Statement of Alice M. Rivlin
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before the
Committee on the Budget
U.S. House of Representatives
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Mr. Chairman and Members of the Committee:

My statement this morning covers the economic outlook, both short- and long-run, and the possible impact of new initiatives in the energy area. You already have copies of CBO's latest economic report, Recovery With Inflation, and the statement will begin with a summary of that report.

The Economic Outlook

The economic outlook has not changed significantly since the enactment of the First Concurrent Resolution on the 1978 Budget. Signs of more vigorous growth this past spring are being succeeded by some weakness in the latest data. Averaging through these fluctuating indicators, CBO's projections show a slow narrowing of the gap between actual and potential output and a reduction of unemployment during 1977 and 1978, with the rate of inflation remaining high by historical standards.

Growth in real output (GNP in 1972 dollars) is projected as slowing from its recent 7 percent annual rate to a range of 3.6 to 5.1 percent during 1978.

Growth in this range would be enough to reduce unemployment at a slow pace, to the 5.9 to 6.9 percent range at the end of 1978.

Consumer prices, which rose by 6.7 percent over the last 12 months, are projected to increase more slowly as food price increases moderate. An increase of 4.5 to 6.5 percent in consumer prices in 1978 is projected. The forecast is summarized in the table on the following page.

The assumptions underlying this forecast include:

- o Food prices settling down to a 5 to 6 percent annual rate of increase after their recent fluctuation, and energy prices continuing to rise at a 10 to 12 percent rate;
- o A slight shortfall in federal spending below the First Concurrent Resolution on the Federal Budget for Fiscal Year 1978;
- o Growth in the broadly defined money stock (M2) near the upper end of the 7 to 9 1/2 percent target range recently announced by the Chairman of the Federal Reserve Board.

The forecast presented by the Carter Administration in its Mid-Year Budget Review is at the optimistic end of the CBO range with respect to growth. On unemployment, the Administration projects a rate of 6.6 percent at the end of this year, compared with the CBO range of 6.6 to 7.2 percent. At the end of 1978, the

TABLE 1. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1977-1978

	Levels				Rates of Change (Percent)	
	Actual		Projected			
	1976:4	1977:1	1977:4	1978:4	1976:4 to 1977:4	1977:4 to 1978:4
GNP (Billions of Current Dollars)	1,745	1,799	1,940 to 1,980	2,130 to 2,190	11.0 to 13.0	8.5 to 11.5
GNP (Billions of 1972 Dollars)	1,280	1,302	1,345 to 1,360	1,395 to 1,425	5.0 to 6.0	3.6 to 5.1
General Price Index (GNP Deflator, 1972 = 100)	136	138	144 to 146	152 to 155	6.0 to 7.0	4.5 to 6.5
Consumer Price Index (1967 = 100)	174	177	184 to 186	193 to 197	6.0 to 7.0	4.5 to 6.5
Unemployment Rate (Percentage Points)	7.9	7.4	6.6 to 7.2	5.9 to 6.9	--	--

Administration projects an unemployment rate of 6.1 percent, compared with the CBO range of 5.9 to 6.9 percent. With respect to inflation, the Administration's projections are higher than the mid-point of the CBO range, but well below the upper end.

While the Administration remains relatively optimistic in its view of the outlook for economic growth, some recent economic news indicates weakening of demands. The unemployment rate rose from 6.9 to 7.1 percent between May and June and aggregate hours of production workers in the private nonfarm economy declined slightly. Retail sales have been unchanged for three months in current dollars, and have declined in constant dollars. If signs of weakness grow and the economy seems headed to the low end of the CBO range or lower, then the Congress might wish to consider modifying the fiscal policy reflected in the First Concurrent Resolution on the Budget.

However, it would be quite premature to decide at this stage that the economy is headed toward the lower end of the CBO range. It is possible that what we are witnessing is a faulty statistical correction for normal seasonal variations. Seasonal correction is especially

difficult when there are large fluctuations in the economy, as there have been in recent years. A significant part of the strength in early 1976, the weakness later in that year, and the strength in early 1977 could be a bias in seasonal adjustment procedures. This is particularly likely in the unemployment rate and could be affecting other data as well.

