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CURRENT ECONOMIC CONDITIONS

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

NOVEMBER 2, 1990

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JOINT ECONOMIC COMMITTEE

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CURRENT ECONOMIC CONDITIONS

FRIDAY, NOVEMBER 2, 1990

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEES,
Washington, DC.

The committee met, pursuant to notice, at 10:25 a.m., in room 2359, Rayburn House Office Building, Hon. Stephen J. Solarz (member of the committee) presiding.

Present: Representatives Solarz and Hawkins.

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF REPRESENTATIVE SOLARZ, PRESIDING

Representative SOLARZ. The committee will come to order.

The purpose of the Joint Economic Committee's second hearing this morning is to examine the current state of the economy and the economic outlook. During the past week, we have had a number of important developments. Congress enacted a budget that will reduce the Federal deficit by $40 billion in fiscal year 1991 and by $490 billion over the next 5 years.

And the Federal Reserve indicated that it would respond by making a 25-basis-point cut in the Federal funds rate.

In addition, some important economic numbers have been released this week, including third quarter GNP growth, personal income and consumption, the Purchasing Managers' index, the leading indicators, and the unemployment figures, as we have just heard.

The precise story they tell about the economy is somewhat confusing. Economists can—and I expect they will today—argue about whether we are actually in a recession or about to suffer one. But the indicators are clear on one broad trend: The economy is weak, with slower growth than at any time since the last recession of 1981–82. The employment picture is also troubling. After many months at 5.3 percent, the unemployment rate jumped to 5.7 percent in September. The labor markets are not in very good shape. Fewer jobs are being created. In 1989, there were 3 million new jobs; this year, the figure will probably be less than 2 million. That is almost a one-third drop. In the last year, we have lost 350,000 manufacturing jobs.

On top of this, there are major uncertainties in the economic environment. The Persian Gulf crisis, rising oil prices, shaky financial institutions, businesses that are burdened with high levels of debt they took on in the 1980's, and our reliance on foreign capital all make our economic footing less sure.

Much has been made of the length of the current economic recovery. But in many respects, the rhetoric about the strength of the economy in the 1980's is proving to be hollow.

The gap between the richest and the poorest Americans has been growing. A study prepared by the majority staff of the Joint Economic Committee, which we are releasing today, shows the gap is the greatest since the Census Bureau began collecting data on family incomes in 1947.

Middle-income families have seen little real growth in incomes in the 1980's and those at the bottom of the income scale actually have lower real incomes today, on average, than they did a decade ago.

In addition, more Americans are living in poverty now than in 1979. The expansion may have been a long one, but the fruits of our prosperity were not shared fairly. People are worried about the economy. Policymakers are worried, too.

Today, a distinguished panel of economists will help us sort out the economic data and assess the current state of the economy.

Our witnesses today are: Mr. Lawrence Chimerine, senior economic counselor with the forecasting firm Data Resources, Inc., and a fellow at the Economic Strategy Institute; Mr. Lawrence Kudlow, chief economist and senior managing partner with Bear, Stearns & Co.; and Mr. Donald Straszheim, chief economist and first vice president with Merrill Lynch Capital Markets.

Gentlemen, we are delighted you could join with us today. And we look forward to getting the benefit of your thinking and analysis. We also hope you will disprove the widely held view that economics is the dismal science. Shed light on the subject, clarify rather than confuse, point us in the right direction, tell us what is wrong and how to correct it, and this committee, the Congress, and the country will be in your debt.

Mr. Chimerine, you may proceed.

STATEMENT OF LAWRENCE CHIMERINE, SENIOR ECONOMIC COUNSELOR, DATA RESOURCES, INC. [DRI], AND FELLOW, ECONOMIC STRATEGY INSTITUTE

Mr. CHIMERINE. Thank you, Congressman Solarz. I am delighted to be here, and it is good to see you again. I have a prepared statement which I hope you will include in the record, and I will try to briefly summarize it.

Representative SOLARZ. Hearing no objection, your prepared statement will be included in the record.

Mr. CHIMERINE. Thank you very much.

I know you are most interested in one of the questions you asked Janet Norwood a few moments ago, whether the economy is in recession, and obviously I will give you my view on that subject, which is "yes;" I will also discuss what brought it about, and where we go from here; and, of course, what role oil price increases and the deficit reduction package plays in all of this.

But I think it is important to begin by making one observation, which I think you made yourself in your opening remarks, Congressman Solarz. The economy has already been quite soft for a relatively long period of time. It began to slow down in early 1989, and over the last seven quarters economic growth has averaged only a little bit more than 1 percent at an annual rate, marginal growth at best. In effect, over this last year and a half or slightly more, we have been skirting recession on a day-by-day basis.

Some areas of the country have been in recession, the Northeast, and many of the Mid-Atlantic States in particular, for at least a year now. Some sectors of the economy and some industries have been especially weak during this period—construction and the automobile industry are cases in point.

But on a national basis, it probably is true that at least until recently, while we were very close, we did not actually slide into a recession. But I think the recent data and evidence, a lot of it anecdotal at this point, suggest that as of right now the economy is declining. It is declining quite rapidly, in fact, and it is very likely that a recession on a national basis began sometime in the last couple of months.

And it is somewhat disturbing. Obviously, any recession is disturbing, but this follows, as I mentioned a moment ago, a year and a half during which the economy was already weak. So it isn't a matter of going from a very strong economy immediately into a recession. We have had a relatively long transition period of slow growth during this period, during which employment growth has essentially stopped, profits have been weak in most industries, and a significant amount of pain and distress has already surfaced even before this recession began.

What evidence is there to support this? Well, orders have been declining over the last month or two. Although data are not yet available, most manufacturing firms I have talked to tell me that their October orders were especially weak, accelerating the downtrend.

Retailing was apparently also very soft in October. Almost every major national retailer has told me that their sales were down this October. That comes from a very weak October last year, so that the comparison makes it even more disturbing.

We have seen sharp increases in recent weeks, as you have noted, in initial claims for unemployment insurance. New jobs have been falling. Other measures of labor market performance have also been weak—help-wanted advertising reached its lowest level last month in a relatively long period. Commodity prices have dropped almost across the board, with the obvious exception of oil, during the past couple of weeks, further indicating softness.

So it isn't difficult, it isn't very difficult at this point, to find a significant amount of evidence that shows that, over the last couple of months, the economy has deteriorated and is now in a state of decline. Whether we will ultimately call this period a recession or not obviously depends on how long this decline will continue, but it is hard for me to see any reason at this point why it won't continue at least for the foreseeable future. So that when we look back, we will probaby say that August of this year, or somewhere around August, was the start of the recession that we appear to be in right now.

Before talking about how long it is likely to last and how bad it likely will become, I think that it is important to describe why we are having this recession. The timing makes it appear that it is oil related. And in my judgment, that is not the case at all. I have very strong views on this. In my judgment, the recession now in place, extending the slowdown that we have had over the past year and a half, in part reflects a fading out of some of the cyclical factors that produced the long expansion in the 1980's.

I think fundamentally the long expansion of the 1980's is very misleading, at best. It was, to some extent, a false prosperity. It was not the direct result of Reaganomics or supply-side policies. It largely reflected the low-starting point when the expansion began because of the two back-to-back recessions which preceded it.

It also reflected to a great extent the demand-side effect of large tax cuts, not the supply-side effects, because those never materialized, and the big military boom; cheap oil during most of the 1980s; the willingness of foreigners to lend heavily to the United States; massive funding into real estate, which produced an enormous construction boom. All of these forces perpetuated an expansion for 6 or 7, I guess 7½ years, despite deterioration in the underlying fundamentals—our competitiveness in the world market has worsened; our savings and investment rates have deteriorated; and we have gone deep into debt in almost all sectors of the economy. So the expansion that we had essentially reflected some of these temporary favorable factors, living on borrowed time, if you will. And I think that that has run out, and that is the dominant reason why the economy began to slow in early 1989, why it has been very soft ever since, and in a sense, why we are now sliding into recession.

Clearly, oil is making it worse, despite the fact that the increase in oil prices now is less than it was during the two oil shocks in the early and late 1970's. The effect of oil price increases on the economy now is far different, reflecting conservation and fuel substitution.

Even the inflationary impact is different. Back in the 1970's, when oil prices went up, it spread to other fuels. And of course, this ultimately fed into wages and then triggered a wage-price spiral, and very sharp interest rate increases.

This time it is different. As of now, we have not seen much increase in the price of other fuels, and there is very little reason to expect the increase in oil prices to show up in wages. Most of the cost-of-living adjustment clauses in labor contracts have been watered down or eliminated. And right now, most employers are more concerned about rebuilding their profit margins and remaining competitive than about maintaining employee purchasing power. So it is likely to be an only one-time price effect, and the impact on the economy in terms of real activity will be considerably less than it was during the two oil shocks during the 1970's.

Nonetheless, it is having an effect—if prices stabilize in the upper $20, or $30 range, as I expect they will, the cumulative effect on GNP will probably be between three-fourths of a percent and 1 percentage point, so it is definitely making a contribution to the recession.

But again it is not the main factor, because the economy was fundamentally weak well before the oil price shock developed. If we had strong underlying growth we would be able to absorb the oil price effect with very little impact on the economy.

What about the deficit reduction package? Congressmen Solarz, I will make several comments. First, from a long-term standpoint, in my judgment, this does not solve the problem. Anything resembling realistic assumptions, in my view, will still result in deficits in the mid-1990's of at least $150 billion a year, even with the package recently implemented and even including the Social Security surpluses which we will have in the years ahead. So if the objective is to bring the deficit down to zero, a substantial amount will still have to be done.

Second, the thing that disappoints me the most is that very little was done on the entitlements. I know that there was some effort in agricultural subsidies and some was done on Medicare. But most of the large entitlements programs were not touched significantly, and in my judgment there is very little chance of getting these deficits fully under control without addressing entitlements.

I know that that means Social Security. I have discussed this many times at these hearings before. The solution ultimately has to be to convert many of these entitlement programs to means-tested programs in one way or another, perhaps by scaling back or preventing any increase in benefits for people who don't need them. And I think that that was the one big area that was not addressed effectively in the deficit reduction package.

In terms of its near-term effect on the economy, in my judgment, it will mean a weaker economy over the next 6 to 9 months. There is absolutely no way that the Fed can counter the restrictive impact of the budget reduction package on economic growth in the short term, in part because the Fed's control of long-term interest rates has been reduced dramatically in recent years as a result of our big dependence on foreign capital. Long-term rates now depend more upon what happens in Germany and Japan and Eastern Europe and other parts of the world than they do on what the Fed does.

We still have big deficits. The dollar is going down. Money is flowing out of the United States. All of these will limit the decline in long-term interest rates in the months ahead.

And given the overbuilding of construction and given the high-debt levels throughout the economy, it is unlikely that a modest decline in interest rates is going to trigger a big upsurge in the economy. The best we can hope for is that it will reduce the magnitude of the recession. But, in my judgment, it won't come anywhere near close to offsetting the restraining impact of the deficit reduction package in the months ahead.

When I put all of this together—the fact that the economy is already declining; that there is almost no strength anywhere in the economy at the present time—even export orders are slowing in response to a slowing of economic activity overseas—it is spreading regionally; layoffs are becoming an increasing concern; consumer confidence has plummeted during the past several weeks—it is clear to me that what has happened over the past couple of months is simply the start of what will turn out to be at least a moderate-size recession that will continue through next summer.

My current estimate is that GNP will drop somewhere in the 1.5 percent range, not a giant recession by historical standards, but a sizable one, particularly after it has followed a period in which the job market has already softened and the economy has been fundamentally weak for such a long period.

I also think that all of the risks are on the down side. For example, oil prices may not stabilize at $30 a barrel, and there may not be a negotiated settlement in the Middle East. War could break out. Prices could go higher.

Second, we may not have seen the complete decline in consumer confidence yet, particularly since real estate prices are dropping everywhere now, almost everywhere.

And third, while it is unlikely, we cannot completely rule out a financial crisis. Many of our financial institutions are extremely weak. A lot of them are close to bankruptcy, and if some of this happens and starts to feed on itself, obviously it will become a depressant on the economy as well.

So when I talk about a moderate-size recession, I think that that is about the best that we can hope for. The risks are heavily on the down side.

