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I may be accused of false advertising, but I think I will only spend a short time on the actual economic outlook and talk more about the budget outlook, because the budget is a matter of great importance to the economic outlook in general and to the agricultural sector in particular.

One reason for not saying very much about the economic outlook is that CBO is only in the very first throes of putting together our report on that for 1985. But it appears that the story will not differ greatly from that in our August report, which was pretty positive. We did forecast an economic slowdown, but with a quick resumption of growth. It now appears that the slowdown was a little more severe than we anticipated, but only a very little more.

Nothing that has happened since has dimmed our optimism that economic growth will resume once this slowdown passes. In our view, it has only been a pause, not a precursor of a recession in 1985.

A lot of numbers confirm that. Of course, we can always be fooled by numbers. They sometimes get revised downward or even turn out to be very wrong.

Inventory-sales ratios are very low compared to recent levels. Admittedly, desired inventory levels may be lower than usual. For one thing, real interest rates are unusually high because inflation has gone down. Moreover, computerization helps keep track of inventories more carefully than in the past.

Notwithstanding all of those things, it seems to me that desired levels of inventories could not possibly be much more than those that are being reported today. And desired inventories would have to get a great deal lower than the actual levels to precipitate a serious recession.

Monetary policy seems to have responded to the economic slowdown. Interest rates are lower--I believe that they have fallen enough to start stimulating demand again--and raw material prices, at least over the last month, have not looked bad enough to signal a downturn.

The deficit outlook, however, is not as happy as the economic outlook. And that, of course, has a big effect on certain sectors of the economy. Right now, the deficit may be affecting the composition of our output more than it's affecting the aggregates.

I say that because I believe there is a link between high deficits and high real interest rates. The high interest rates, of course, hit the farm sector immediately.

There is also a link between high real interest rates and the international capital inflows that have been pushing up the dollar. As all of you well know, the high exchange rate grievously harms the agricultural sector.

Economic events since the deficits began to grow in the early 1980s are a little bit surprising. At least, they are surprising to me. In the beginning, we talked a lot about the deficit crowding out economic activity in the United States. We had in mind the crowding out of investment, mainly, and perhaps investment in consumer durables and in housing rather than regular business investment. In fact, this was taken for granted to the point where people rarely were very specific about what would be crowded out.

None of us anticipated that participants in international capital markets would be so willing to finance our budget deficit. The surprising capital inflow since the early 1980s has been very beneficial to the economy as a whole. It has helped us to finance the deficit, which is another way of saying it has helped us keep interest rates lower than they would have been otherwise.

Through its effect on the dollar, the inflow has also helped us keep inflation lower than it would have been. That effect on the dollar, of course, has transferred the crowding out process from capital formation, where we all expected it to be, to the foreign trade sector--to export industries, and more important, to industries that compete with imports.

So the crowding out has occurred, but it has been a very different way than expected. I repeat that we are better off with that foreign capital than without it. At the same time, I'm not sure I would like to try and convince a farmer or steelworker or autoworker of that fact. The benefits have been to the economy as a whole, while the harm has been very concentrated in a very few sectors of the economy.

While the capital inflow has helped us deal with the deficit, it also creates the biggest risk that our future may not turn out to be as happy as I've pictured it. Drawing on international capital markets means that international investors acquire more and more dollar assets over time. And there is a question as to how many dollar assets they will want to hold. There is some concern--not a great one but still a concern--that at some point the investors in international capital markets will say, "No more. We have no need for more dollars." At that point, the dollar would, of course, fall, and inflation and interest rates would rise.

How would the Federal Reserve System react to that situation? Would they defend the dollar or not? In any case, if the change happened very quickly, it could indeed shock the economy into a recession.

Again, I emphasize that this grim scenario is not one that we at CBO are forecasting. We simply see it as a risk that has to be considered. In contrast, if the dollar were to fall more slowly, I don't think there would be any real problems. The concern is over an abrupt change in the dollar.

Since the deficit is so crucial to the economy, particularly to the industry that you are interested in, let me talk a little bit about the outlook for the budget.

Last year Congress passed a rather significant tax increase. There were also some expenditure cuts. It may come as a surprise to many that the Congress has been so active over the deficit recently. Conventional wisdom a year ago was that the Congress is incapable of doing anything painful in election years. In fact, these actions lowered the projected deficit in the late 1980s by an amount equal to one full percentage point of the GNP. Now, that's a lot.

In the old days, a fiscal policy change of one percentage point of the GNP would have been considered a major policy change. In the present context--because the problem is so huge--that change appears to be quite trivial and therefore is referred to as only a downpayment on the deficit. But by previous standards it was a big change. That's the good news.

The bad news, of course, is that that action simply stabilized the deficit at about 5 percent of the GNP. This amounts to a huge sum relative to past deficits--a number that we didn't approach even during major recessions. Deficits of this magnitude are usually experienced only during wars.

Moreover, the 1984 legislative action in no way changed the fundamentals of the budget problem. Two programs are responsible for a very large share of the spiraling deficit: defense and health.

Defense is projected to grow at a 5 percent real rate. Health will be growing rapidly too. In defense the most important fundamental fact is our massive commitments around the world.

While I certainly wouldn't argue that defense is being delivered with utmost efficiency, even the most efficient defense is bound to be costly unless we change our foreign policy.

In health, of course, the most important fundamental is the rapid aging of the population--and the aging of the aged. That is to say, the number of people over 80 is going up much faster than the number over 60.

