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Before the Committee on the Budget
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Mr. Chairman, my statement this morning will cover four topics:

- o The economic outlook as projected by CBO;
- o The budget estimates included in the mid-session report on the fiscal year 1979 budget recently released by the Administration;
- o Fiscal policy options for fiscal year 1979 now receiving attention in Congress; and
- o The need for closer coordination of monetary and fiscal policies for inflation and unemployment.

THE ECONOMIC OUTLOOK

This Committee begins its consideration of the Second Concurrent Resolution on the Budget for Fiscal Year 1979 at what I believe to be the most difficult time for economic policymakers since the beginning of the budget process. Inflation is accelerating just at the moment that the economic expansion is showing signs of running out of steam. Despite last month's drop, unemployment remains high by postwar standards. Most forecasters project little improvement in the jobless rate in the months ahead and some foresee deterioration. As a result, policymakers face a most troubling dilemma. On the one hand, the standard remedies for inflation may weaken economic growth--and, perhaps, trigger a new recession. On the other, actions designed to sustain the recovery run the risk of aggravating the already rapid increase of prices.

It is also a particularly difficult time to forecast the behavior of the economy. The contours of any economic projection depend critically on the resolution of this policy dilemma, and that final outcome is still very much in doubt. For the purposes of this forecast, we have made the following policy assumptions:

- o As is customary, we have taken as given the fiscal policies included in the First Concurrent Resolution.
- o With respect to monetary policy, we have assumed that short-term interest rates will not rise much further and that credit conditions will not become so restrictive as to abort the expansion.

Based on these assumptions, CBO expects economic activity to grow at a 3.5 to 4.5 percent rate during 1978, slowing by about one-half a percentage point during 1979. As shown in Table 1, the unemployment rate is forecast to range between 5.2 and 6.0 percent by the end of 1979. The most unpleasant side of this scenario is the outlook for prices. While inflation is likely to moderate from the double digit rates during the first half of 1978, the increase in the Consumer Price Index (CPI) for the entire year is expected to be in the range of 6.8 to 7.8 percent, substantially above the 6.6 percent rise during 1977. Prices are projected to continue to rise at a rapid rate in 1979, although, in the the absence of any unanticipated shocks, they will probably decelerate somewhat from this year's pace.

There are at least three aspects of this projection that deserve some further examination. First, in a period of relatively

TABLE 1. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1978 AND 1979

Economic Variable	Levels			Rates of Change (Percent)		
	1977:4 (actual)	1978:4	1979:4	1976:4 to 1977:4 (actual)	1977:4 to 1978:4	1978:4 to 1979:4
GNP (billions of current dollars)	1962 a/	2160 to 2202 a/	2354 to 2457 a/	11.8	10.1 to 12.2	9.0 to 11.6
Real GNP (billions of 1972 dollars)	1360 a/	1408 to 1421 a/	1446 to 1481 a/	5.7	3.5 to 4.5	2.7 to 4.2
General Price Index (GNP Deflator, 1972=100)	144 a/	153 to 155 a/	163 to 166 a/	5.8	6.4 to 7.4	6.1 to 7.1
Consumer Price Index (1967=100)	185	198 to 200	210 to 214	6.6	6.8 to 7.8	6.2 to 7.2
Unemployment Rate (percent)	6.6	5.5 to 6.1	5.2 to 6.0	-	-	-

a/ Estimates do not reflect July 1978 revisions in GNP levels.

high unemployment, why has the outlook for inflation deteriorated so badly? Second, given the assumption of an accommodating monetary policy, why have we forecast a slowdown in the growth of economic activity? Third, if there is a slowdown, why won't it turn into a recession?

Outlook for Inflation

Inflation has accelerated sharply since the beginning of the year. The rate of increase of consumer prices between December and May (10 percent annual rate) was about twice the rate during the second half of last year. This upsurge did not reflect widespread shortages of labor and capital. Instead, about 90 percent of the acceleration was associated with the simultaneous occurrence of three events: a rapid increase in food prices resulting from the harsh winter and reduced cattle supplies, the depreciation of the dollar, and the January increases in payroll taxes and the minimum wage.

