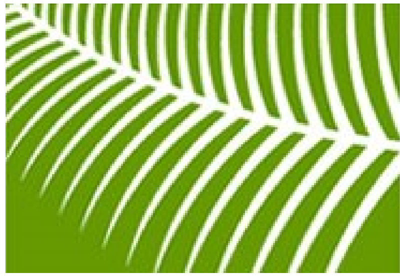

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OUTLOOK FOR THE U.S. ECONOMY

Rudolph G. Penner
Director, Congressional Budget Office

These are trying times for economists. Indeed all times are trying for economists. Once, when Paul Samuelson was asked how far into the future economists could forecast, he said minus one month. That is to say, if we only knew what happened last month we would be ahead of the game. Even that statement is optimistic, I think, because we can't really forecast the past anymore. Our various statistical agencies keep revising past history so just when we think we understand the numbers, they change them.

CBO's last official forecast was done in August. In other words, we don't follow the first rule of forecasting which is forecast often. But things haven't changed a great deal since that time. Then and now we faced the same major uncertainties in the economy.

At the top of the list for the short run I put the effects of tax reform. There is a general consensus in the economics profession that tax reform is going to be good for the economy in the long run. While capital will be taxed more heavily and therefore we would expect to have less of it in the long run, it will be taxed more equally. I think there is a general consensus that we will get a big rise in productivity from using what capital stock we have more efficiently.

The short-run effects of tax reform are hard to predict. It is so complex that it affects almost each individual and firm in the economy differently. As Mark Twain once said, almost all generalizations turn out to be wrong. We don't know exactly how tax reform will affect the end of this year and the beginning of next year. Those that get an advantage at the end of this year may try to move their activities forward, and those that have an advantage at the beginning of next year may try to move their activities back. This could cause some disruption, although we don't think that it will be major.

The second uncertainty is the trade balance. Economic theory and common sense tell you that with the economies of our foreign trading partners growing, although not vigorously, and with the exchange rate having changed as much as it has over the last number of months, the trade balance should be turning around. Indeed in our August forecast, we did have a major turnaround for 1987. It has been slower in coming than we anticipated, but there do seem to be signs now that at least the situation has stopped deteriorating. The last couple of months look pretty good on a seasonally adjusted basis. Whether 1987 turns out to be good, bad or indifferent really hinges on the extent of the trade turnaround.

The third major change is in government policy. Partly because of the Gramm-Rudman-Hollings law we expect a huge reduction in the Federal deficit this year. Our own estimate has it going from $221 billion in fiscal 1986 to something like $151 billion in fiscal 87. Now the old-fashioned view of such a turnaround was that while deficit reduction is good in the long run for economic growth, in the short run it can be quite contractionary. Our own view is that theory has to be modified in the current economic situation.

The degree to which our economy has to be viewed as part of the world economy has altered radically in recent decades. In our view, our policies now have an immediate impact on international trade and the international capital market. In the case of changes in fiscal policy, we believe that there is a very close relationship between the size of the Federal deficit and the size of our trade balance. Indeed you might even call them Siamese twins. We see the nexus working this way: As we reduce our Federal deficit, we take some pressure off interest rates in our capital markets. This makes the United States somewhat less attractive to international capitalists as a place in which to invest. That should weaken the dollar and make our markets more competitive. In other words, we see the contractionary effect of deficit reduction as being offset to a considerable degree by an improvement in the trade deficit.

Now indeed if things worked perfectly, economic theories suggest that the offset should be dollar for dollar. That is to say, if we had perfectly fluctuating exchange rates and perfect international capital markets, fiscal policy should be impotent in the American economy. Now we don't believe that things work quite that well, and some of the major uncertainties in this nexus that I have described are the time lines and whether the trade balance and the budget can get out of phase. But, the bottom line is that one of the reasons we anticipate improvement in the trade deficit is our optimism about the budget deficit.

We think that capital markets have become much more efficient in recent years. Capital markets move so quickly that some of the long-run benefits of deficit reduction are brought forward rapidly, especially in today's environment where the budget deficit problem has caused so much anxiety. We think the beneficial psychological effects of showing that the situation is turning around should be salutary to the economy.

The last reason that we don't have a big contractionary effect from this huge deficit reduction that I talked about is unfortunate. The reason is that much of that change from $221 billion to $151 billion is illusory, because it is dependent on a lot of very temporary factors that the Congress took advantage of to get under the Gramm-Rudman target, one of those being a temporary bulge in tax revenues of $11 billion resulting from the tax law. Because it is so temporary, we wouldn't expect that to have a big economic effect.

We engaged in slight of hand with regard to the timing of expenditures. We moved some expenditures such as general revenue sharing from 1987 to 1986. We moved the military pay day from the last day of fiscal year 1987 to the first day of fiscal year 1986 to reduce the '87 deficit and did a number of things of that type worth about $4 billion altogether. I suspect, by the way, as we confront the 1988 budget problem we may do things like move the military payday back again, saving over $2 billion in each of two years by doing so. Add to this list about $7 billion in asset sales that really don't have a very different effect on the economy from selling Treasury bonds. When you add it all up, the $151 billion estimate we are making for the deficit in 1987 is a significant understatement of the true underlying deficit problem. Adding back those items that I mentioned, you would have a deficit in the $170's. That's a big improvement over the year before, but not as much improvement as the accounting numbers will show.