New technology also plays a role, both in defense and in health. Technology opens up remarkably expensive options for us--from artificial hearts in health to Star Wars in defense. The basic point is that both sectors will continue to grow rapidly unless there are major changes in policy.

The most disturbing growth item in our budget is a nonprogrammatic one--interest on the debt. In CBO's projections it grows from 3 percent of the GNP currently to 4 percent by 1989.

During most of the postwar period, it has generally been between 1 and 2 percent.

The most worrisome effects of deficits take place over the longer run. Moreover, it's possible to discuss the longer-run effects in terms of two very different scenarios. One I call a panic scenario, and the other one merely a disturbing scenario.

In the panic scenario, the deficit becomes so large and so much is added to the debt every year that the interest bill on the debt goes up faster than it can be paid--that is, it is not politically feasible either to cut spending or to raise taxes sufficiently to offset that rise in the interest bill.

What can be done then? An ordinary person whose interest bill is rising very much faster than income would simply declare bankruptcy. I suppose countries could do that, in theory at least, but they have another alternative not open to the rest of us that stems from their monopoly over the creation of money.

When a government reaches the point where it feels it can't cut spending anymore and can't tax anymore and can't borrow anymore because the interest bill is so high, it can turn to the creation of money.

At that point, of course, we are no longer talking about a little bit of inflation. Rather what we are talking about is very similar to the situation now afflicting Israel. The Israelis have been financing government with the creation of money, and the inflation rate is so high now that it is hard to measure. Some people say it's over 600 percent per year.

A friend of mine who has just returned from Israel said that he saw a sign in a shop that read, "We take shekels." That tells you a great deal about what can happen in an economy experiencing hyperinflation.

We are a long, long way from the Israeli situation, but in some projections CBO made last February, the deficit was rising, while the interest bill was rising at increasing rates along a path that was concave from above. Projected out to the 1990s, the interest line started going straight up. I think something akin to panic might have been appropriate if we had thought the country would go down that road very far, but we didn't think that. And, of course, the country didn't take that road. We were in an unstable situation in the sense that it was not feasible to continue that fiscal policy forever. But our political system responded. The Congress did enough to take us off the unstable road and put us on a stable road--but I must say, only barely.

A bit of bad economic luck could put us back on that unstable road again. Yet the legislated down payment on the deficit has bought us a lot of time, and that is why it was so important.

If we don't have to worry about the unstable situation in which the deficit is so huge that it feeds on itself, then we can turn to more traditional concerns about the effects of deficits. The most important one involves intergenerational equity.

At the beginning, I suggested that I thought a growing deficit would be very destructive to capital formation. In turn, that would reduce the potential for growth in the future and mean lower standards of living for our children and grandchildren. It would take a long time, of course, before it's noticeable. Indeed, a typical economic growth model would suggest that you can eat, drink, and be merry for as long as 20 years before you have eroded your capital stock to the point where both consumption and investment have to fall.

In any case, that process does not seem to be occurring. We have been able to keep domestic capital formation high by drawing on international capital markets. But that is also costly to future generations, because more and more of our future production will be devoted to servicing debt. In the first case, where domestic capital formation falls, production falls. The second case, where all the deficit is financed with international money, production doesn't fall but an ever larger share of it has to be devoted to paying interest and dividends to foreigners.

Under this scenario, there may be no reason to panic, but the deficit is still a very disturbing issue. Some would call it a moral issue. How many resources should we take away from our descendants to spend on ourselves?

What are the options for doing something about all of this?

On the spending side the most important thing to know about the federal budget is that most of the money goes for very few items. Probably I'm not telling you much that you don't know already, but it is a point that is absolutely crucial to the current budget debate.

I have mentioned defense and health as expenditures that are growing very rapidly. These programs also are already very large. In health, Medicare is the dominant program and it is the one that you have to watch in looking at future budget trends.

I haven't mentioned another huge program yet because it's not growing very much--namely, Social Security. It is only growing at about the speed of the economy and as the rest of the budget. Nevertheless, it's so big already that it's very important in any budget discussion.

Indeed, if you add up defense, Social Security, Medicare, and the interest bill on the debt, you have in CBO's projections an amount of spending that equals approximately 90 percent of the revenues that we project for the late 1980s.

The other 10 percent have to finance welfare for the poor, foreign aid, highways, agriculture programs, FAA, student loans, and so on through all the different areas of government. These other programs are, essentially, trivial compared to the big four.

For these reasons, it is very hard to imagine dramatic changes in federal spending unless reductions are made in the four big programs or unless the programs in the rest of the budget are radically changed. When I say radical, I mean doing away with many things that the federal government has done traditionally.

On the tax side, there are only three basic options. We can raise rates in our current tax system. Economists, regardless of ideology, don't like that because they feel the worst thing about our current system is that we have eliminated so much income from taxation. They would prefer the so-called tax reform or base-broadening approach taken in bills like Bradley-Gephardt, Kemp-Kasten, and now the Treasury Department proposal.

The third approach is to create new taxes such as a value added tax or some new energy tax. This option has not been in the press much recently, but I think it's a little more complicated than public discussion has led us to believe. I don't want to demean the notion of a value added tax or some new energy tax, but it is very difficult to design a new tax. A value added tax, if the experience in other Western democracies tells us anything, would have several rates. We would have to hire 10,000 to

20,000 new revenue agents to administer the whole thing. So, it's not a really simple matter to start from scratch and create some new tax. But again, I don't want to say that this means it is a terrible idea.

Let me stop, though, at that point and take questions.