One last comment, Congressman Solarz, and that gets to what will happen after this recession is over. You can gather from my remarks that I think we are in the early stage now of what will turn out to be an extremely long period of adjustment, essentially adjusting to some of the excesses of the 1980's—and some of the things we have neglected, such as our declining competitiveness in world markets, the weakness in the financial system, high-debt levels, overbuilding in real estate, and so forth.

In my view, even when this recession ends it is very likely that the best we can get is a very mediocre recovery, rather than the normal vigorous recovery we get when recessions end, because this recession is different than the others we have experienced. This is not directly or primarily the result of an oil price shock, or inventory overhang, or a brief period of tight money. This reflects a number of more structural, long-lasting factors that, in my view, will hold down the economy on a longer term basis.

So quite frankly, I think that the outlook for the next several years, not just the next 12 months, is very mediocre at best, and we are now perhaps in the second year of what will turn out to be a relatively long period of very low average growth by historical standards in this country.

Thank you, Congressman Solarz.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine. I am a Senior Economic Counselor to Data Resources, Inc., a Fellow at the Economic Strategy Institute in Washington, DC, and President of Radnor Consulting Services in Wayne, PA. I appreciate the opportunity to testify before the Joint Economic Committee on the current economic situation and the near term outlook.

In sum, my views are as follows:

1. After nine years from enactment, it is clear that the supply side program of massive tax cuts and deregulation has not produced the results that were predicated. If anything, the underlying fundamentals, including the rate of saving and investment, productivity growth, competitiveness in world markets, etc. actually deteriorated in the 1980's, jeopardizing growth for the 1990's.

2. Following eighteen months of a sharp deceleration in growth, the economy appears to have entered into a recession in the last two months. This weakening trend since early 1989 precedes the recent oil price shock.

3. The current slowdown is very different in nature than previous periods of recession or slowdown in the post-war period. In particular, while a winding down of cyclical forces and a reversal of some of the temporary stimulants of recent years are contributing to the slowdown, it also in great part reflects more long lasting structural factors such as high private debt burdens, massive overbuilding in construction, a weakened financial system, and large budget deficits.

4. Barring an outbreak of war, the recent oil shock will not have as large a negative impact on the economy as the oil shocks during the 1970's. However, depending upon where prices ultimately stabilize, it could reduce real GNP by up to one percentage point by next summer.

5. The recently passed deficit reduction package will also exert some drag on the economy in the period immediately ahead, even if the Federal Reserve is successful in bringing interest rates down. Any easing by the Fed is likely to have only limited effects on long term interest rates because of still large deficits and because of our dependence on foreign capital; modest declines in long-term rates, in turn, are not likely to produce enormous stimulus for the economy in view of the high debt levels and overbuilding which currently exist.

6. These factors will extend the downturn now underway through the rest of this year and the summer months of 1991, with a total decline in real GNP of between 1 and 1.5%, but with the risks almost all on the down side. Furthermore, given the inability to use anti-cyclical policy effectively, coupled with the continued impact of some of the adverse structural factors, this recession will not be followed by the normal vigorous recovery that has characterized other post-recession periods. Thus, I would expect only very modest growth at best in late 1991 and in the following year or two.

7. Unfortunately, there is little that can be done from a policy standpoint to improve the near-term outlook -- in my view, economic policy from here on in should focus mostly on improving productivity and competitiveness in the long term. This can best be accomplished by not only continuing to reduce budget deficits, but by doing so in a way that shifts spending priorities toward building for the future, and changes the tax structure to promote more long term investment.

Review of the 1980's

Before looking ahead, I think it is useful to look back at the performance of the economy in recent years, with particular emphasis on the impact of the supply side policies that were implemented early in the 1980's. As one might remember, these policies consisted largely of substantial tax cuts (particularly in marginal tax rates), and deregulation of many industries, both of which were designed to increase the incentives to expand production in the United States. Supply-side economics was thus billed as the economics of incentives and production rather than the economics of consumption.

After nine years from implementation, it is clear that the results have been very disappointing. First, the incentive effects that were predicted have not materialized:

(a) Perhaps the major expected outcome of the supply-side program was to be a significant increase in personal savings, reflecting lower marginal tax rates (which increase the after-tax return on savings), as well as the enactment of IRA's, Keoghs, and other savings incentives. However, the personal saving rate has declined sharply throughout the 1980's despite the supply-side program, and despite the highest real interest rates in recent history (which also increased the return on savings). The reasons behind the decline in the saving rate are numerous - the major one in my judgment is that the squeeze on purchasing power forced many families to cut their savings in order to maintain living standards.

(b) The supply-side program was supposed to increase investment, as a result of reductions in corporate taxes and of the expected increase in private savings. However, both gross and net investment as a share of GNP were lower during the 1980's than in prior decades. Furthermore, the investment mix has shifted to relatively short-lived types of equipment, rather than the more longer term investments which are more closely associated with increasing capacity and productivity.

(c) The cuts in marginal tax rates were supposed to increase the growth in the labor force because of an increase in the after-tax return on work effort. However, while labor force growth did accelerate, this largely reflected demographic factors and the income squeeze which caused many families to send another member into the labor force in order to generate a second income.

(d) The supply-side program was supposed to pay for itself -- budget surpluses were predicted within a few years because the increase in economic activity that would result would more than offset the direct revenue loss of the tax cuts. Needless to say, this did not happen -- instead, we have had, and still have, the biggest deficits in peacetime history of the United States, with no end in sight. Supply-siders will attribute this to the failure to cut spending and to other factors -- spending has not been cut, however, because of the big military buildup which accompanied the supply-side program, and because of exploding interest on the national debt resulting from large deficits. These large budget deficits on top of the decline in personal savings produced massive declines in national savings in the 1980's, again exactly the opposite of what had been predicted.

(e) Perhaps of greatest concern is that the predicted upturn in productivity growth has not materialized -- in fact, after a brief spurt in the mid 80's, productivity growth has fallen sharply again, and remains far below both the historical trend in the United States and the current rates of productivity growth in most other countries.

(f) Deregulation was supposed to result in a more balanced economy. However, much of the growth of the 1980's came from massive over-building of most types of construction, from a consumption boom in luxury items, and from an enormous military build-up -- if anything, the economy was less balanced in the 1980's than it had been previously.

(g) International competitiveness was supposed to improve in the 1980's as a result of the surge in productivity that had been expected. Of course, what really happened was a string of mind-boggling trade deficits, the likes of which no country has ever experienced. Supply-siders are quick to describe these deficits as a sign of strength, reflecting faster growth in the United States than elsewhere, as well as the overvalued dollar caused by foreign desires to invest in the U.S. However, despite a flattening out of the U.S. economy over the last 18 months, an acceleration of growth in most other countries, a 60% decline in the U.S. dollar on foreign exchange markets since 1985, rising foreign direct investment in the United States, and, declining oil prices in much of the 1980's, the trade deficit is still running at an annual rate of over $90 billion, still enormous by any standard.

Reaganomics was also supposed to usher in a period of prosperity for all as a result of the incentive effects that were anticipated. Thus, even though some argued against the program because of the big tax cuts at the upper income levels, it was argued that the benefits would trickle down throughout the economy. Unfortunately, this has not happened;

(a) Despite an economic expansion that lasted over 7 1/2 years, economic growth during the decade of the 1980's as a whole actually lagged behind previous decades; average growth in the 80's was even lower than during the stagflation days of the 1970's. This reflects two factors: first, the rate of growth during the 1980's expansion was relatively modest in comparison with growth rates during most previous expansions in the postwar period; and secondly, the recovery started from a very low base, following the two severe recessions in the early 1980's. Thus, in effect, the expansion of the mid 1980's simply made up for the ground lost during those two recessions, indicating that the recovery was largely cyclical in nature rather than reflecting any changes in underlying fundamentals.

(b) Despite supply-side economics, real wages have not grown during the 1980's -- by many measures, they actually declined. Thus, the average income earner is not significantly better off now than at the start of the decade. Furthermore, as indicated earlier, an increasing share of families now require a second income just to maintain the same standard of living they had earlier. And, for most families, housing is less affordable than it was ten years ago (resulting in a decline in home ownership); the cost of a college education is further out of reach; and healthcare is even more expensive, or not provided for them by their employers.

(c) Some income groups have improved dramatically during the 1980's, primarily those in the upper ranges of income. In effect, the stagnant average real income pattern of the '80's hides the fact that real incomes rose sharply for people with high incomes and actually declined somewhat for people at the lower end (especially when measured on an after-tax basis). Thus, there has been little or no trickle down during the 1980's.

It is clear by now that the supply-side program has not worked as advertised despite the long expansion during the mid 1980's. But in my view, perhaps the biggest indictment of the supply-side program is the fact that it has actually jeopardized the future of the United States economy. Put very simply, we have not been building for the future, as witnessed by our low levels of investment; by a deteriorating infrastructure; by the legacy of massive budget deficits (which are squeezing out many programs needed for future growth and will have to be serviced by future generations); by the absence of an effective energy policy (so that rising oil prices will hinder economic growth as we move forward); by the deterioration in the financial system (including a massive collapse of the thrift industry), which will make credit less available or more costly in the future; and by still high real interest rates (which is not helpful for the process of economic re-building).

In my view, several lessons should be learned from the experience of the 1980's. First, while the essence of supply-side economics may have been correct, namely that the effects of tax changes and regulatory policies on incentives to produce should not be ignored, too much of a good thing can be counterproductive. In effect, the world is not linear -- some tax cuts may have been desirable, but the enormous magnitude of them turned out to be counterproductive because their adverse effects on budget deficits, and on disinvesting for the future, etc. began to swamp the incentive effects. Neither extreme is desireable -- thus, while high taxes and too much regulation may stifle the economy, the solution is not insufficient regulation or excessive tax cuts. Secondly, the U.S. economy is extremely complex -- any simple theory such as that cutting taxes will solve all of our problems, etc. is usually an overexaggeration at best, and dangerous at worse. Finally, there is a big difference between a free market economy, and indifference and neglect. It is possible to both believe in free markets and also that some government regulation and involvement is needed in some activities.

Current Economic Situation

Despite a better than expected third quarter GNP report, I believe that the U.S. economy has weakened considerably in the last several months. The 1.8% increase in real GNP in the third quarter, even though not especially large, overstated the strength of the economy because it included a sizeable increase in auto sales (due to discounting) and auto production (as a hedge against a possible strike), plus it appears that a low price deflator (for technical reasons) also inflated real GNP. The current weakness is better indicated by:

(a) the decline in new orders in the last several months;

(b) sharp declines in commodity prices during the last six weeks;

(c) rising initial claims for unemployment insurance;

(d) the literal collapse in consumer and business confidence in recent weeks;

(e) sharp declines in real disposable personal income in recent months (and the resulting falloff in personal savings); and

(f) anecdotal evidence, which indicates a substantial decline in retail sales in October.

While the decline in economic activity now apparently taking place coincides the rise in oil prices, it is important to note that the economy began to slow well before the Iraqi invasion of Kuwait. In fact, real GNP growth has averaged only about 1.3% at an annual rate since the end of 1988, subpar growth by any standard. While construction and autos have been the two weakest sectors of the economy, the softness appears to have spread into other sectors, including consumer spending on other durables and even some non-durables and discretionary services. In addition, orders for business fixed investment have flattened out after an upsurge in prior years, and cutbacks in military procurement appear to be taking hold. In sum, there is very little strength anywhere in the economy, although exports are continuing to rise modestly to provide some support in certain selected industries. On a regional basis, the Northeast and Middle-Atlantic states appear to be suffering the most, although a slowdown in employment growth is now showing up in virtually every other region as well. Corporate profits have been declining during most of this period, and job growth tapered off and then stagnated even before the oil price increase -- only a sharp decline in labor force growth prevented an even faster rise in unemployment than has actually occurred. Thus, in my view, while the rise in oil prices is contributing to the weakness in the economy, it is not the major factor (as discussed below).

