash management proposals.

c/ CBO's fiscal year 1980 current law estimate includes action completed to date by the Congress plus anticipated supplementals for certain entitlements such as Medicaid, and for the 7 percent federal pay raise that became efective on October 1, 1979. The CBO outlay estimate for 1980 also includes a supplemental for the food stamp program on the assumption that the Congress will lift the authorization ceiling, but does not include any other discretionary supplementals for such programs as energy and national defense.

d/ CBO's current law projection plus an assumed 7 percent federal pay raise in October 1980.

BUDGET OPTIONS

During most of the postwar period, rising unemployment would have led to considerable pressure for short-run fiscal stimulus--tax cuts and/or spending increases--in order to provide a temporary boost to sagging demands, particularly consumer spending. If the unemployment rate rises to unacceptable levels, sentiment for such "demand management" will undoubtedly be felt again. But in the present environment of record high inflation and lagging productivity, such a simple prescription may not be an efficient way to counter our economic problems. There are three reasons for this. First, fical policies that temporarily boost demands may aggravate inflation, unless great care is taken in choosing these policy measures. Second, fiscal measures designed to stabilize aggregate demand cannot efficiently deal with problems arising from changes in aggregate supply, which typically affect prices and employment simultaneously. Fiscal stimulus may help to offset the real effects of a "supply shock," such as a sharp increase in the price of imported oil. But longer-run policies to encourage conservation or to increase domestic energy supplies are needed to get to the root of the problem. Finally, demand management policies may not be sufficient to achieve goals for long-run economic growth. Such policies can help maintain high levels of capacity utilization, but this is only one of the requirements for increased investment spending. In the long run, in order to achieve high growth goals, it is also necessary to provide sufficient return on capital investment to divert resources away from consumption to investment.

A combination of long- and short-run fiscal measures may be required in order to move toward more than one goal at a time. But the fiscal policy options for the 1980s are not easy. Some objectives may have to be sacrificed. Hard choices have to be made between maintaining high employment and pursuing rapid deceleration of inflation, as well as between high consumption today and more rapid economic growth in the future.

APPENDIX. COMPARISON OF FORECASTS

The CBO forecast is in general agreement with the consensus view among economic forecasters, which projects high inflation, weak productivity gains, and rising unemployment during the next year or two. Table 4 shows that the CBO and Administration forecasts for 1980 are quite similar.

Comparison of CBO and other forecasts for calendar year 1981 is not meaningful because forecasts for that year are greatly influenced by differing assumptions about tax cuts and federal spending levels.

TABLE 4. COMPARISON OF CBO AND OTHER FORECASTS FOR CALENDAR YEAR 1980

	Real GNP (percent change)	Unemployment Rate (percent)	Consumer Price Index (percent change)
Commercial Model			
Chase Econometrics a/	-1.2	7.2	11.5
Data Resources, Inc. b/	-1.4	7.1	11.8
Merrill Lynch c/	-1.8	7.6	11.2
Wharton Associates d/	-0.6	7.1	11.9
Average of 42 Business Forecasts e/	-1.0	7.4	11.0
Administration Forecast	-0.6	7.0	11.8
CBO (mid-point of projected range)	-0.9	7.0	11.3

a/ January 22, 1980.
V January 1980.
c/ January 10, 1980.
d/ January 4, 1980.
e/ From Blue Chip Economic Indicators, vol. 5, no. 1, January 10, 1980.