Statement of

Alice M. Rivlin, Director
Congressional Budget Office

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Mr. Chairman and Members of the Committee:

I appreciate this opportunity to be with you today to discuss the economic outlook as you prepare for the Second Concurrent Resolution on the Budget.

Mr. Chairman, with your permission, I would like to insert for the record a report on the economy, Sustaining a Balanced Expansion, that the Congressional Budget Office issued last Tuesday. My remarks this morning will, to a large extent, summarize the report.

The recovery over the past year has been rapid, strengthening confidence in the economy. During the first year of expansion, since the recession trough in the second quarter of 1975, real growth averaged 7 percent. Inflation slowed from the double-digit rates of 1974 to the 5 to 7 percent range during 1975 and--apart from a few irregularities--has remained there ever since. Unemployment fell from its high of nearly 9 percent in May 1975 to 7.6 percent in the first quarter of 1976. However, after an initial sharp decline, unemployment has been rising for the past three months--the July rate released last Friday was 7.8 percent, up from 7.5 percent in June and 7.3 percent in May--and this bears watching.

A number of factors have contributed to the strength of the recovery. Last year Congress enacted a sizeable tax cut that stimulated private spending and a number of special outlay programs. Monetary policy has been accommodative over the past year, in the sense that interest rates have held steady since the bottom of the recession rather than rising as they generally do in periods of rapid economic growth. Further, food and fuel prices have increased very little over the past year, and so the economy has not been subject to the outside inflationary shocks that characterized the 1973-74 period.

But despite this encouraging news, there are still problems for economic policy. Unemployment remains high--after a year of recovery it is still above the level reached at the bottom of most earlier recessions--and it will be several years before it will return to pre-recession levels even if growth is sustained at the current rate. After dropping from 8.9 percent to 7.6 percent between May and February, unemployment has remained virtually unchanged for the past six months. Similarly, output remains far below potential. Total output is now barely ahead of its peak of two and a half years ago, and most industries are experiencing substantial excess capacity.

As the economy continues to grow unemployment should continue to decline. But concern about inflation as unemployment falls is likely to shift attention to special labor market policies to reduce unemployment still further. Although there is considerable debate among economists about how low the unemployment rate can go before inflation begins to pick up (some putting it in the 6 percent range, others closer to 4.5 percent), most agree that the so-called "noninflationary unemployment rate" is higher now than in the past decade. This means that although we can still go a long way toward reducing unemployment using expansionary fiscal and monetary policies without fear of inflation, bringing unemployment down to the levels achieved in the 1960s is likely to require supplementary measures.

Inflation, too, remains above its long-term average rate. Although the decline in inflation from 12.2 percent in 1974 to 5.5 percent over the past year has been dramatic, continued growth in the economy may make further "disinflation" difficult. High unemployment and substantial excess capacity in the economy will serve to offset the usual inflationary forces associated with recovery over the next year or two, but whether this economic slack will be sufficient to shake out the inflationary legacy of the 1973 to 1974 experience without additional anti-inflation measures is less certain.

Although the rebound from the recession was strong, it was uneven. Real growth in the third quarter of 1975 (at an annual rate) was 11.4 percent (largely due to an anticipated inventory turnaround) followed by a much smaller 3.3 percent growth rate in the fourth quarter. In the first quarter of 1976, real growth picked up to 9.2 percent, but then slowed to 4.4 percent in the second quarter. While inventory shifts typically produce uneven growth in the early phase of cyclical recoveries, the quarterly changes in GNP growth have been unusually erratic in this upswing. The uneven pattern of growth during the past year, coupled with uncertainties about monetary policy and food and fuel prices have produced some uneasiness about the sustainability of the recovery over the next several years.

The Economic Outlook

In its latest economic report, Sustaining a Balanced Expansion, the Congressional Budget Office projects economic trends through calendar year 1977. I would like to summarize these projections.

The projections in the report are based on the First Concurrent Resolution on the Budget (with outlays of $413 billion in fiscal year 1977 and a deficit of $50.8 billion); monetary growth slightly above the high end of the Federal Reserve targets, leading to a gradual rise in the Treasury bill rate to just over 7 percent by the end of 1977; export growth of 5.5 percent (in 1972 dollars); and farm prices rising by about 4 percent and wholesale food prices by about 8 percent during the forecast period.

The projections based on these assumptions are shown in Table 2 (page 13 of the report). They show continued growth in output over the next year and a half, but at a slower rate than during the past year of the recovery. Specifically, the projections show:

- a rate of growth of real GNP of 5 to 6.5 percent (annual rate) during the remainder of 1976 and 4.5 to 6.5 percent during 1977;

- an inflation rate (as measured by the GNP deflator) of about 5 to 7 percent during the next six quarters, roughly the same as the 5.5 percent rate during the first year of recovery;

- an unemployment rate between 6.9 and 7.3 percent of the labor force by the end of this year and between 5.8 and 6.4 percent by the end of 1977.

These growth rates are somewhat more rapid than is characteristic of the same period in most (though not all) recoveries. However, because of the unusual depth of the 1974-1975 recession,

TABLE 2

ECONOMIC PROJECTIONS, 1976 AND 1977

	Actual (preliminary) 1976:II	Projected Range		Projected Growth (annual rate, percent)	
		1976:IV	1977:IV	1975:II to 1976:IV	1976:IV to 1977:IV
GNP, Billions of Current Dollars	1673	1755 to 1785	1965 to 2005	11.5 to 12.5	11.0 to 12.5
GNP, Billions of 1972 Dollars	1260	1290 to 1300	1350 to 1380	5.0 to 6.5	4.5 to 6.5
General Price Index (GNP deflator, 1972 = 100)	133	136 to 138	143 to 147	5.5 to 6.5	5.0 to 7.0
Consumer Price Index (1967 = 100)	169	172 to 175	181 to 186	5.0 to 6.0	4.7 to 6.7
Unemployment Rate (percent)	7.4	6.9 to 7.3	5.8 to 6.4	--	--

SOURCE: United States Congress, Congressional Budget Office, Sustaining a Balanced Expansion, 3 August 1976, p. 13.

recovery at the projected rate should not create serious strains on capacity or inflationary bottlenecks through 1977.