Causes of the Slowdown

The current economic slowdown is far different in nature than previous periods of recession or stagnation in the post-war period. In particular, while cyclical forces are clearly playing a role, especially reduced pent-up demand, and now oil price increases are an added depressant, I believe that a large part of the slowdown reflects more longer lasting structural factors than those which have produced recessions in the past. This in part explains why the current sluggishness has already lasted for about a year and three-quarters, even before the contraction that appears to have occurred in the last few months. These factors include the following:

(a) Both corporate and household debt (in relation to profits and incomes) remain far higher than at previous cyclical peaks. In my view, high outstanding debt levels are holding down spending on consumer durables and on new investment (especially since both real incomes and profits are being squeezed).

(b) Rising credit quality problems in real estate and other loans, coupled with regulatory changes requiring higher capital, have tightened credit standards -- thus, even if households and corporations do not feel constrained by current debt levels, they are not having as easy access to credit as during the previous five or six years.

(c) Despite the rising budget deficit in nominal terms, fiscal policy is now becoming restrictive and is likely to remain so for many years. The increases in the nominal deficit are primarily due to rising interest expense, weak tax receipts due to the sluggish economy, and the explosion in thrift bailout costs, none of which are now stimulative -- meanwhile, the deficit package now being adopted will produce sizable fiscal drag.

(d) Many state and local governments are in the process of cutting spending or raising taxes to ease budget problems as well.

(e) The enormous overbuilding of most types of real estate in many areas, coupled with weakening property prices, has caused a sharp decline in new construction.

(f) Nominal and real interest rates remain very high at a time when most high rate of return expenditures have already been made.

These factors are very different than the inventory overhangs, oil price shocks, or other factors which caused previous mild recessions or slowdowns. In effect, we experienced an expansion in the 1980's built largely on cheap oil, large tax cuts, military and construction booms, and the willingness of foreigners to invest heavily in the U.S. -- these factors are all being reversed. At the same time, the factors which are critical for long-term growth, such as saving and investment rates, productivity growth, the quality of education, competitiveness in world markets, etc., have all deteriorated. And, of course, we have borrowed heavily from the future -- we are now paying the price.

Oil and the U.S. Economy

A new factor has entered into the economic outlook for 1991 and perhaps beyond, namely the enormous uncertainty regarding oil prices resulting from the Iraqi invasion of Kuwait last August. The price of crude has nearly doubled following the invasion. The specter of higher oil prices brings back memories of the 1970's, when two oil shocks (the OPEC embargo in 1973 and the Revolution in Iran in 1979) were both followed by major recessions. The key question now of course is whether the same outcome is likely this time.

In order to answer this question and to assess the impact of oil price increases on the outlook for 1991, it is first necessary to review some basic aspects of the relationship of oil to the economy. First, as a result of conservation and improvements in energy efficiency, as well as some substitution to other fuels, the U.S. economy is far less sensitive to oil price increases now than it was in the 1970's. As a rough rule of thumb, a given increase in the price of oil will now have only about two-thirds of the effect on U.S. inflation, GNP growth, and employment than it did at that time. Secondly, the increase in oil prices thus far has been far less than it was back in the 1970's. In fact, over the seven year period beginning in 1973, the price of oil increased from about $3 a barrel to $40 a barrel -- or an increase of 13 times, far more than the near doubling in recent months. Furthermore, the level of oil prices in real terms is considerably lower now than after the run up in the 1970's -- the price of crude would need to rise to between $60 and $70 a barrel to be equivalent on a constant dollar basis to the $40 per barrel price of 1979. Finally, primarily because of large supplies, other energy prices have been relatively stable in recent months, unlike the situation in the '70's when the price of other energy sources rose considerably in sympathy with the increase in oil prices. In sum, barring dramatically higher prices, it is unlikely that the impact of the Iraqi invasion of Kuwait on U.S. economic activity will even approach the effects that were realized in the 1970's.

In addition, while uncertainties still remain and many scenarios are possible, further substantial increases in oil prices are unlikely because (a) the loss of Iraqi and Kuwaiti production caused by the embargo has been largely (though not completely) offset by increased production from other OPEC countries and elsewhere; (b) even an all out war in the Middle East is not likely to cause major permanent shortfalls in production, as was demonstrated by the long Iraqi/Iranian War; (c) energy growth was slowing, in part because of slower economic growth, prior to the invasion; and (d) both public and private inventories were very large when the current crisis began, providing a substantial buffer against production cuts. This reinforces the conclusion that the effects of the current oil crisis are likely to be significantly less than experienced in the 1970's.

One final difference between now and the 1970's is also important, namely the changing patterns of wage determination in the United States. One reason the recessions following the first two oil shocks were steep was because the increase in oil prices triggered a major acceleration in overall inflation, partly because it quickly spread to other energy sources, but mostly because the resulting increase in the inflation indexes was soon passed on in higher wages, which generated a new round of price increases, and ultimately a major wage-price spiral. This of course caused a dramatic increase in overall inflation, as well as big increases in interest rates directly resulting from that inflation and from Federal Reserve efforts to stop it.

It was these secondary effects on inflation and interest rates that caused a substantial part of the recessions under discussion. The situation today is quite different. In particular, the cost of living adjustments in most union contracts have either been watered down or eliminated. Furthermore, the top priorities for most companies in today's environment are to rebuild profit margins and to remain competitive in world markets -- both have led to strong efforts to hold down wages even at the expense of employee purchasing power. Thus, while inflation has increased dramatically as a result of the recent increase in oil prices, it will prove to be a one-time phenomenon rather than the onset of a continuing ratcheting up of inflation as was the case in the 1970's.

While all of the above is favorable, in the sense that it implies that the oil price increases thus far will not devastate the economy, there are a number of negatives that must be taken into account as well. First, as discussed earlier, the economy was extremely sluggish before the oil shock developed -- thus, even though the effect of the oil shock will not be enormous, it comes on top of an economy that was already weak, significantly increasing the risk of recession. Secondly, rising oil prices will combine with increases in the amount of oil imported (because of declining domestic production) to significantly increase the U.S. trade deficit -- in so doing of course, it will make it even more difficult for U.S. trade deficits to decline without either further downward pressure on the dollar or weaker demand in the United States. In my view, higher oil prices is thus another reason why it is imperative that the United States improve its productivity and competitiveness in the years ahead. Thirdly, while the rise in interest rates was substantially less than in the 1970's, long term interest rates did rise by about two-thirds of a percentage point following the Iraqi invasion, and remain significantly above previous levels. This not only will cause some additional weakness in the economy over and above the direct effect of higher oil prices and inflation, it also will aggravate long term problems by increasing the cost of capital.

Deficit Reduction, Interest Rates, and the Economy

The near term outlook will obviously also be impacted by the deficit reduction package now being put in place, as well as by Federal Reserve policy. The big questions, of course, are whether the Fed will follow its recent easing move with additional ones, and if so, how much of a decline in interest rates will occur and what will be the impact on the economy?

While I urge the Fed to continue to ease, and fully expect them to, the Fed's control over long-term interest rates is dramatically less now than it was in earlier periods. In fact, the direction of long-term rates will be determined more by what happens to the dollar on foreign exchange markets, by interest rates in Japan, Germany and other major industrialized countries, and by the flow of capital to other parts of the world, than by Federal Reserve policy. Given the conditions currently in place, particularly the declining trend of the U.S. dollar and the increased need for capital in other parts of the world, as well as still large federal demands for credit even with the deficit reduction package, it is unlikely that long-term interest rates will decline sharply. Furthermore, declines in interest rates will take far longer to impact demand than will the tax increases and spending cuts in the deficit reduction package. Finally, in my judgment, the impact of declining rates on demand will be considerably less than we have experienced in the past because (a) tighter lending standards will offset some of the easing, (b) those sectors of the economy that are most sensitive to interest rates are either overbuilt, or are characterized by limited pent up demands, and (c) debt levels are currently so high that many corporations and households are making a concerted effort toward reducing debt rather than expanding it. Thus, in my judgement, there is virtually no way that declining interest rates can offset the restraining effect that the deficit reduction package will have on the economy during the very near term. The fiscal package therefore will slow economic growth in the short term, even though I strongly believe it is necessary for the long term health of the economy.

Short-Term Economic Outlook

The major assumptions which underly my near-term assessment of the economy are as follows:

1. I am assuming that a negotiated settlement will occur in the Middle East, involving at least a partial Iraqi withdrawal from Kuwait and cutbacks in oil production by other OPEC countries, which will permit oil prices to stabilize in the upper $20's per barrel by early next year.

2. The deficit reduction package recently passed by Congress will be implemented; nonetheless, the deficit will still be close to $250 billion in the current fiscal year if thrift bailout costs are included, and will still be in the range of $150 billion per year during the middle of the decade unless additional steps are taken.

3. I believe that at least some modest additional declines in the U.S. dollar on foreign exchange markets are likely in response to weakness in the U.S. economy, to lower U.S. interest rates, to poor U.S. competitiveness in world markets, and to other international factors. In addition, I expect economic growth in the rest of the world to slow during 1991. The net effect will be about a 6% increase in real U.S. exports next year.

4. I expect the Federal Reserve to continue to gradually ease monitory policy in response to growing concerns about the health of the financial system. My best guess is that short-term interest rates will be about 50 basis points lower than they now are by next summer, and that long-term interest rates will be approximately 25 basis points lower.

In my view, the oil price increases and the deficit reduction package will be sufficient to convert the current softness in the economy into a moderate recession which is likely to last until late summer of 1991 -- as indicated earlier, I believe that this recession has already begun in the last month or two. My current estimate is that real GNP will decline between 1 and 1.5% during this period. However, I feel strongly that the risks are predominately on the downside, so that any recession which occurs later this year and during 1991 could be significantly deeper than I now expect. These major risks are as follows:

(a) It is possible that oil prices will not come down to the levels I have assumed but in fact could rise somewhat from current levels if a negotiated settlement is not reached and/or if an actual out-break of war takes place. Obviously, substantially higher oil prices would weaken the economy further in the months ahead.

(b) While consumer confidence has declined sharply in recent months, it has still not fallen to levels experienced prior to some earlier recessions. However, the sharp decline in property values, coupled with spreading layoffs, could cause confidence to erode further -- if this were to occur, consumer spending would be even weaker and a deeper recession would result.

(c) The problems in the financial system have now spread throughout the economy. While I believe that a financial crisis will be adverted, there is nonetheless some risk of major bankruptcies among financial institutions, and for that matter, in the non-financial sector as well. If such failures or bankruptcies were to occur, this could cause further caution among lenders, additional declines in confidence, and have other adverse effects on the economy, especially in view of the high debt levels which now exist.

Notwithstanding these risks, I believe the most likely outcome is that we will avoid a very deep recession, as I mentioned earlier. This in part reflects the fact that inventory levels do not appear to be excessive in most industries so that reductions in inventories are not likely to initiate a major downturn, the fact that interest rate increases in recent months have been relatively small in comparison with those that have preceded many other recessions, and the absence of any acceleration in the rate of inflation (excluding the oil price increases). Furthermore, order backlogs are still relatively high in a number of industries, in part reflecting increased export orders.

The recession now underway is only part of what is a generally poor picture of the U.S. economy. First, the economy has already been soft for more than 18 months -- thus, the coming recession follows what has already been a relatively long period of economic sluggishness, rather than following a period of more vigorous growth. Secondly, and most importantly, the evidence suggests that a strong recovery will not occur when the recession does end. This reflects the long-term structural factors that I have discussed previously; in particular, on-going fiscal restraint, a very limited pickup in new construction, and the adverse effect of still high private debt and tighter lending standards on consumer spending and business investment, suggest a prolonged period of very slow growth even after the recession ends. In effect, we are now paying the price, and will continue to pay the price, for some of the excesses of the 1980's, particularly the massive substitution of debt for equity, the stretching out of maturities on consumer loans, the overlending to real estate, extremely high government borrowing, growing dependence on foreign capital etc., all of which will require a longer adjustment period than in the past. As a result, I believe that we are now about 18 months into what will turn out to be an extremely long period of very low average growth -- the recession only compounds the problem.