Although the CBO forecast assumes that no comparable food and depreciation shocks will occur next year, the rate of price increase is projected to moderate only slightly from this year's pace. The principal impetus to this continued high level is expected to be rising labor costs. If past behavior holds true, the recent jump in the CPI will cause a lagged acceleration of wage gains and a corresponding markup of prices late this year and in 1979. Past performance also indicates that restrictive

macroeconomic policies, imposed now, would have only a small effect on this inflationary momentum during the next few years. Like the special factors that induced the price acceleration earlier this year, subsequent wage catch-up has proved to be relatively insensitive to variations in total demand. Under such circumstances, it takes many years of high unemployment to reduce inflation significantly.

Reasons for the Slowdown

The foreign trade and state and local government sectors are expected to provide moderate stimulus to the economy during the next year and a half. Thus, the outlook for slower growth through 1979 rests largely on the behavior of three sectors of the economy: housing, consumption, and business fixed investment.

Spending on residential construction provided significant impetus to the rise in real GNP last year. Such strength, however, probably will not continue through the projection period; the rapid tightening of credit markets during the past year has already limited the availability of funds for home mortgages. Savings and loan institutions have experienced a significant deceleration in deposit inflows since last autumn, and, by May, commitments outstanding for future mortgage lending had fallen for five consecutive months.

The prospects for consumer spending also appear less bright. Personal debt has risen sharply relative to income, and tighter

mortgage conditions will reduce opportunities to convert real estate equity to cash--a practice that apparently helped sustain consumption throughout the expansion. Furthermore, consumer attitude surveys indicate that the recent surge in retail sales may be based in part on the attempt to avoid expected future price increases. Such buy-in-advance behavior would reduce consumer spending later this year or, perhaps, in 1979.

The growth of housing and consumer spending typically slows as an expansion ages, but such slowing is usually somewhat offset by increased outlays for plant and equipment. According to the Commerce Department's survey of business anticipations, constant dollar business fixed investment is again likely to increase faster than overall growth, but less rapidly this year than last. Moreover, a slowdown in the overall pace of economic activity means less pressure on capacity utilization throughout the forecast period. As long as capacity utilization is not increasing, there is less likelihood of an investment boom.

Reasons for No Recession

Most forecasts agree that growth will slow, although many go further than the CBO projection and predict a recession within the next year and a half. This is admittedly a difficult call,

but--given our policy assumptions--CBO does not believe that current economic trends point to a recession. This assessment is based on a number of factors:

- o The tax cut included in the First Concurrent Resolution offsets the effects of rising payroll taxes and of high inflation on income tax rates and should help sustain consumer spending.
- o In addition, the tax package should stimulate business fixed investment.
- o The impact of higher interest rates on housing activity may be softened somewhat by the new option available to lending institutions to pay market interest rates on deposits of $10,000 or more.
- o The recent depreciation of the dollar is expected to boost net exports.
- o Perhaps most importantly, there is little evidence of the kind of imbalances between production and final sales that typically characterize a period preceding a recession. Throughout the current expansion, businesses have pursued a cautious inventory policy, keeping stocks closely aligned with sales.

These reasons, however, do not touch on the principal difference between the CBO projection and those who foresee a near-term recession: the future course of monetary policy. As I noted earlier, CBO has assumed no significant further tightening of credit markets. By contrast, many forecasters anticipate a recesssion brought about by a credit crunch, as the Federal Reserve responds to the recent acceleration of inflation and rapid growth in the basic money supply.

EVALUATION OF OMB JULY BUDGET ESTIMATES

In its mid-session review of the fiscal year 1979 budget released July 6, the Office of Management and Budget (OMB) lowered its estimates of the budget deficits by over $10 billion for both fiscal years 1978 and 1979, as compared with its January estimates. The reduction in the 1978 deficit estimate is almost entirely caused by lower outlay estimates as a result of the continuing shortfall in expenditures. For 1979, the deficit reduction results partly from lower spending estimates, but mostly from changes in the Administration's tax reduction proposals. Table 2 compares the latest OMB estimates for the budget totals with the 1978 Second Concurrent Budget Resolution limits and the 1979 First Concurrent Resolution targets.

We have reviewed the new OMB estimates, and have submitted the results to the Budget Committees. The review incorporated our new assumptions about the economic outlook, an analysis of actual outlay and receipt patterns in recent months, and other relevant programmatic information provided by the Administration.