It should not, however, affect the industrial production index, which is seasonally adjusted by a different procedure from most other data--one which deliberately omits the influence of fluctuations during 1975 and 1976. The fact that the industrial production index continued to grow strongly in June, therefore, lends some support to this view of recent economic statistics. If the view is correct, we would expect unemployment and much other data as presently adjusted to show a weak second half of 1977 followed by a strong early 1978.

Apart from seasonal adjustment, there are basic uncertainties about the economic outlook that statistics for one or two months cannot resolve. The future of business spending on new plant and equipment is one of them. The CBO projection of investment spending follows fairly closely the Commerce Department's survey of business plans for 1977 and projects an 8 percent rate

of growth (in constant dollars) during 1978. Those with the more optimistic views of real growth prospects than CBO projections are counting on a major investment boom to develop sometime late in 1977.

Another key uncertainty about private demand is the saving rate. Consumers saved less than 5 percent of their current disposable income in the first quarter of this year, an extremely low rate influenced by the end of the Ford Motor strike, the large fuel bills due to cold weather, and a change in estate and gift tax laws. The CBO forecast projects a saving rate above the first-quarter rate but remaining in the 5 to 6 percent range throughout the forecast period. Since 5 or 6 percent is substantially below the rates recorded in recent years, this is a fairly optimistic projection. Judgments in this area have to be tentative, however, since data revisions could alter significantly the recent level of saving rates.

Assumptions about monetary policy and the behavior of financial markets introduce additional uncertainty. The CBO forecast assumes that M2, currency plus demand and time deposits at commercial banks, will grow at the upper end of the target range recently announced by the

Federal Reserve--7 to 9.5 percent per year--and that short-term interest rates will increase by about one percentage point over the next six quarters.

These financial assumptions involve two related risks. First, it is possible that the Federal Reserve will hold the growth of monetary aggregates below the upper end of the target ranges or that it will lower its targets from time to time, as suggested by Chairman Burns of the Federal Reserve Board in recent testimony. The second risk involves the possibility that the largely unexpected stability of interest rates in the last two years was an historical aberration and that even the rate of monetary growth projected by CBO would involve a sharper rise in short-term interest rates than the moderate upward trend in our forecast.

Budget Goals for 1981

Uncertainties multiply as we attempt to look beyond 1978. Nevertheless, it is important to address as clearly as possible the issue of prospects for moving simultaneously toward a balanced budget and a low unemployment rate over the next four or five years.

In an earlier analysis of this issue, CBO concluded that to reach an unemployment rate of 4.5 percent and a

balanced budget by 1982 would require a level of nonfederal demand which is strong by historical standards. With only moderate nonfederal demands, it would be necessary to settle either for a continuing deficit or for a higher unemployment rate.

We know of no reason to alter these conclusions. According to CBO's latest calculations, strong nonfederal demands, including a major investment boom in 1979 and 1980, would make it possible to reach an unemployment rate slightly below 5 percent by 1981, in combination with a balanced federal budget with outlays equal to 21 percent of GNP. This would provide budgetary room for new spending initiatives (above current policy) amounting to $15 or $20 billion in 1981. Without an investment boom, even if other private demands are strong, achieving the same unemployment goal would require continuing deficits in the neighborhood of $50 billion through 1981. Since GNP is projected as rising during these years, roughly constant deficits would represent a declining fraction of GNP.

The Persistence of Inflation

Almost all projections of the economy over the next few years include a continuation of inflation at rates

which are high by historical standards. The CBO report on the economy just issued concentrates on the puzzle of continuing inflation in a slack economy, and addresses the question of whether there is any prospect of quick relief from historically high rates of inflation.

The principal reason why inflation rates continue high is that, once inflation is anticipated as a continuing feature of economic life, it gets built into a great many economic contracts and decisions and develops very strong momentum. During the last decade, inflation has become embedded strongly in our economic machinery. The rapid spread of cost-of-living-adjusted labor contracts, the reflection of inflationary expectations in a broad spectrum of interest rates, and the automatic linking of major federal entitlement programs to consumer price increases are a few important examples.