Policy Recommendations

Unfortunately, the policy options available at the present time are extremely limited, primarily because appropriate steps were not taken when economic growth was stronger. Nonetheless, I would suggest the following:

1. The focus of monetary policy should be to ease as much as possible when conditions permit. While this is not likely to result in strong economic growth, it will at least provide some cushion against the risk of a very severe recession. I believe such Federal Reserve policy is warranted not only because the major responsibility of the Fed is to maintain a viable financial system, but also because the inflation risks are way overstated. While it is true that some of the inflation measures have not shown much improvement so far this year, it is clear that most of the inflation is in healthcare, college tuitions, and other services which are generally unrelated to general economic conditions. And commodity prices, and prices of most assets, are rapidly declining. Furthermore, part of the inflation problem in the United States reflects weakness in productivity growth -- this can only be cured in the long term by more investment, which will not take place unless the cost of capital is reduced.

2. I believe the focus of fiscal policy in the years ahead should be to build for the future by not only continuing to reduce budget deficits, but by doing so in a way that will promote more research and development, investment, infrastructure spending, etc. This implies a continuing shift in spending priorities away from the military and entitlements toward those type of expenditures that in the long run raise productivity and improve our competitiveness in world markets. And changes that are made in the tax structure should be made with the same goals in mind.

3. In my judgment, trade policies will take on new significance in the 1990's since a significant improvement in our trade position is absolutely essential to offset weakness in domestic demand, to counter the impact of higher oil imports on our trade deficit, and to enable the U.S. to eventually begin to pay-down our foreign debt. Achieving better trade performance obviously will depend mostly on improving productivity growth in the United States and strengthening our competitive position in world markets. However, trade policy may be important as well -- while I strongly support the efforts now being made to open up

foreign markets for U.S. agricultural products and for the export of various services, it is important to remember that a major turn-around in trade will require strengthening of U.S. manufacturing. With this goal in mind, the focus of U.S. trade policy in the year's ahead should be to continue to press for opening of foreign markets for U.S. goods and for prevention of foreign penetration of U.S. markets that results from dumping, foreign subsidies, or other unfair trade practices.

Representative SOLARZ. Thank you.

There seems to be a disconnect between your prognosis and your persona. Throughout this economic dirge I detected smiles. [Laughter.]

Almost as if you were deriving some kind of vicarious professional satisfaction.

Mr. CHIMERINE. I am just a happy guy, Congressman Solarz. [Laughter.]

No, that is not the case at all.

Representative SOLARZ. What do you look like when you deliver good news? [Laughter.]

Mr. CHIMERINE. I am trying to overcome the perception that economists are dismal. It may be a dismal science, but not all economists are dismal.

Representative SOLARZ. All right.

Mr. Kudlow, please proceed.

STATEMENT OF LAWRENCE A. KUDLOW, CHIEF ECONOMIST AND SENIOR MANAGING DIRECTOR, BEAR, STEARNS & CO., INC.

Mr. KUDLOW. Thank you, Congressman Solarz.

There are some points on which I agree with Larry Chimerine, but not many, although I confess my views are not entirely as optimistic as they normally are. So it is kind of good news and bad news.

Let me touch on, since Larry Chimerine touched on most of the negatives with respect to current business conditions, there are some positives, and actually I would argue to some extent the economy has proven to be a bit more durable and resilient in the last year than a lot of forecasters thought.

There has been a lot of recession forecasts out there, a lot of recession forecasts for many years. It hasn't panned out, and I have no doubt that at some point in my lifetime there is going to be a recession, and it wouldn't surprise me if the current quarter, the fourth quarter, because of the oil price arithmetic which is going to drive inflation probably to 8 or 9 on the GNP deflator and that may well push real income and real output into negative territory.

But I am not so sure that the 1991 outlook is recessionary, and if it is, I think that it would be a very mild, shallow-type recession. Not a happy occasion, but not necessarily the worst thing in the world. We cannot repeal the laws of the business cycle.

On the other hand, more positively, I would note that there are some areas of balance in the economy which are important, particularly in the areas of money and prices. Normally, recessions and especially deep recessions are preceded by sharp increases of inflation. That was the case in the 1960–70 recession, the 1973–75 recession, and the 1981–82 recession. All three of those were preceded by major runups of inflation, and in the case of the last two cycles, double-digit inflation. We don't have that now.

The GNP deflator, a reasonable measure of inflation, has been running around 4 percent for the last four or five, I guess almost six quarters. And in fact, all during this expansion cycle, 1982 to 1990, the deflator has been running, although sometimes higher, sometimes lower, about 3.5 to 4 percent. It is a very good performance, at least in the last 20 years, it is very good.

And therefore, we have not seen, with respect to capital goods spending or inventory spending or commodity investment, we have not seen major imbalances, major speculative inflation-driven misallocation of resources. We have not seen that. And that adds an element of balance.

The second point, with respect to market interest rates, the rates are too high, in my judgment. And my hope is that fiscal and monetary policies can help rates to decline in the next year or two, notwithstanding rates are still very moderate.

Normally, deep recessions are preceded by a sharp runup of interest rates. We have not seen that. In fact, while I agree with Larry Chimerine that the economy has been hanging on by its toenails, if you will, in the last year or two, interest rates have actually descended, on balance. They have come down. Short-term rates since the winter of 1989 are down about 2 full percentage points. Treasury bills, Federal funds, bank CD's. And that has added an element of stimulus into the economy.

Longer term rates, on balance, have descended by less, by a half percentage point, although you can go back to 1987 when 30-year Treasury bonds were 10 percent, and they fell to 9 percent and they remained at 9 percent for most of 1988 and the early part of 1989, and then they descended to 8 percent. Last winter they jumped for a moment to about 9.25 percent, and I think during the oil shock they got as high as 9.25 percent, and now they are down below 8.70 percent in recent days.

So that is all right. On balance, long-term rates have declined by about a half a percentage point, while short rates, as I said, have declined by about 2 percentage points. So that's OK. In fact, I would regard the movement of interest rates in the last year or so as on the whole stimulative to the economy. We may want to discuss the role of the Federal Reserve at some point.

But that is where I would put that, and if I look at measures of liquidity such as the money supply, on this point, too, I think we have had a mildly stimulative policy. The Fed tends to track M2 for their targeting purposes, so I will use that aggregate. On a year-to-year basis, M2 was as low as 2.5 percent in the middle of 1989. Today, currently it is running about 5 percent, just under 5 percent.

So on the whole, the monetary situation in a quantity sense has also been mildly stimulative and typically preceding recessions, especially deep recessions, you expect to see historically either a large contraction in the growth of money or possibly in the decline in the level of money. We haven't found that either. We have seen an increase in the expansion of money. Rate of increase has gone up.

So that strikes me as mildly stimulative and in an inflationary environment which is very stable, the question of oil prices, which is vexatious because I agree with Larry Chimerine the industrial and economic conditions today surrounding the oil shock are different than they were 10 or 15 years ago. But on the whole, excepting for the arithmetic, which may give us a negative quarter this current quarter, I don't think the structure of prices generally for all goods and services has been affected by the oil shock in any significant way other than the plain CPI-PPI arithmetic which will last a few months and then probably recede.

On this point, commodity indexes have been relatively flat for the better part of the last 2 or 3 years, and there has been no major change in the last 3 or 4 months. If you use the widely followed Commodity Research Bureau index of spot of futures prices, which includes food and agriculture, includes industrial prices and includes metals and precious metals, it has been in the range of 220 to 240. I think at the close of business yesterday it was 229, not much change at all.

In the 1970's when we had oil shocks, the commodity indexes soared as did the price of gold. And the price of gold has also been very steady, centering around $370 or $380 for the better part of the last couple of years and including the summer and fall. I think it got as high as $420, as low as $360, but no major move there.

So I think with respect to price expectations as embodied in these commodity measures, sensitive commodity measures, I don't see any oil impact whatsoever. And my guess is even though both households and businesses have taken a defensive position with respect to cutting spending and cutting costs as we work through the Middle East situation because of the uncertainty, and I don't have any particular wisdom on the politics or the diplomacy, I see this as a very limited economic effect at least in macro terms, very, very limited.

Furthermore, I would note that inside the economy there are corrections taking place which suggest we are moving toward better balance rather than away from it. There is a deleveraging effect with consumers and businesses, trying to bring down their debt liabilities. We have seen quite a decline in the rate of increase of both consumer and corporate debt in the last 2 years, and actually that step seems to have started on the consumer side in 1987 following the Tax Reform Act of 1986, which began the process of reducing and eliminating various consumer-type tax deductions.

And with respect to corporations, I think there are some problems and issues in the business sector in corporate debt. However, here too companies are taking strong steps to reduce their borrowing. The data show very clearly that corporate borrowing has come down substantially. Loan demand is very, very weak as inventories have been pared back. And I think on the whole that is very good, it is very healthy, and it is part of the normal correctives involved in a market-oriented economy.

Business inventories are very low. Normally a deep recession is preceded by a sharp runup of inventories, which is part of the inflation speculation. We have not had that. Either business managers are a lot smarter in this cycle or they are using computer technology and information technology more readily and rapidly, or both.

It strikes me that the purchasing agent on the front line is a lot closer to the financial people in the front office because of computerization. And overall inventory, the sales ratios are as low as they have been in, I think, 8 or 9 or 10 years. That is certainly not a problem, and suggests balance in the economy rather than serious recessionary-type problems.

Janet Norwood talked about the weakness in manufacturing jobs. I agree with her, of course, that the data show that very clearly. But I would add one other wrinkle. I mean part of the slump in manufacturing came about because of an extreme profit squeeze, particularly in 1989. But as an ongoing story, unrelated to the profit squeeze, the manufacturing sector in this country has been downsizing and cost cutting for many years to respond to competitive global pressures. And therefore their productivity rates have been very strong throughout the 1980's. Indeed, the United States compares quite favorably with any of our foreign competitors in this area.

And I suspect as profits are actually improving in manufacturing, they were actually positive in the second quarter, and I haven't received them, the data are not out for the third quarter yet, there is still some employment cutting, some cost cutting at all levels—white collar, blue collar, and so forth—in order to try to produce more output with fewer costs. And that is a story that is true in France, Germany, Britain, Japan, and Korea, just as it is true in the United States. I think it is very good.

One measure nobody has talked about this morning is industrial production, which is the measure of output. Industrial production has actually been accelerating. The low point on the year-to-year basis was January, when production was negative, and it has slowly been raising to a year-to-year growth rate of about 2.5 I believe, 2.7 percent, through the month of September.

I don't know if we can hold those levels, because I am worried about the fourth-quarter activity, but this idea of producing more with less is a very important competitive global theme. American companies have responded very well.

Again, on the consumer debt side, I mentioned that they were deleveraging. An awful lot of people in the investment community are very worried about consumer debt. I think those worries themselves are positive because that means everybody will think about that. It would be worse if nobody thought about it.

On the other hand, I want to note or make my usual plea before this committee and other sessions this year—and you have not been in the chair for these sessions—but my plea is to employ double-entry bookkeeping. I actually don't know much about accounting. Most economists don't. But if we are going to look at the liability side, we should also look at the asset side. And the fact remains, throughout the 1980's that releases from the Federal Reserve and the Commerce Department have shown repeatedly that consumer asset values have increased significantly in the 1980's, even with the slump in property values of the past year and consumer wealth has therefore risen substantially.

And my argument is that creates a cushion, a reserve cushion to tide them over during the slump period, and it is not all bad. Again, it creates a better sense of balance.

So on the whole my reading of the economy is we would probably have a negative fourth quarter, but I think the situation is relatively more balanced than many do, and I think on the whole the monetary situation is mildly stimulative, and I think that we can achieve modest expansion of growth in 1991.

My guess is that real growth could rise by 1.5 or 2 percent from the end of 1990 to the end of 1991. It is not great; I am not satisfied with it. Some higher unemployment is going to go along with that. But at least it isn't circa 1933, which is what some of the mood swings in the investment community and the media have suggested.

I have a lot of concerns, however, about the budget bill, and most particularly the tax pieces of the budget bill. I have concerns about the spending side, but I am less familiar, the final numbers haven't come out yet or if they have I haven't seen them. I told this committee in July that I thought it was the wrong time to raise taxes as the economy was weak, on the cusp of recession.

I want to repeat that point of view: My judgment is the tax piece of this bill was a mistake. And in particular, I used the phrase "animal spirits," where I argue that risk capital and entrepreneurship were at low ebb. New business formation, which was responsible for 90 percent or more of the jobs created in the 1980's, has been slumping. According to Dun & Bradstreet, since 1986 new business incorporations have dropped by 21 percent. In the prior 6 years they had increased by 65 percent. I think that is a big problem, new business. And my judgment is raising payroll taxes, raising income tax rates, and the like will not be helpful to that situation.