Bottlenecks in a few critical industries contributed to inflation in 1973 and some concern has been voiced recently about possible materials shortages during the next year or two. A special section of our report analyzes likely trends in output and capacity for a number of critical industrial materials and concludes that shortages are unlikely to develop before the end of 1977, given overall output growth at a rate of 4.5 to 6.5 percent.

There are only very minor differences between these projections and the forecast we made at the time of the First Concurrent Resolution on the Fiscal 1977 Budget. We have lowered the projected unemployment rate range slightly, but our projections for real output growth and inflation remain essentially the same.

Given this outlook, the First Concurrent Resolution on the Fiscal 1977 Budget may be characterized as a moderate fiscal strategy which, if coupled with a fairly accommodative monetary policy and only modest increases in food and fuel prices, will most likely result in a continued recovery through 1977, although at a somewhat slower rate of growth than over the past year. If implemented, it would provide more fiscal stimulus than the proposed Administration budget. However, it is slightly more restrictive than the fiscal year 1976 budget in which special tax cuts and somewhat high "current policy" outlays provided additional stimulus.

In terms of the high-employment budget (an estimate of receipts and outlays at 4 percent unemployment that eliminates the recession-induced component of the deficit), the First Concurrent Resolution represents a moderate shift toward restrictiveness. In the first half of calendar year 1976, the high-employment budget was in deficit by about $10 billion. The First Concurrent Resolution would move the high-employment deficit close to zero for fiscal year 1977.

Fiscal Policy Alternatives

Although major changes in fiscal policy are not under active consideration at the present time, the Congressional Budget Office has analyzed the possible effect of small departures from the First Concurrent Resolution on the Budget for fiscal year 1977.

One such departure would be a sustained veto of much of the proposed public employment legislation. Specifically, elimination of $5.6 billion in outlays on public employment is estimated to reduce unemployment by 400,000 by the end of calendar year 1977. This estimate takes into account "fiscal substitution" by state and local governments that receive employment grants, and hence is an estimate of the net reduction in jobs, economy-wide. Unemployment would be 0.3 percentage points higher by the end of 1977 than in the baseline forecast. Although the impact on the inflation rate is likely to be negligible in the short run, the Consumer Price Index might be reduced by about 0.3 percentage points by 1980.

An expansionary alternative that would add an additional $10 billion in outlays to the First Concurrent Resolution was also analyzed. An added $10 billion in outlays would reduce the unemployment rate by about 0.2 percentage points by the end of 1977, and add about 0.2 percentage points to the Consumer Price Index by 1980.

Monetary Policy

I said earlier that monetary policy appears to have accommodated the strength of the recovery over the past year, though it was feared that the Federal Reserve's announced target range for the narrowly-defined money stock (M_1, or checking accounts and currency) was too low to finance a vigorous recovery without sharply rising interest rates. The fear that a credit crunch would slow or reverse the recovery did not materialize, however, even though M_1 growth remained near the target range's lower limit. Interest rates have not shown any decisive upward movement, and short-term rates currently are slightly lower than they were at the trough of the recession. This combination of events--rapid increases in output and income, rather slow M_1 growth, and stable or falling interest rates--is not typical of the early stages of recovery from recession in our economy, and economists are puzzled as to its causes.

Other broader measures of the money supply such as M_2 (defined as M_1 plus savings deposits at commercial banks), have grown faster than M_1 over the past year. Further, the Federal

Reserve targets for these aggregates are higher than for M_1. If M_2 continues to grow at a rate near the upper end of its target range, as it has so far during the recovery, we expect short-term interest rates to rise gradually throughout the forecast period. Specifically, our forecast shows the three-month Treasury bill rate rising from its current 5.3 percent to 7.1 percent by the end of 1977.

We do not expect interest rates to rise to a level high enough to cause a serious outflow of funds from savings institutions during the next year and a half. This means that housing is not likely to be hampered by a credit squeeze, although housing activity is not likely to increase as fast over the next year and a half as it did early in the recovery.

Although the Federal Reserve targets presently appear consistent with only gradually rising interest rates, given the economic projections in our report, credit conditions could change. The report simulates a number of alternative monetary scenarios and projects their impact on inflation, unemployment, and growth. Increasing or decreasing the rate of growth in M_2 by 1 percent, for instance, is projected to affect nominal GNP by $10 billion in either direction, the unemployment rate by 0.2 percentage points, and the Consumer Price Index by 0.2 percentage points by 1980.

Conclusion

Adherence to the First Concurrent Resolution reflects a moderate fiscal strategy which coupled with gradually rising interest rates will most likely result in a continued recovery through 1977, although at a slower rate of growth than over the past year. This will leave unemployment in the 6 percent range at the end of 1977, above what most observers consider to be an inflationary unemployment rate. Materials shortages and capacity bottlenecks are not anticipated.

Ruling out unforeseen outside events, there is less uncertainty about the economy through 1977 than for 1978. Some forecasters are predicting a downturn in 1978 while others foresee continued growth for the remainder of the decade. The Congressional Budget Office has not attempted to forecast 1978. A lot will depend on the course of monetary policy and on next year's budget. But we will continue to monitor economic developments very carefully over the next few months in preparation for the fiscal year 1978 budget resolution.