Statement of Alice M. Rivlin
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before the
Committee on the Budget
U.S. House of Representatives
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There should be no release
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Mr. Chairman, my testimony today will cover three interrelated topics that are treated in greater detail in the CBO report The Economic Outlook for 1979-1980: An Update distributed to you earlier this morning. First, I will review recent developments in the economy; second, I will provide an update of the CBO forecast of last January; and third, I will discuss briefly possible changes in fiscal policy.

The details of the CBO forecast have altered because of recent economic developments, but its basic message has not changed since I testified before this Committee six months ago. We still expect a mild recession to occur this year, followed by a recovery in 1980. At the same time, we expect inflation to recede from its current double-digit pace, although remaining high by historical standards.

Current Developments

The most far-reaching development occurring since January has been the rapid acceleration of inflation. The rate of increase of prices has been on a steep upward trend in the past few years. In 1977, consumer prices rose by 6.8 percent; in 1978, by 9 percent. During the first five months of this year, inflation has been running above a 13 percent annual rate.

Inflation has accelerated so far this year for several reasons.

- Energy prices have surged since the end of 1978, reflecting the sharp rise in OPEC oil prices and contributing about 2-1/2 percentage points to the inflation rate.

- o Food prices have risen significantly, in large part resulting from the shortage of beef and contributing 1/2 percentage point to the acceleration of inflation.

- o Home mortgage interest costs have jumped in the first five months of the year, adding roughly 1 percentage point to the inflation rate.

The effects of the acceleration of inflation have been pervasive. Rapid price increases have eroded household purchasing power and undermined consumer confidence. In addition, high inflation has discouraged an easing of monetary policy despite a weaker economy and relatively slow money growth. These factors have played--and will continue to play--important roles in the slowing of economic activity. Constant-dollar GNP rose only slightly in the first quarter and possibly declined in the April-to-June quarter.

The weakness in economic growth during the first half of 1979 was earlier than expected and was largely traceable to reduced spending by the household sector--both for personal consumption and for home purchases. Retail sales, adjusted for inflation, dropped at an 11 percent annual rate between December and May, and apparently continued their slide in June. The domestic automobile industry has been especially hard hit. Unit auto sales in June were down at a 40 percent annual rate from six months ago, as energy uncertainty helped depress purchases of larger models. Because of this weakened demand, auto inventories have reached record high levels.

Home purchases are also off from the end of last year. On the basis of partial data, sales of new single-family houses in the second quarter appear to be below the fourth quarter of 1978 by roughly 20 percent, at an annual rate.

Household spending is weak for several reasons:

- o The drop in real personal income that has occurred since the end of last year because wage and employment growth have been insufficient to offset the acceleration of inflation;
- o The high debt of households, which as a percent of disposable income reached a record high level last winter;
- o High interest rates, which dampened housing activity; and
- o The slump in consumer confidence, which appears rooted in the acceleration of inflation and--more recently--in uncertainty about energy supplies.

In contrast to the household sector, business spending has continued fairly robust this year, although there has been some weakening in new contracts and orders recently. Business inventories have been rising, but, with the exception of autos, the ratio of inventories to sales still remains low by historical standards. This apparent lack of speculative inventory building has led most analysts to conclude that any recession occurring in 1979 would be mild compared with the 1974-1975 downturn.

The CBO Forecast

CBO is not forecasting a major recession. Our current policy forecast calls for a moderation of inflation in the coming months, a mild recession during 1979, and a recovery in growth next year. The major elements of the CBO forecast, shown in Table 1, can be summarized as follows:

- o Growth in real GNP is projected to fall in the 0 to minus 2 percent range over the four quarters of 1979, followed by a rebound in 1980 in the 1.9 to 3.9 percent range.

- o Consumer prices are projected to increase by 9.9 to 11.9 percent during 1979, decelerating to a 7.9 to 9.9 percent range during 1980.

- o The unemployment rate is expected to rise to the 6.4 to 7.4 percent range by the end of this year and to a 6.7 to 7.7 percent range by the end of 1980.

This forecast, like all CBO forecasts, depends critically on assumptions about fiscal and monetary policies:

- o Federal spending and tax programs are those contemplated in the first budget resolution for fiscal year 1980. Federal budget outlays are assumed, for the forecast, to total $495 billion in the current fiscal year and $540 billion in fiscal year 1980. Next year's outlay figure includes an $8 billion overrun, relative to the first resolution, occurring in transfer payments, national defense, and interest payments. Revenues are assumed to be $6 billion higher in fiscal year 1979 than specified in the budget resolution and $10 billion higher in 1980.

- o Even though short-term interest rates are expected to decline because of weaker loan demands, monetary policy is assumed to remain relatively restrictive through most of 1979. Toward the end of the year, however, the Federal Reserve is assumed to adopt an easier policy. This further easing of credit conditions is in accordance with statements of Chairman Miller before the Budget Committees that monetary stimulus is preferable to fiscal stimulus if the economy weakens.