What is more, I think the economic assumptions underlying this budget agreement are highly flawed. My judgment is we are not going to achieve our fullest economic potential because of the increase in average marginal tax rates and payroll tax rates and the overall rise in the tax burden. This is of enormous concern to me. It is a major threat.

The economy expanded from 1982 through 1990, the third quarter at least, at a 3.4 percent annual rate, and it was a good show. I don't think that we are going to get that kind of growth in the 1990's under this direction of tax policy.

Representative SOLARZ. Mr. Kudlow, I don't want to cut you short, but I would like to conclude the hearing before the recession ends, or 11:30, whichever is sooner, because I do have another engagement, and Mr. Straszheim I assume would like to make a contribution. And if time would permit, I would like to ask a few questions. So if you could possibly conclude.

Mr. KUDLOW. I would be happy to stop. I don't want to crowd out any of my colleagues. We can pick up all of this up. I think I have made my principal points. Thank you.

[The prepared statement of Mr. Kudlow follows:]

PREPARED STATEMENT OF LAWRENCE A. KUDLOW

At the crucial point where economic policy intersects with actual real world economic conditions, the recently completed budget deal clearly missed a significant opportunity to stimulate stronger growth by strengthening incentives for capital formation, work effort and production. Instead a sizable increase in personal tax-rates and overall tax burdens summing to about $18 billion in 1991 and $137 billion over 5 years poses a serious threat to already sagging confidence levels and the longer term path of U.S. output. In my judgement the budget deal places U.S. fiscal policy on the wrong path.

A capital gains tax-rate reduction would have substantially helped real estate and new business formation, where in both cases the principal investment return is payable through capital gains at point of sale. The sad tale of falling commercial and residential property values is already well publicized. A tax reduction here would unlock sizable capital gains generated since the mid 1970's. The reinvestment of these gains would have reliquified the entire financial system -- including banks, thrifts and insurance companies -- and stopped the hemorrhaging of collateralized loan values.

Less well known, however, is the contraction of net new business formation. Since the capital gains tax-increase in 1986 new business incorporations have dropped by 21% according to Dunn and Bradstreet. This follows a remarkable period from 1980 to 1986 when new business incorporations increased by 65%, or 53,000 per month, coming to an average of 636,000 per year. More than 90% of all new jobs created in the 1980's came from these newly started businesses.

Over the past four years the combination of a deteriorating dollar exchange rate, a rising inflation rate and a 40% hike in the capgains tax -- without relief from indexation or the

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deductibility of capital losses -- has completely stifled the animal spirits of capital risk-taking and entrepreneurship. Yet the Congress and the Administration, in their wisdom, have chosen to provide no relief on this vital front. Instead, $40 billion in higher taxes, and an average effective marginal tax-rate increase from 28% to 32%, were placed on upper income citizens who are the economic activists, those most likely to take entrepreneurial risk and those who are the primary suppliers of capital necessary to start new business venture.

What's more, policymakers have failed to recognize the suppressant effects on working family households of the last two increases (1988 & 1990) in the Social Security payroll tax-rate, amounting to roughly $50 billion. This has reduced the after-tax reward for work effort and it has lowered disposable income necessary for consumer purchases. Instead the budget deal raises the payroll tax by another $30 billion by lifting the cap on medicare. For self-employed business owners and others, this combination of payroll tax increases over the past three years substantially raises the cost barrier of new employee hires.

On top of this, a $25 billion increase in the gas tax, falling in the wake of a 49% rise in the price of gasoline, which itself generated a roughly $40 billion tax equivalent increase, will also pose a significant burden on working families and small businesses. All told, of the $18.3 billion net taxes raised in 1991, $8.5 billion or 41.1% will fall on the middle class ($20,000-$75,000), $3.8 billion or 18.4% on the affluent class ($75,000-$200,000) and $8.4 billion or 40.6% on the wealthy (over $200,000).

As I testified before this Committee last July 12, with the economy standing on the cusp of recession, this is the wrong time to raise taxes. I know of no economic theory which argues that higher taxes are the antidote for a slumping economy; neither Keynesian, nor monetarist nor supply-side. Therefore, in view of the tax policies recently adopted by the Administration and the Congress, the economic outlook is fraught with major risks.

First, over the near-term, there is substantial risk that higher taxes will further damage consumer confidence. The consumer confidence survey published by the New York Conference Board has plummeted by an unprecedented 40% in just the last two months. This index has been steadily declining since mid 1989, and thus it is not surprising that real consumer purchases have advanced at a slow 1% annual rate over the past four quarters.

Related to this, residential fixed investment has contracted by 4.2% over the past year and by 13.3% over the past two quarters. Housing starts and building permits have dropped to their lowest levels in eight years. Remarkably, car sales have held steady at close to 7 million units at an annual rate, and retail sales have accelerated to a 4.9% annual rate of gain for the three months ending in September. But as weekly unemployment claims have in just the last two reported weeks jumped 59,000 to 454,000, its highest level in over 7 years, and a sure harbinger of a sizable rise in the civilian unemployment rate, it is hard to see how rising tax burdens can possibly help the situation.

Despite the substantial economic threat generated by the newly legislated package of tax increases, it still remains true that the economic growth agenda put in place in the 1980's has not yet been fully dismantled. Certainly compared to the misguided policies of the 'Seventies, the U.S. economy is generally de-taxed, deregulated and disinflated. Despite a considerable outpouring of pessimism from the investment community, a careful reading of key indicators continues to suggest that the domestic economy is more resilient and durable than many observers think.

At present the underlying inflation rate remains moderate, as shown by the 4.0% average increase of the GNP implicit price deflator reported over the past five quarters. While fourth quarter inflation is likely to rise temporarily to around 8%, and this is likely to squeeze real income and real output into negative territory, the calm and stable behavior of gold prices and sensitive commodity indexes do not suggest that the oil price shock has damaged expectations for the general structure of domestic prices for all goods and services.

Long term Treasury bond yields have actually descended from 9% to 8.7% over the past three weeks, another healthy sign of the limited impact of the oil shock. Meanwhile short-term interest rates, including federal funds and Treasury bills, have dropped by nearly 2% over the past 18 months, indicative of a gradual shift in Federal Reserve policy from significant restraint to moderate stimulus.

Money supply (M2) growth has increased from 2 1/2% in May 1989 to just below 5% recently, also corroborating the injection of high-powered liquidity into the banking system. Not surprisingly, with loan demand quite weak in the slumping economy, this added liquidity is reflected in bank balance sheets by an increase in the ratio of total bank securities to total bank assets from 14% to 16%, while the growth of total bank assets (a proxy for bank credit) has stabilized around 6%, roughly in line with the moderate growth of nominal GNP.

These stabilizing developments in the area of money, credit and prices suggest that the extreme pessimistic view on the economy may be wrong. Perhaps the combination of self-correcting forces within the economy, such as the trend toward de-leveraging of consumer and corporate balance sheets, along with a relatively low business inventory level in relation to sales, as well as the absence of skyrocketing inflation and interest rates, foreshadow the possibility of moderate economic expansion next year rather than continuing and deepening recession. Perhaps. But the Congress and the Administration have taken a tremendous risk with the decision to significantly raise taxes.

Over the longer-term, this risk is substantially magnified. The decision to raise the top average marginal tax-rate from 28% to 31%, with another 1% increase from the loss of exemptions and the tightening of deduction, represents a sizable rollback of incentives to producers and investors. Instead of keeping 72 cents on the marginal dollar, economic activists will have to settle for 68 cents. This amounts to a 5.5% reduction of incentives which over time will render the economy less efficient by constraining the supply of labor, capital and output.

From 1954 through 1989, real GNP in the U.S. economy increased at an annual rate of 3.0%. When tax rates were high in the 1950's and 1970's, output dropped below trend. When tax-rates were lowered in the 1960's and 1980's, real output jumped above trend. Although no one can be sure of the exact marginal tax-rate needed to maximize economic growth and budget revenues, research suggests that the increase from 28% to 32% on the top average marginal tax-rate will move the future path of real GNP below 3% in the years ahead.

Assuming a 5.5% loss of incentive, the growth of potential real output drops from 3.0% to 2.8%. Measured in constant 1982 dollars, by 1995 the level of real output is projected to reach $4.773 trillion on the 2.8% path instead of $4.812 trillion on the 3.0% path. Over the 5-year period 1991-95, the cumulative output loss totals $101 billion. Since the growth of real output closely parallels the growth of employment, the 2.8% output path would lead to a cumulative jobs loss of 1.1 million by 1995.

These calculations substantially undermine the economic assumptions of the budget. Despite the significant rise of tax-rates, the budget summit agreement assumes average real GNP growth of 3.3% during the 5-year policy horizon. This is nearly identical to the 3.4% average rate of real output growth from 1982 to 1990, a period of sharply reduced tax-rates. More realistically, an increase of tax-rates will reduce economic efficiency and lower the output path to 2.8%, bringing down projected 1995 output by a cumulative $300 billion from the summit baseline, for an estimated 1995 budget deficit $66 billion deeper than deficit path assumed in the budget agreement.

Beyond this output shortfall, the scarcity of goods brought on by the higher top tax-rate will render the assumed stock of money to be more inflationary. Taking the budget agreement's assumption of 6.8% nominal GNP growth from 1991 through 1995, the combination of real output and prices will not be as fortuitous as the 5-year average estimates of 3.3% output and 3.4% inflation. Because higher tax-rates and reduced incentives will limit the supply of output over the next 5 years to 2.8%, then 6.8% nominal GNP growth will generate about 4% inflation over the forecast horizons.

In turn, this suggests that the interest rate assumptions embodied in the agreement are wildly unrealistic, since actual and expected inflation are the major determinants of interest rates. Rather than an average Treasury bill rate of 4.8%, 6.5% is sufficiently optimistic. Rather than an average 6% Treasury bond yield, 8% is far more realistic. This suggests that outlays for net interest expense will be $79 billion higher than projected by 1995. Combined with the $66 billion deficit increase from reduced output, by 1995 the total deficit should be raised by $145 billion. In terms of the so-called "consolidated deficit" used in the original summit budget agreement, these calculations would turn a $68 billion deficit originally projected for 1995 into a $213 billion deficit, very close to the $220 billion deficit just published for FY 1990.

Apart from the narrow point of the unrealistic economic assumptions in the budget, and the view that lower output, higher inflation and higher interest rates are inconsistent with deficit reduction, the broader principal issue is this: taxes are the wrong medicine. The wealth of nations has never been enhanced through rising tax burdens. We cannot tax ourselves into prosperity, or higher saving, or international competitiveness. The Congress and the Administration have embarked on the wrong path.

And you are sending the wrong signals to a weakened and anxiety-ridden economy. Already the public suspects that next year Washington will be right back with another significant tax hike. This is all a clear breach of faith. In 1986 the tax reform bill phased out numerous deductions in return for impressive tax-rate relief. Now the deductions continue to be eliminated, but tax-rates are being raised.

This is a policy which will prevent the U.S. economy from ever reaching its fullest potential. It is a policy which will never resolve the deficit. It is a policy which will only magnify the sense of public distrust concerning the Federal government.

Representative SOLARZ. Mr. Straszheim, please proceed.

STATEMENT OF DONALD H. STRASZHEIM, CHIEF ECONOMIST AND FIRST VICE PRESIDENT, MERRILL LYNCH CAPITAL MARKETS

Mr. STRASZHEIM. I have a prepared statement I would like entered into the record. My views are my own and do not necessarily represent those of my employer.

The data this morning on employment are convincing. I think we are in a recession. It seems to me we are getting what Federal Reserve Chairman Greenspan called cascading evidence of the weakness in the economy. The question which really is relevant now, it seems to me, is: What is the length of this recession, what is its depth, and how and when does it end? I think that those are very difficult questions to answer, more so this time than normally is the case.

Oftentimes, we economists are concerned about housing, inventory levels, and the real-side variables in the economy. Conventional sorts of analyses often suffice. Now, I think that the risks are different. They are financial sector risks, a real chance of a financial accident of some sort which could make the downturn worse. These are hard areas to gauge, difficult to see the pathway through the economy from these financial difficulties.