On the spending side, the July OMB estimates of total outlays for both 1978 and 1979 appear to be somewhat high in terms of our analysis of spending patterns. For fiscal year 1978, we now estimate that total outlays will be about $448 billion, about $3 billion below the latest OMB estimate, adjusted for the treatment of earned income credit payments. For 1979, we estimate that

TABLE 2. FEDERAL BUDGET TOTALS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS

	1978		1979	
	Second Resolution Limits	OMB July 6 Estimates a/	First Resolution Targets	OMB July 6 Estimates
Revenues	397.0	400.3	447.9	448.2
Outlays	458.25	451.4	498.8	496.6
Deficit	61.25	51.1	50.9	48.5
Budget Authority	500.1	502.9	568.85	571.4
Public Debt	775.45	768.3	849.1	847.8

a/ The OMB July 6 estimates have been adjusted to treat the earned income credit payments as income tax refunds, as was done for the Second Budget Resolution for 1978. The First Concurrent Resolution for 1979 and the OMB July 6 estimates classify these payments in excess of an individual's tax liability as outlays and budget authority.

the outlays resulting from the President's budget proposals would be about $6 billion less than estimated by OMB in its mid-session review. Adjusting for the policy differences between the President's budget proposals and the First Concurrent Resolution targets, our latest spending reestimates would bring the target for outlays down to around $493 billion. For our economic forecast, we assumed that 1979 outlays would total $495 billion.

The Administration revenue estimates for fiscal year 1978 remain virtually unchanged from the January budget, but slightly above the CBO figures. CBO now estimates 1978 receipts at $397.7 billion, compared with $400.3 billion for OMB (adjusting for the earned income credit payments).

Largely because the President has reduced the size of the tax cut he proposes, OMB has revised its fiscal year 1979 receipts estimates upward to $448.2 billion. This figure is $2 billion higher than CBO's estimate, but our figure is based on the legislative assumptions of the First Concurrent Resolution, which differ from OMB's. When adjustments are made for these different legislative assumptions, the two estimates are virtually identical.

Our estimating differences with OMB for receipts and outlays in both years tend to offset each other, so that our estimates of the deficit for both 1978 and 1979 are reasonably close to OMB's.

POLICY OPTIONS

Recognizing the need for stimulus to sustain economic growth, the Congress enacted a First Concurrent Resolution last spring with several new initiatives, including a sizable tax cut. With these

measures, the deficit is expected to be about $47 billion in fiscal year 1979, down only slightly from the current fiscal year. The full-employment budget deficit, one measure of fiscal stimulus, would increase slightly from fiscal year 1978 to 1979:

FULL-EMPLOYMENT BUDGET BALANCE
(National Income Accounts Basis)

Fiscal Year	Billions of Dollars
1977	-14.5
1978	-17.9
1979	-20.7

The Congress now has an opportunity to review that earlier decision in the light of changing conditions. Recent economic developments are mixed. Inflation is considerably worse than expected, while the unemployment rate has declined more rapidly than anticipated. At the same time, however, most forecasters believe the outlook for economic growth has not improved--if anything, it has worsened. Hence, the policy dilemma: measures aimed at reducing inflation could slow growth and risk a new recession, while policies designed to sustain economic growth could accelerate inflation.

Restrictive Fiscal Policy Options

If the Congress believes that continuing the current fiscal policy provides too much stimulus at this stage of the economic

expansion--particularly in light of the persistence of inflation--it can take steps to reduce the fiscal year 1979 deficit. One way to achieve a more restrictive budget would be to forego all or part of the $15 billion tax cut for fiscal year 1979 ($20 billion annual rate) that was included in the First Concurrent Resolution to take effect in January 1979.

The CBO forecast described earlier includes this tax cut (assumed to be $11.4 billion in personal and $3.6 billion in corporate taxes). What would the outlook be without the tax cut? CBO's guess is that the effect on our forecast by the end of 1979 would be to reduce real growth by more than one-half of one percentage point and to raise the unemployment rate by about two-tenths. A policy of no tax cut would not reach its maximum restrictive effects on real economic activity until the end of 1980, however, when the impact on production and employment would be larger. In terms of inflation, prices might be about 0.2 percent lower by the end of 1980, with the impact still incomplete since inflation reacts to fiscal policies more slowly than does unemployment.

A significant restrictive economic effect could also be attained by cutting expenditures. Assuming that the Congress could achieve a cut in spending of $10 to $15 billion beyond the estimated $4 billion shortfall, the effect on economic activity would be roughly similar to that described above for eliminating the tax cut, depending on the composition of the reductions. Achieving

a reduction in spending of this size, however, would require difficult actions, such as foregoing the October pay raise for federal employees and sharply reducing the planned new spending initiatives for defense, agriculture, urban aid, veterans' benefits, and other programs that have not yet been enacted. Alternatively, savings could be sought in existing programs in order to achieve the spending reduction and still provide room for some new spending initiatives. One way of achieving this would be an across-the-board cut in budget authority provided in all 1979 appropriation bills for nonmandatory payments under existing law.