TABLE 1. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1979 AND 1980

	Levels			Rate of Change (percent)		
Economic Variable	1978:4 (actual)	1979:4	1980:4	1977:4 to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 1980:4
GNP (billions of current dollars)	2215	2351 to 2443	2584 to 2789	13.1	6.2 to 10.3	9.9 to 14.1
Real GNP (billions of 1972 dollars)	1415	1386 to 1415	1412 to 1469	4.4	-2.0 to 0.0	1.9 to 3.9
General Price Index (GNP deflator, 1972=100)	157	170 to 173	183 to 190	8.3	8.4 to 10.4	7.9 to 9.9
Consumer Price Index (1967=100)	202	222 to 226	240 to 249	9.0	9.9 to 11.9	7.9 to 9.9
Unemployment Rate (percent)	5.8	6.4 to 7.4	6.7 to 7.7	--	--	--

The projected downturn this year would be one of the milder declines in output in the post-World War II period. The midpoint of the CBO forecast suggests a decline in real activity that is smaller than all but two of the six postwar recessions.

The turnaround in 1980 is projected to result from several factors:

- The reduction in output to achieve a mild adjustment in inventories is expected to be completed by early 1980.

- As mentioned earlier, monetary policy is assumed to be eased late this year, placing downward pressure on interest rates and boosting construction activity.

- Durable goods consumption should turn up, partly because of improved consumer finances, increased replacement needs, and higher demands for household appliances resulting from the rebound in residential construction.

Nevertheless, the 1980 rebound is projected to be weak compared with the earlier postwar upturns. Continued rapid inflation is expected to limit how far interest rates can fall. The recovery will also be restrained by a substantial amount of fiscal drag resulting from the combination of inflation and the progressive income tax structure, assuming no tax cut, as well as by weak growth in federal spending. The restrictive effect of fiscal policy on the economy is reflected in changes in the federal budget balance, measured at full employment; the budget is estimated to swing toward surplus by about $33 billion in fiscal year 1980 following a $20 billion shift in the same direction in fiscal year 1979.

The CBO outlook is by no means pessimistic relative to private forecasters. This can be seen in Table 2, which compares the CBO forecast with those of three prominent commercial forecasters. Our forecast, for example, shows more growth than do two of the three private forecasts. Even though the Wharton forecast assumes a $22 billion tax cut early next year, it is less optimistic over the 1979-1980 period than is the CBO forecast.

TABLE 2. COMPARISON OF ECONOMIC PROJECTIONS FOR 1979 AND 1980

	CBO Current Policy Forecast a/	DRI b/	Wharton c/	Chase d/
Growth in Real GNP (percent)				
1978:4 to 1979:4	-1.0	-1.3	-0.6	-1.5
1979:4 to 1980:4	2.9	3.8	1.7	1.8
Increase in Consumer Prices (percent)				
1978:4 to 1979:4	10.9	10.9	12.7	10.5
1979:4 to 1980:4	8.9	7.9	10.9	7.7
Unemployment Rate (percent)				
1979:4	6.9	6.8	6.9	7.2
1980:4	7.2	7.2	7.9	8.3

a/ Midpoint of forecast range.

b/ Data Resources, Inc. (control, June 28, 1979) includes a windfall profits tax.

c/ Wharton Econometric Forecasting Associates (control, June 28, 1979) assumes a $22 billion tax cut at the beginning of 1980, equally divided between the individual income tax and the corporate income tax.

d/ Chase Econometrics (standard, June 22, 1979) assumes a $26 billion tax cut during the fourth quarter of 1980.

Uncertainty

It is always difficult to forecast turning points of the business cycle with accuracy, and there are more uncertainties now than usual. Thus, while most forecasters are not optimistic about the near-term outlook for real growth, a quick resurgence of final demands cannot be ruled out. If this happens, real output would be higher this year than CBO expects and unemployment would be lower. At present, however, there appears to be a greater chance that the outcome could be worse than forecast by CBO. Possible events that could weaken the outlook over the next year include:

- o Further supply shocks such as a severe fuel shortage or poor harvests that raise prices further than expected and curtail output;
- o A prolonged strike in a critical area such as the automobile industry; or
- o A sharp drop in the exchange value of the dollar.

Moreover, the assumption that monetary policy will be eased toward the end of this year may prove unrealistic. The Federal Reserve may give greater priority to anti-inflationary policies, especially if it fears that an easier policy would threaten the exchange value of the dollar.

Implications for Policy

If the economy weakens, the increased slack in product and labor markets will help mitigate inflationary pressures. The rise in unemployment, however, would present the Congress with a very difficult policy dilemma. One response to a rise in the jobless

rate would be greater fiscal stimulus. But such a response could aggravate inflation. In this situation, the Congress may want to examine closely the policy option of continuing current policy and making no immediate change. An argument for no immediate change in fiscal policy is the great uncertainty in the economic outlook. As mentioned earlier, it is difficult to forecast unemployment and inflation with accuracy. The jobless rate has not yet risen, and the consensus outlook for an increase in unemployment could be wrong. Toward the end of the year, the course of the economy should become more clear. At that point, if the unemployment rate appears headed toward an unacceptably high level, the Congress may then want to consider a more stimulative fiscal policy.

One thing that can be done now is to begin to work on a contingency plan for fiscal stimulus that could be used should the unemployment rate rise to an unacceptable level. In developing such a plan, the Congress will want to keep in mind that inflation likely will remain high for some time and that it may be worthwhile to link any fiscal stimulus to measures that reduce inflation. This might be accomplished by a cut in payroll taxes or by tax incentives to hold down wage demands. In addition, business income tax cuts might improve productivity in the long run, thereby contributing both to a reduction in inflation and to higher

economic growth. Supplemental unemployment insurance benefits or some other measure to mitigate the hardship of unemployment might also be considered.

Mr. Chairman, that concludes my statement this morning. I will be happy to answer any questions you or Members of the Committee have.