We could end up with, if a whole host of those areas went wrong, the longest and most severe recession in the postwar period. I am a betting man, and I will bet that this downturn is more average size, but I think there are greater risks and higher variance around the possible forecast outcomes now than is typically the case.

What I would like to spend my time on this morning is a variety of these special factors, in particular, banking and commerical real estate, oil and the Mideast and what that might mean to us, the State and local budget dilemma, comments about the Federal budget mess, and then last I would like to conclude with a quick comment about the 1990's.

It seems to me the 1990's are likely to be the slowest growth decade since the 1930's. And I will say something about that.

Representative SOLARZ. Do you think you can do this in 10 minutes?

Mr. STRASZHEIM. I will come pretty close, Congressman Solarz.

Representative SOLARZ. Thank you.

Mr. STRASZHEIM. First, if you would take a quick look at my prepared statement, the graphics labeled "exhibit F" deal with the banking sector, the banking sector difficulties. I have more copies here if you need them.

The banking sector is in, it seems to me, its worst shape in a long time. The data on exhibit F only go through calendar 1988. But 1989 was clearly worse, off the top of the chart in both cases. And 1990 is indeed going to be substantially worse yet.

It seems to me that the Achilles' heel of the banking sector is commercial real estate. In exhibit G of my prepared statement, the bottom chart shows that the banks now have more real estate loans outstanding than they have conventional commercial and industrial loans, the first time in the history of our banking system that this is the case.

The reason this is important, it seems to me, is that there is a lot of damage already being done in commercial real estate, and I think that much more is to come.

Let me show you one area. We talked before about the regionality of the economy. Let me just refer you to exhibit H of my prepared statement. Exhibit H shows what is going on in the Massachusetts economy. The commercial vacancy rate, office vacancy rate, in Massachusetts is not really appreciably higher now than it was in about 1985. But the dotted line in exhibit H reveals that employment gains in Massachusetts are lagging the United States by about 5 percentage points.

That State has done no better than the national average since late 1984. It has been sinking fast since late 1987. And you can cross out Massachusetts from the label on this chart and substitute New York or New Jersey or Rhode Island or Connecticut, and they all would look essentially the same.

It takes solid economic growth to take up unused office space. We don't have that kind of solid growth, and I think we have a significantly worse problem to face in the years to come than we have seen already. All you have to do is look around the Nation and you can identify the three major commercial building booms of the 20th century. The first, in the 1920's, was those buildings of granite, with thick walls, small windows and so forth. There was little building in the 1930's and the 1940's until the 1950's. At that time, what you had was the rectangular square, steel girders, big glass windows, very functional buildings and so forth. Again, little building in the 1960's and the 1970's until the 1980's.

And now, we have this enormous boom in the 1980's spawned, first of all, by the 15-10-5-3 accelerated depreciation rules in the 1981 tax law which allowed people to depreciate these buildings with an economic life of 40 years over 15 years. A variety of other changes in the tax law in 1981 encouraged the same thing.

And then in the second half of the 1980's there was really no loan demand in the bank sector from either agriculture, from energy, from rust belt, so the banks went into this in a big way. The bottom line is we are badly overbuilt in the cities in this country. We had booms in the 1920's, the 1950's and the 1980's. And it looks to me about 2010 will be the next time that we can again expect something like this.

The next concern is oil and the Mideast. If you would turn quickly to exhibit A of my prepared statement. I think that there is a high variance again in terms of where we will end up in oil prices and, accordingly, its effects on the overall economy. Our assumptions are $31 a barrel for oil in the first half of 1991 and about $25 a barrel in the second half of 1991. But it is easy for one to conceive of oil prices being anywhere from $16 to $66, depending upon the kind of screnario one wants to paint regarding the various outcomes in the Mideast.

I would refer you also to the chart above the table on the top of exhibit A, which shows gasoline taxes in the United States and various industrialized economies around the world. I was struck by the most recent debate on the budget which finally ended up with a 5-

cent-a-gallon tax hike, when the gasoline tax in most industrialized countries around the world is anywhere between $2 and $5 a gallon. Enough said about that topic.

Exhibit E of my prepared statement refers to the State and local budget dilemma. I think that this is a problem that has not received the attention that it deserves. In the top chart on exhibit D, the dotted line reveals the operating budgets. The operating budgets in the 50 States and all of the localities around the country in aggregate are in worse shape now than any time in our recorded history. And there are, as a consequence, enormous changes that are going to have to take place. It is going to require difficult choices: either higher taxes, lower spending, or some combination thereof. And this area is, I think, going to drag down the economy as well.

Exhibits I through K refer to the most recent budget deal. I just refer you to exhibit I, the budget estimates made by our Presidents during the last 15 years. That is the dark line. And the little lines that angle up into the right with the date behind them are the longrun estimates made by our Presidents during the last 15 years as well. They never turn out right. It is no wonder that the public is cynical about the kinds of decisions that are made in Washington.

Exhibit J reveals to me a major part of the problem, which is what I regard as the unrealistic economic assumptions which again underlie the budget. The 1990 and 1991 numbers seem to me to be plausible, but for 1992 through 1995, it is blue sky forever, 4 years of growth culminating in 3.6 percent growth in 1995, with inflation falling under 3 percent, the 13-week T-bill at 4.2 percent and the 10-year Treasury at 5.3 percent.

These are a fantasy. The problem, of course, is that with an economy weaker, revenues will not be what has been anticipated. With interest rates higher than this, interest costs are going to be dramatically higher than anticipated. And while I am sure there is plenty of pride in the changes in the budget process in the caps on spending and all the rest, it is these untouched-by-human-hand scenarios that I think are going to ultimately frustrate the budget. I anticipate us coming back some years in the future to face much more difficult budget decisions.

The last point I want to refer to is shown in exhibit L of my prepared statement, my point about the 1990's being the slowest growth decade since the 1930's. The top table shows our GNP potential. The 1990 number of 2.5 percent growth is a widely held number. Federal Reserve Chairman Greenspan has talked about that one, and I show there the components thereof: labor force, productivity, and the workweek, and so forth.

The 1965 number, 4.3 percent, is a number used by the Council of Economic Advisers 25 years ago. The slowdown in the labor force is due largely to demographics. It is a separate item.

But the slower growth in productivity, it seems to me, is the result of self-inflicted wounds. It is due to 25 years of incoherent budget policy in which we encouraged consumption and discouraged savings and investment. It is due to 25 years of neglect of our educational system; 25 years of neglect of our infrastructure.

I see no evidence that we are going to turn this around any time soon. We have penciled in here a set of numbers for the year 2000 which suggest to us that our growth rate is going to continue to slow to something under 2 percent.

It seems to me that these are all manmade problems, all man solvable if we would simply get about making the hard choices in terms of spending priorities and the tax laws and so forth. I am hopeful but, I must say, not expectant.

As this recession ends—recessions come and go, this one will too, perhaps later in 1991—we will all be looking for a period of rapid growth. I suspect that our growth will be better than during the recession period, but I would not look for a period of very rapid growth. I would look for a basically slow-growth environment throughout the whole decade of the 1990's.

[The prepared statement of Mr. Straszheim follows:]

PREPARED STATEMENT OF DONALD H. STRASZHEIM

I am delighted to appear again before the Joint Economic Committee to discuss the condition of the economy. The views expressed here are my own and do not necessarily represent that of my employer.

Summary Points

- The U.S. economy fell into recession approximately coincident with the invasion of Kuwait by Iraq. The oil price rise will magnify the severity of the downturn—but is not the cause of it.

- The best bet is that the downturn will be about one year in length, which is the average length of a recession in the postwar era. The risks, however, that the recession could be the most severe of the last half century are substantial.

- All downturns are different, and the key problem areas to watch now are oil prices and the Mid-East, the FDIC banking squeeze and the associated commercial real estate excesses, the state and local budget dilemma, and the general high level of leverage in our economy.

- The budget spectacle in Washington has led to another sharp drop in confidence—in both the general public and in the business/financial community—in our ability to manage our economic affairs. There is an international element to this dismay as well. The budget outcomes will be worse than advertised because the economic assumptions are again unrealistic. And again, little attention was paid to long-run growth incentives.

- The prospect is that the 1990s will be the slowest growth decade since the 1930s.

The Economy in Recession

The U.S. economy has been advancing sluggishly since the second quarter of 1989, and has now fallen into recession. We anticipate that the recession will last through mid-year 1991, making this downturn approximately average sized as post-war recessions go. The evidence of recession is all around us, but the prospects for the next year are quite mixed across sectors.

- Consumers face rising gasoline prices, flat—at best—home values, and talk of cost-cutting and hiring freezes at the workplace. These are the elements of a sharp consumer contraction, and a weak holiday selling season is to be expected.

- A similar set of concerns confront business—a possible recession, oil sector fears, confusion in Washington, and weak sales—indicating poor capital spending prospects.

- Housing activity is already so weak that there is further additional downside risk in this sector.

- Inventories are excessive in some industries, but are not broadly out of line with sales.

- Trade should hold up reasonably well with the dollar having declined sharply and better export markets. The dollar is expected to decline even more which should benefit our exports.

There are a variety of trouble spots in the economy which look bad indeed, and there is perhaps a higher risk than normal that this downturn could cumulate into a most serious recession. However, the best bet is that all of the worst events will not ccme to pass, leaving this cyclical episode rather average in both depth and duration.

The two risks most ominous are oil prices and events in the Mid-East, and the problems in banking and finance.

The embedded cost-push inflation rate is now about 5-to-5 1/2% and a recession may reduce the inflation rate to near 4%. Unfortunately, the prospects of more progress than that would likely require a much deeper recession than now looks probable.

The oil price rise is elevating the current inflation statistics, but this can be regarded as an episode unlikely to be broadly built into our overall wage and price structure. We are assuming $31 per barrel oil prices in the 1991 first half, and $25 per barrel in the 1991 second half—admitting the chance that prices might be either far above or far below these assumptions.

While the goal of zero-inflation is a laudable one, the experience of the 1980s should have taught us that the cost of attaining that goal will be high indeed.

Corporate earnings are likely to be under severe downward pressure through 1991 in this weak economic environment.

Interest rates should be declining into mid-1991, with the Federal Reserve persistently easing monetary policy in an effort to blunt the size of the recession. The Fed this week pushed the Fed Funds rate from 8.0% to 7.75%, and we anticipate them easing to 6.50% by roughly mid-year 1991.

In this environment, long-term interest rates are likely to fall, but perhaps one-half as much. The rise in interest rates overseas is a contraint—but not an absolute floor—on our rates. Our dependence on foreign capital inflows and the budget mess in Washington remain factors holding our interest rates higher than they would otherwise be.

The dollar is likely to continue its erratic decline over the next year as U.S. economic activity is depressed, as U.S. interest rates remain low relative to abroad, and as Japan and Germany pursue tight monetary and loose fiscal policies. A renewed dollar crisis could happen at anytime, causing joint central bank intervention. The U.S. manufacturing sector should hold up relatively well in the current economic weakness, supported largely by trade.

The cyclical circumstances of the "real" measures of the economy (housing, inventories, etc.) do not look especially ominous. It is other vulnerabilities (oil, financial, etc.) that likely pose the greatest risk. These problems also are the most difficult to gauge.

Oil and the Mideast

The recent difficulties in the Mid-East highlight our oil import vulnerability and put into hgh relief the fact that 17 years after the first OPEC embargo we still have no national energy policy. The recent difficulties with raising the gasoline tax is instructive. The table (Exhibit A) shows how much lower energy taxes are in the U.S. than elsewhere in the world. Our import dependence is once again over 50% and at its highest level ever (Exhibit B). The question arises whether the U.S. citizenry will stand for a major ground force involvement in the Mid-East when we have no energy policy at home.

Depending upon the scenerio chosen for these Mid-East events, it is conceivable that oil prices this time next year might be $16 a barrel or $66 a barrel—or anywhere in between. Unfortunately, this is a major source of uncertainty in the economic outlook.

Note also that the inflation-adjusted gasoline price is near its lowest level of the past quarter century (Exhibit C).