If the Congress were to forego the tax cut or take comparable action on the spending side, fiscal policy would be more restrictive in 1979 than in 1978. To the extent that the economy is approaching full employment, such a reduction in fiscal stimulus could reduce the risk of generating excess demand inflation. But we must recognize that real growth appears to be slowing, and there is a substantial danger that monetary and fiscal policies will become restrictive simultaneously, a shift that in the past has generally been followed by recession.

Expansive Fiscal Policy Options

In contrast to these various restrictive measures, the Congress has before it a proposal for substantial tax reductions. S. 1860 (the Roth-Kemp Tax Reduction Act) proposes large tax cuts over a period of three years without comparable reductions in

spending. The first-year tax cut--about $6 billion more in fiscal year 1979 than that included in the First Concurrent Resolution--does not appear to be so large that it would generate widespread excess demand, but the commitment to large future tax cuts involves substantial risk. Conventional economic analysis indicates that, as a result of such a policy, the budget deficit would rise sharply. With the economy likely to reach full employment during this period, a large stimulus of this kind would be highly inflationary.

Some of the proponents of this policy option, however, argue that the conventional view is incorrect. They contend that large tax cuts increase incentives to work, save, and invest to such an extent that the cuts would pay for themselves in the first or second year and, therefore, would not be inflationary.

CBO does not know of any empirical evidence for the view that the supply-side effects of tax cuts are so large and so quick. The evidence available to us supports the conventional view that the stimulative effects of most types of tax cuts occur primarily through increased aggregate demand and that the total effects are not large enough for tax cuts to be self-financing.

THE COORDINATION OF STABILIZATION POLICIES AND STRUCTURAL MEASURES

Past experience suggests that some incidences of poor performance by the economy have resulted from excessive shifts of monetary and fiscal policies in the same direction. The fiscal and monetary

authorities each assumed that the other would not take appropriate action in response to current economic trends; together they overreacted. Such an overreaction appears to be possible at this time. If monetary and fiscal policies are both used to reduce inflationary pressures, the chances for a recession are great.

Closer coordination of monetary and fiscal policies might also result in a mix of policies that might be preferred by the Congress. For example, the combination of a tighter fiscal policy and an easier monetary policy might:

- o Reduce federal deficits and, perhaps, decrease the size of the federal sector as well; and
- o Encourage investment spending, with the resulting growth in capacity reducing inflationary pressures.

At present, adequate arrangements for choosing specific economic goals and implementing a coordinated policy do not exist. Although attempts at closer coordination of fiscal and monetary policies are not without their risks, the benefits in terms of stabilization and growth could be substantial. Hence, this is an appropriate time to examine mechanisms for improving coordination of monetary and fiscal policies, such as requiring the Federal Reserve to:

- o Clearly specify its money and credit targets for the ongoing and upcoming fiscal years before enactment of the budget resolutions;
- o Reveal its estimates of the level of unemployment, production, and prices for the end of the fiscal years; and
- o Explain periodic revisions of its objectives and plans.

Finally, let me return to my major theme: that this is an unusually difficult time for economic policymakers, with the tradeoff between inflation and economic growth looking very harsh indeed. Under these circumstances, the Congress may wish to place more emphasis on structural measures that might ultimately improve this tradeoff. These may include:

- o Skill training;
- o Public service employment;
- o Reform of government regulations;
- o Encouraging free international trade;
- o More vigorous enforcement of antitrust legislation;
- o Lowering of agricultural price supports;
- o Carefully managed commodity stockpiling programs;
- o Reducing the minimum wage for youth;
- o Incomes policies, such as TIP (tax-based incomes policies); and
- o Reductions in payroll taxes.

Some of these may be rejected for good reasons not related to macroeconomic considerations. Each, however, can help with the inflation-unemployment tradeoff.

Even with structural improvements and better coordination, however, simultaneous inflation and unemployment will continue to present difficult choices for macroeconomic policymakers. Measures to deal with one of these problems may well worsen the other. Ultimately, the resolution of this dilemma will depend on whether the Congress gives greater emphasis to inflation or to sustaining economic growth.