There are no costless ways to reduce inflation quickly. Contractionary macroeconomic policies reduce inflation eventually but carry a grave risk of causing recession. A fiscal policy restrictive enough to take 1 percentage point off the rate of inflation three years from now is estimated to cost 1.2 percentage points more in the unemployment rate--an addition of more than a

million to the number of unemployed workers--in the first year of the policy, and continuing serious unemployment impacts for several years thereafter.

Wage and price guidelines or controls have often succeeded in reducing inflation while they have been in effect. Evidence suggests, however, that part of the gain in lower inflation rates is only temporary and that there are often substantial associated problems of evasion, inefficiency, and inequity. Policies to reduce price increases in individual sectors--control of hospital costs or holding down increases in the minimum wage, for example--can lead to modest improvements in the inflation outlook but are strongly resisted by the groups whose incomes might be adversely affected.

Finally, a number of tax incentive and related schemes to penalize inflation or reward wage stability may offer a promising strategy, but must be rated uncertain because they are untried. Further thought and possibly experimentation with these newer ideas and perseverance on special steps for individual sectors may yield some benefits. As a basis for budget planning for 1978, the realistic outlook is for no more than a slow unwinding of the current rate of inflation.

Energy Proposals

The Carter Administration proposals with respect to energy would, if enacted, have minor impact in 1978 and more important impacts in 1979 and later years. The effects of the energy program were analyzed in a CBO report issued the first week of June. At that time we estimated that the Carter energy plan would add about 1.6 percent to the level of consumer prices by 1980, or about half a percentage point per year to the rate of inflation from 1978 to 1980. We also estimated that the Carter proposals are likely to reduce constant dollar GNP by no more than 0.7 percent by the end of 1980. Unemployment is expected to be no more than 0.2 percentage points higher than it would be without the proposals by 1980. The overall conclusion of our study is that the strategies proposed by the Administration are generally effective in reducing America's energy use and dependence on oil imports. We believe that the Administration's estimates of the energy savings attributable to the plan are slightly optimistic--but enactment of the plan is likely to result in oil equivalent energy savings of at least 3.5 million barrels per day by 1985.

Recent Congressional action on the energy package has raised the possibility that prices for new natural gas will be deregulated rather than controlled at a level of $1.75 per thousand cubic feet, adjusted thereafter for increases in other fuel prices, as proposed by the Administration. Assuming that prices for new gas would, in the short run, rise well above the BTU equivalent for oil--to about $4.00 per thousand cubic feet--we have estimated that deregulation of new natural gas would increase consumer costs for new gas by an average of about $10 billion per year between now and 1985. Although estimates of additional production resulting from deregulation are speculative, we do not believe that deregulation would increase production by more than one trillion cubic feet per year--the equivalent of about one-half million barrels per day--by 1985.

Like the Carter energy proposals, deregulation would probably add to the overall inflation rate and slightly reduce the growth of output for a few years. We estimate that the Consumer Price Index would rise by about half a percent per year more with deregulation than without it, during the years 1978-1985. The effect on output and unemployment depends on the investment response of

gas producers which is extremely hard to forecast, but it seems likely that deregulation would add two to four tenths of a percentage point to the unemployment rate by 1980.

In response to a request from the Chairman, CBO has prepared estimates of the budgetary impacts of the National Energy Plan, as reported by the various House Committees. Our analysis indicated that in fiscal year 1978 the plan would increase federal outlays by $0.3 billion. The Joint Committee on Internal Revenue Taxation has estimated that the plan would reduce revenues by $1.0 billion in FY 1978. Taken together, the spending and revenue effects would increase the federal deficit by $1.3 billion. However, beginning in FY 1979, the situation turns around sharply. Instead of increasing the deficit, the plan would reduce the deficit by an estimated $1.7 billion in FY 1979, and by much larger amounts in succeeding years.

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

Thank you.