State and Local Budgets

The "operating" budgets of the 50 states and localities throughout the nation are farther in the red now than at anytime in the past half century (Exhibit D). The problem is clear. State and local spending has been rising between 2% and 4% annually for the last eight years, and federal grants-in-aid have fallen from 16% to 10% of the federal budget since 1980—and are headed sharply lower in the years to come (Exhibit E). The result is that many state and local governments are going to be facing the difficult choice of either raising taxes, cutting spending, or some combination thereof in the coming years. Both actions are inherently contractionary and could both prolong and deepen the recession.

Banking, FDIC, and Commercial Real Estate

FDIC data reveal the serious problems in banking (Exhibit F). Profitability in the banking business has been seriously eroded in recent years and the FDIC system is under severe strain (Exhibit G). The Achilles heel of the banks is their exposure to commercial real estate which is now at its highest level in history.

One characteristic of the present economic circumstance is that the economy's condition is highly varied across regions. Exemplifying the worst conditions is the situation in Massachusetts. While the commercial vacancy rate is no higher than in the mid-1980s, the economy is sinking rapidly, with employment growth lagging that in the U.S. overall by over 5 percentage points (Exhibit H). Since a better regional economy is not in prospect, this region's problems are most certainly going to get worse before they get better.

The commercial real estate excesses now troubling the economy can be traced to the 1981 tax law and to the mid-80s difficulties in agriculture, energy, and the rust belt. The workout of our commercial real estate difficulties will not likely be completed until some time in the next century.

Many of our largest banks are now hobbled with bad loans in high-yield, commercial real estate, and to lesser-developed countries. Their profitability is gone, and many are backing away from their conventional lending businesses. While the extent of the banking industry problems is difficult to gauge, we may face the necessity of major regulatory changes, consolidation in the industry of an unprecedented degree, and "shot-gun" weddings engineered by regulators. In such an unsteady environment, economic activity may be one of the victims.

The Budget Mess

The recent budget debate has been a spectacle of unparalleled proportion, further solidifying the feeling both here and abroad of the business and financial community that we are unable to make the hard choices necessary in good governance. The changes in the budget process are a step forward. And the tax and spending changes will give us a lower deficit than would have resulted from a series of continuing resolutions. And, these changes, taken in isolation, will tend to slow an already weak economy—although I believe them necessary in the long run for deficit reduction. However, there are a variety of reasons to be skeptical about the recent budget deal.

The history of the budget estimates of the Presidents all the way back to the Budget Impoundment and Control Act of 1974 reveals a recurring pattern of budget shortfalls—no wonder the public is skeptical (Exhibit I).

Part of the problem relates to the economic assumptions which underline the budget. While the near term estimates for 1990 and 1991 are plausible, the 1992-1995 estimates are not. I know of no forecaster who believes that 1995 will culminate a four-year period of growth in excess of 3.5%, with inflation under 3%, and Treasury bill rates falling to 4.2% and 10-year Treasury notes falling to 5.3%. This problem is not new. The economic assumptions of our Presidents have been too optimistic for years (Exhibit K).

If the economy is weaker than assumed, the revenues generated will fall short of projections. And if interest rates are higher than assumed, interest costs on the national debt will exceed present projections. The end result is clear. Even if the new spending caps and other budget procedures work perfectly, we will once again face even tougher budget choices than we have just faced.

Slow Growth in the 1990s

While recessions come and go—the current one will too—the 1990s promise to be the slowest growth decade since the 1930s. Our GNP potential can be thought of via the contribution made by labor force growth, productivity, and the average workweek (Exhibit L). The 1965 figure was a consensus figure used by the Council of Economic Advisors at the time, and the 1990 figure is widely agreed to and has been mentioned by Federal Reserve Chairman Greenspan at various times. The labor force slowdown is largely demographically driven. But the majority of the decline is in slower productivity growth. It is the result of a quarter century of tax policies that encourage consumption and discourage savings and investment, and a similar period of neglect of our infrastructure and our education system.

My own sense is that unless there is a dramatic change in our outlook on economic management—and I see no reason to expect such a change—our GNP potential by the year 2000 will be down to somewhere below 2% annually. We do not have a budget crisis—we have a chronic condition. The "opportunity cost" of this slowdown is enormous, and it is in this context that the budget matters, the deficit matters, and the savings rate matters. These problems are all man-made and man-solvable if we would just get about doing it.

The budgetary steps taken last week were a constructive first step. They were necessary but not sufficient.

Exhibit A

Retail Oil Price Profile of Key Industrial Nations

BEFORE AND AFTER THE IRAQ INVASION OF KUWAIT

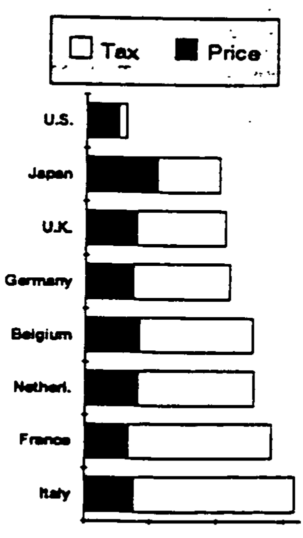
(US $ Per Gallon Except As Noted)

GASOLINE:	Tax* Included	Tax Excluded	Pre-Invasion Excl. Tax	Cumulative Price Increases Gallon	Cumulative Price Increases Barrel
Italy	$6.33	$1.52	$1.10	$0.42	$17.64
France	$5.63	$1.35	$0.88	$0.47	$19.74
Netherlands	$5.09	$1.63	$1.22	$0.41	$17.22
Belgium	$5.06	$1.67	$1.18	$0.49	$20.58
Germany	$4.38	$1.49	$1.05	$0.44	$18.48
U.K.	$4.24	$1.57	$1.15	$0.42	$17.64
Japan	$4.06	$2.19	$1.69	$0.50	$21.00
U.S.	$1.26	$1.01	$0.82	$0.19	$7.98
HEATING OIL:					
Italy	$3.85	$1.07	$0.76	$0.31	$13.02
France	$1.87	$1.17	$0.86	$0.31	$13.02
Netherlands	$1.75	$1.12	$0.83	$0.29	$12.18
Japan	$1.41	$1.41	$1.07	$0.34	$14.28
Germany	$1.33	$0.98	$0.76	$0.22	$9.24
U.K.	$1.29	$1.18	$0.78	$0.40	$16.80
U.S.	$1.22	$1.19	$0.95	$0.24	$10.08
Belgium	$1.19	$1.02	$0.73	$0.29	$12.18

* Tax component estimated by The Oil Daily based on IEA data. Includes excise taxes, duties and VAT, but not general sales taxes.

Note: Oil prices ex tax compiled by The Oil Daily primarily based on U.S. Energy Information Agency Data.
Price changes include impact of currency fluctuations.

Gasoline



Heating Oil

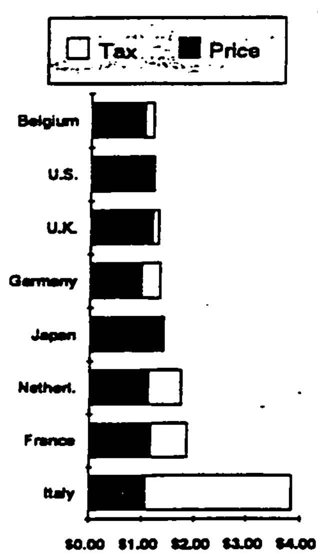
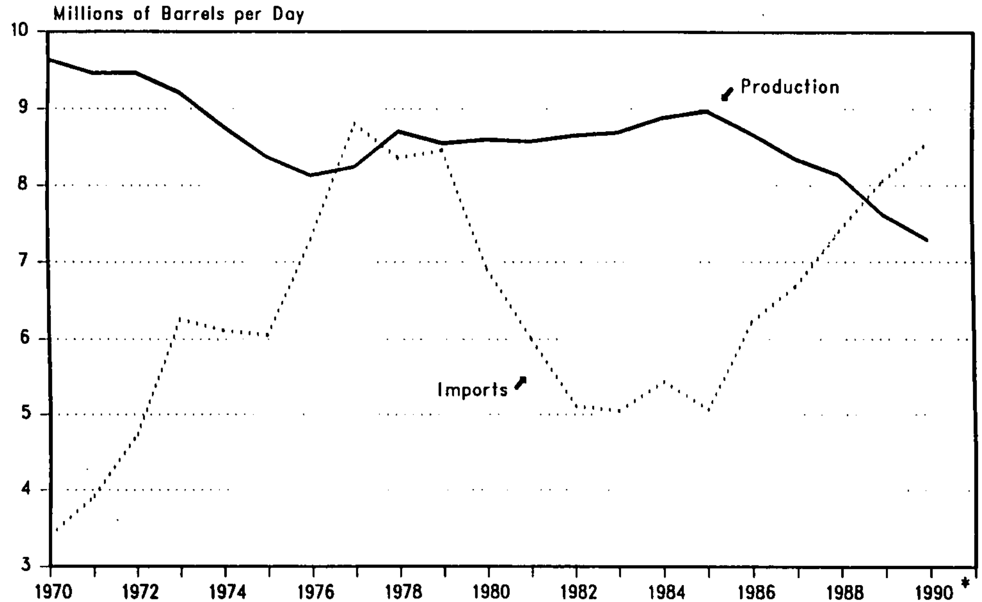


Exhibit B

Oil Production Down, Import Vulnerability

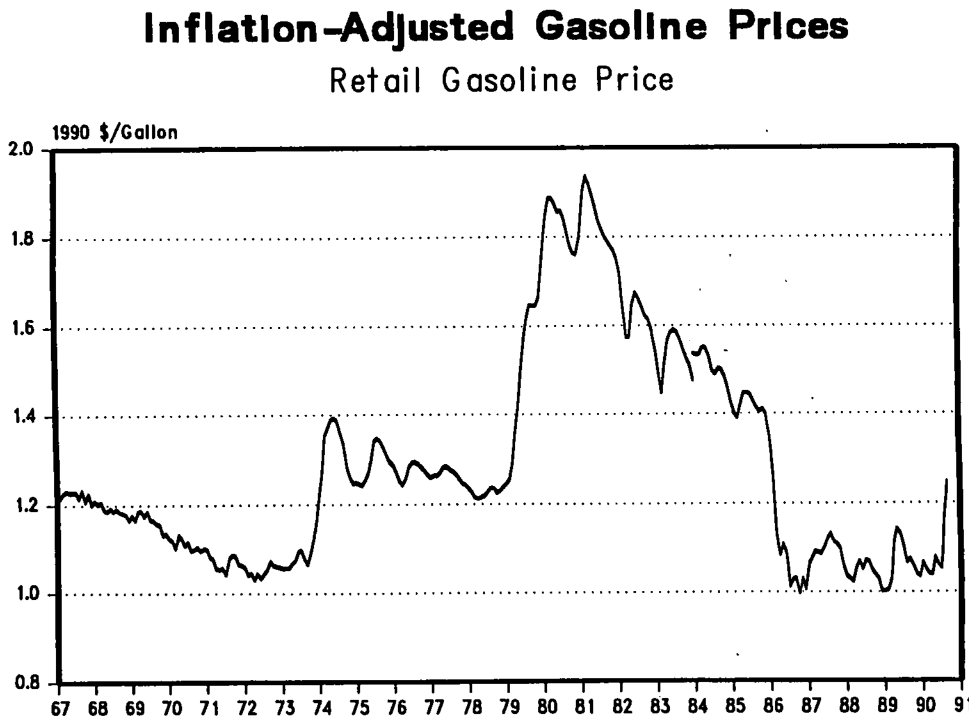
Domestic Production vs Imports



SOURCE: American Petroleum Institute.