The last uncertainty that people worry a lot about but apparently don't get very excited about is the debt situation--the LCD debt, the oil-related debt, the farm-related debt, the huge debts that our consumers have taken on. While the numbers are spectacular, I think that we have been handling that situation with enormous skill. It's our bank regulators and the the Federal Reserve System that have to take a lot of the credit. We have been muddling through skillfully, and I would expect us to continue to muddle through. I list debt as an uncertainty because most forecasters do.

Adding all of this up, we get a semi-optimistic view of 1987. For the rest of 1986, we see the economy growing a little over 3 percent. The first report on the third quarter was 2.9 percent. In 1987 we see growth during the year of about 3 1/2 percent, which is a little bit more optimistic than the consensus as reflected by the blue-chip forecasters, whose average is about 2.9 percent. As forecasting goes, that is not a real difference. Our average forecast error (and I pat ourselves on the back and say we are one of the best) is about 1 percentage point, so the difference between forecasts is not statistically significant. On the bad news side, we do have inflation accelerating a little. This year, during the year, it averaged a remarkably low 1.2 percent. Next year we have that rising to 4 percent. We don't see that really as a fundamental change in the deflationary trend that we have experienced over the last number of years. Rather that acceleration reflects the disappearance of some temporary factors. We expect the benefits of the oil price fall to be gone by then. The exchange rate fall by itself is inflationary but not in a lasting way. Because we are optimistic about real growth and because we have inflation going up again, logic demands that we have to have interest rates going up some. We have the 90-day Treasury bill rate averaging a little over 6 percent next year as compared to recent rates of about 5.4 percent. Unfortunately, none of this adds up to a very significant fall in the unemployment rate. We have about a 6.7-percent average next year.

What are the major risks to this forecast? There is a very small band of forecasters that think we might have a recession next year. I find it very hard to put together a recession scenario, but you can never rule it out. I would think that the odds are very low--probably about 1 in 20. One thing that we have going for us next year that really I think puts a cushion under economic activity is that inventories are in extraordinarily good shape. Even if all business wants to do is maintain recent inventory/sales ratios, that implies a very large increase in inventory investment for next year.

On the other side of the coin, our forecast may prove too pessimistic. You don't hear much talk about a possible boom; most forecasters seem to have ruled out any possibility of a real boom. However, there is a possibility out there. I think the probability is low but there is a possibility of a great variety of things coming together. There are sets of assumptions that one can make that make tax reform actually quite expansionary next year. I would not make those assumptions, but they are not totally unreasonable. If you had that effect plus trade suddenly turning around more vigorously than we expect in response to the exchange rate change, you could have really quite a significant boom. Would such a boom turn into inflation? Again, I think that the underlying trend with regard to inflation is clearly down. The wage settlements and nonunion area of the economy have been behaving extraordinarily well. I find it hard to see a real acceleration of inflation without some turnaround there and without some bigger increase in commodity prices, but there are a few economists around who think that the wages will start to move when unemployment

gets around 6.8-6.7 percent, or in other words, about the levels we forecast with our modest growth next year. My own judgment is that this is unlikely to occur until the unemployment rate gets considerably lower, say into the low 6's, and you can even make an argument for the high 5's. But for the sake of our analysis we use about 6 percent as what the economists call the natural rate of unemployment, the rate below which wages would start to accelerate, and above which they should continue to be well behaved.

Looking at the whole picture, again I return to the dependence of the outlook on this very uncertain trade picture. That's where most of our optimism comes from, but trade is also the major reason our forecast is tenuous. Consumer expenditures are unlikely to increase as much as they did last year. We don't have much life in investment because we are worried about the disruption caused by tax reform. Of course, we don't get much life out of government because of the constraints imposed by Gramm-Rudman-Hollings. A very large share of our strength comes from the trade sector.

Let me just take my last couple of minutes to turn to the budget outlook. The CBO only forecasts the economy so we can estimates the budget. I mentioned in passing that the deficit situation had turned around and it certainly has from the kind of situation we were portraying a couple of years ago, where deficits were not only rising rapidly--perhaps towards the $300 billion level by the end of this decade. They were rising much faster than our income. We were in a truly unstable situation where we were adding to the debt so fast that the interest bill on the debt was a major part of the budget problem and threatened to get completely out of control.

Now we are projecting declining deficits. The major change, by far the most important quantitatively, is in the defense sector, where earlier on the Congress had voted for growth in defense budget authority of over 5 percent per year in real terms through the mid-80's. The political pendulum has swung with a vengeance and in fact the defense program in terms of spending authority was cut in real terms in 1986 and cut further in '87 with the recently passed appropriation.

That turnaround does not mean that the problem is solved. I think this is a very important point to make: while some are satisfied with the news, we portray even a deficit in the $150's or the $170's as enormous compared to our past history and point out that our national debt will still be growing significantly faster than our income. And, there is always a chance of either the economy going bad or something changing. For example, an international crisis that made us increase defense again would very rapidly put us into the $200 billion deficit range. In short, the current situation certainly is not satisfactory. It leaves no room for a variety of risks and is open to great uncertainty.

I suppose in this crowd I should mention that one of our greatest uncertainties, of course, is our agricultural payments, the one part of the budget that is totally out of control. We actually have those coming down a little bit next year. We are very nervous about that; so nervous we are looking for a good agricultural economist at CBO. We want someone who can tell us how to make both the farmer and the consumer better off while lowering the cost of subsidies and improving the agricultural trade balance. Actually, three out of four will do. With that advertisement, I will stop and take your questions.