* Through August 1990

Exhibit C

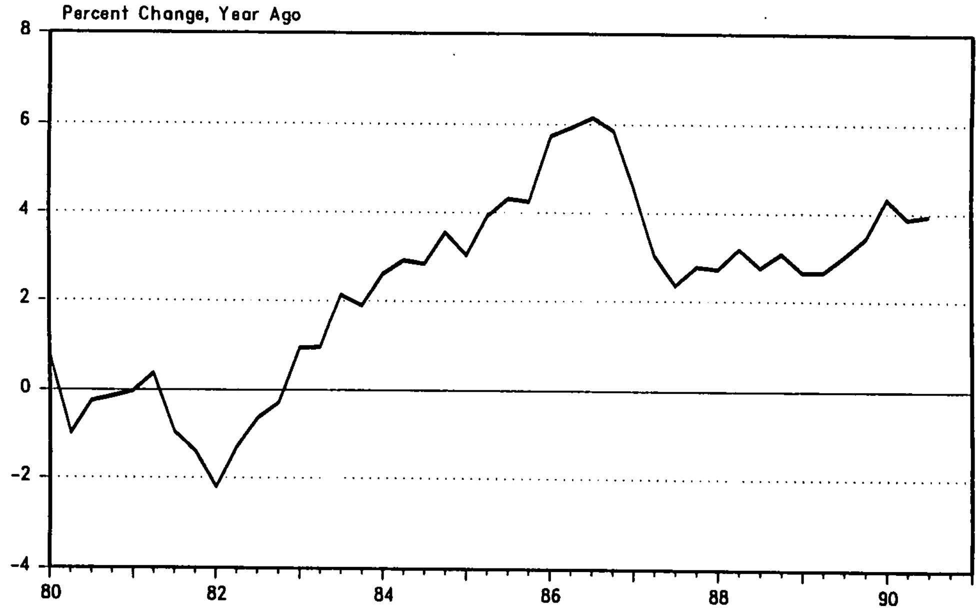


SOURCE: Department of Labor, Oil & Gas Journal

Exhibit D

Rising State & Local Spending

Total Real State & Local Outlays

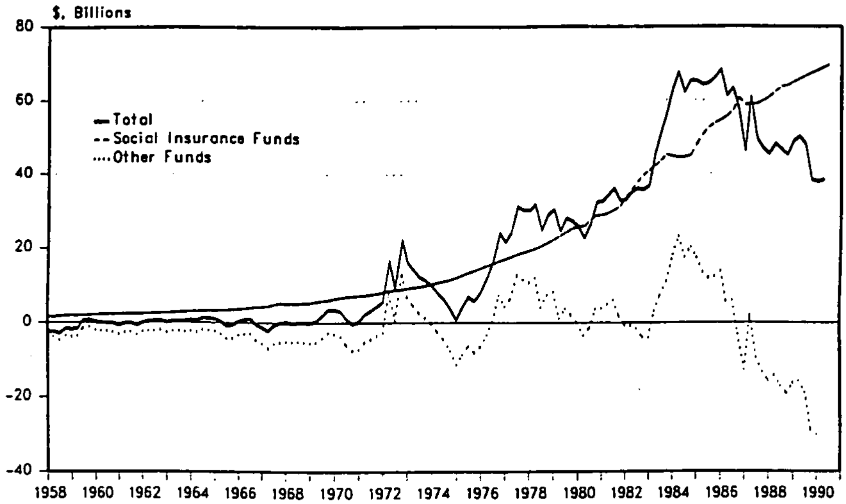


SOURCE: Bureau of Economic Analysis.

Exhibit E

State & Local Budget Situation

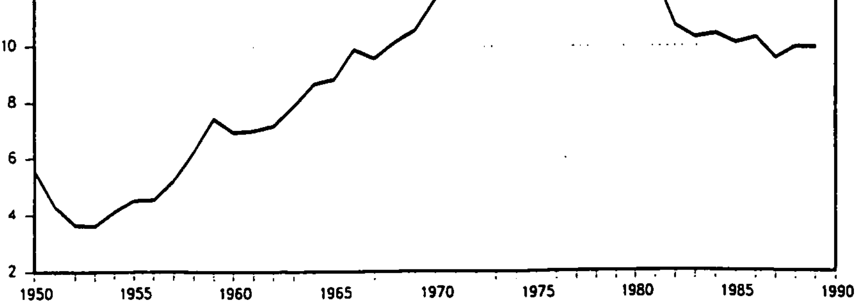
Total, Social Insurance Funds, & Other



SOURCE: Bureau of Economic Analysis.

Fewer Federal Grants-In-Aid

As Percent of Total Federal Budget

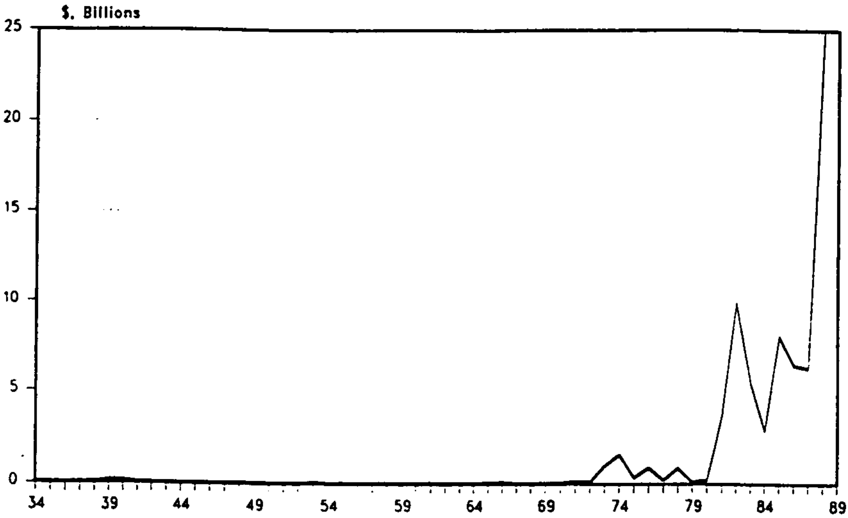


SOURCE: Bureau of Economic Analysis.

Exhibit F

Deposits at Closed Banks

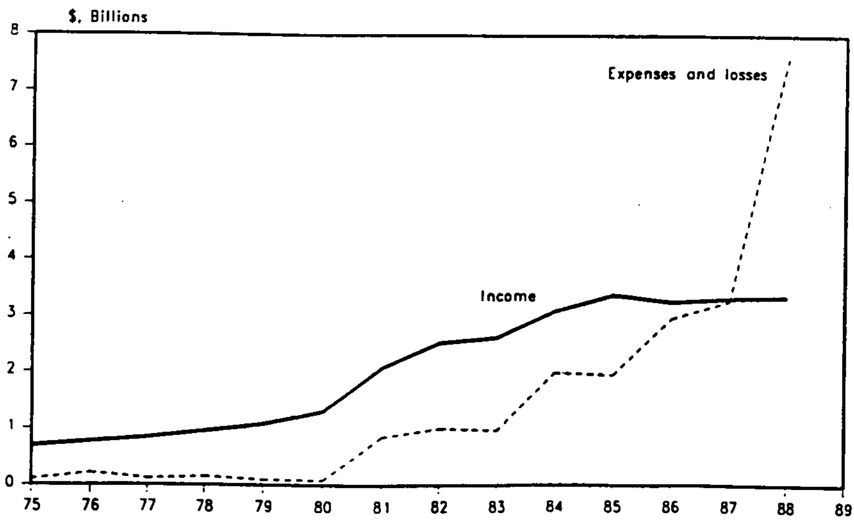
Deposits at Banks Closed for Financial Difficulties



SOURCE: Federal Deposit Insurance Fund.

The FDIC Squeeze

Income vs Expenses and Losses

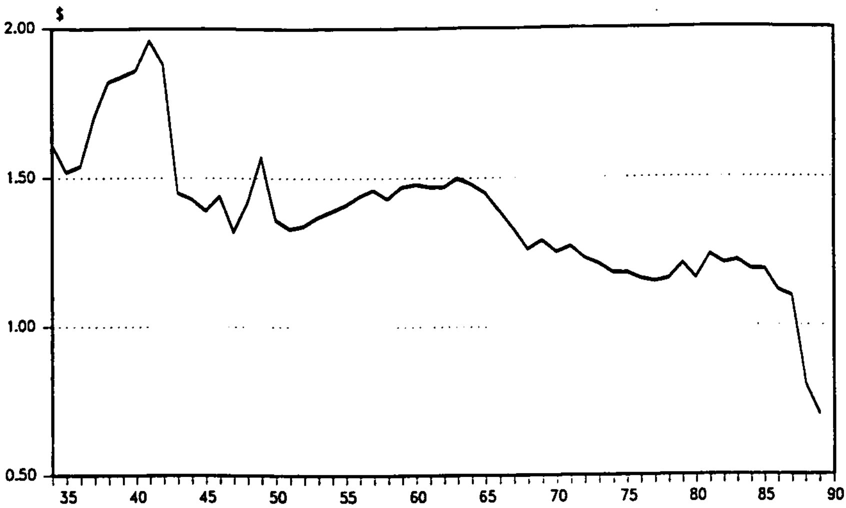


SOURCE: Federal Deposit Insurance Func.

Exhibit G

FDIC Deposit Insurance Plummets

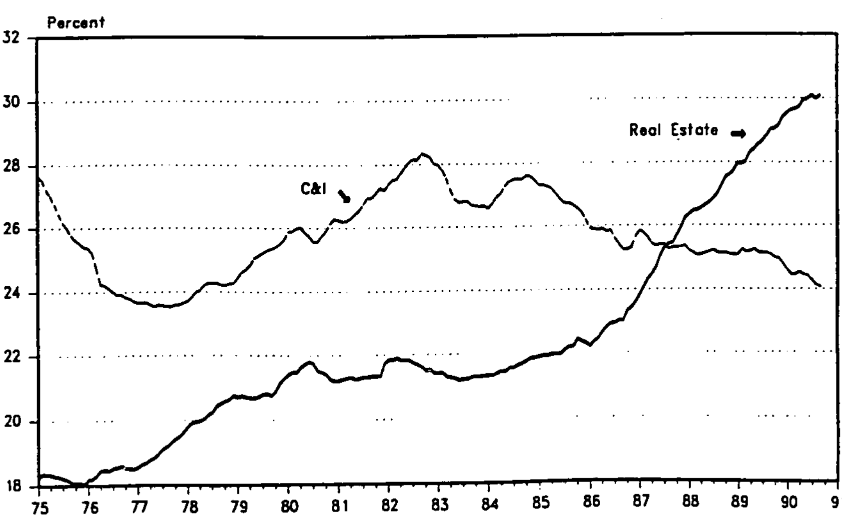
Ratio of Deposit Insurance Fund to Insured Deposits



SOURCE: Federal Deposit Insurance Fund.

Real Estate Loans vs C&I Loans

As a Percent of Total Bank Loans

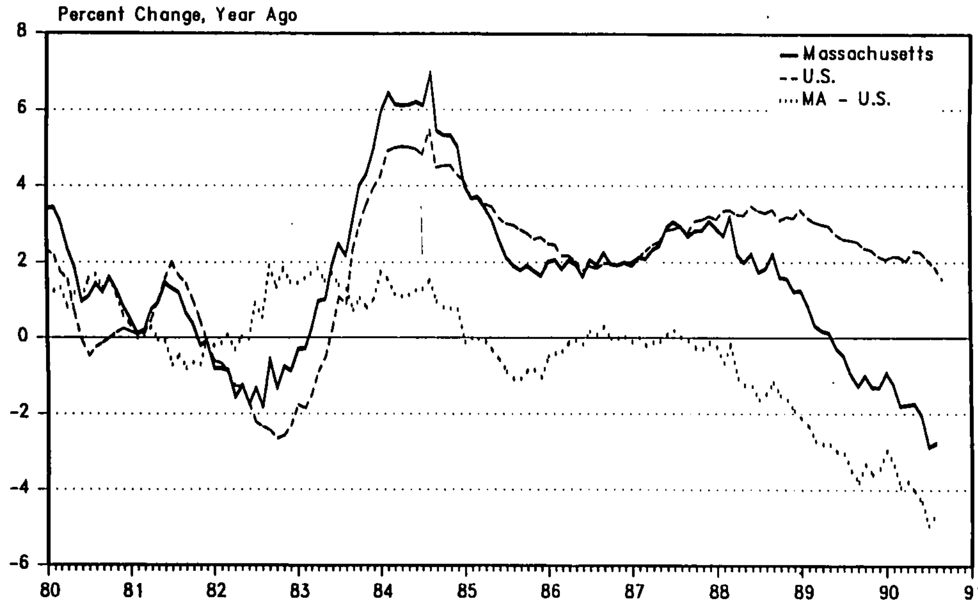


SOURCE: Federal Reserve Board.

Exhibit H

Massachusetts Employment

Massachusetts minus U.S. Employment Gains

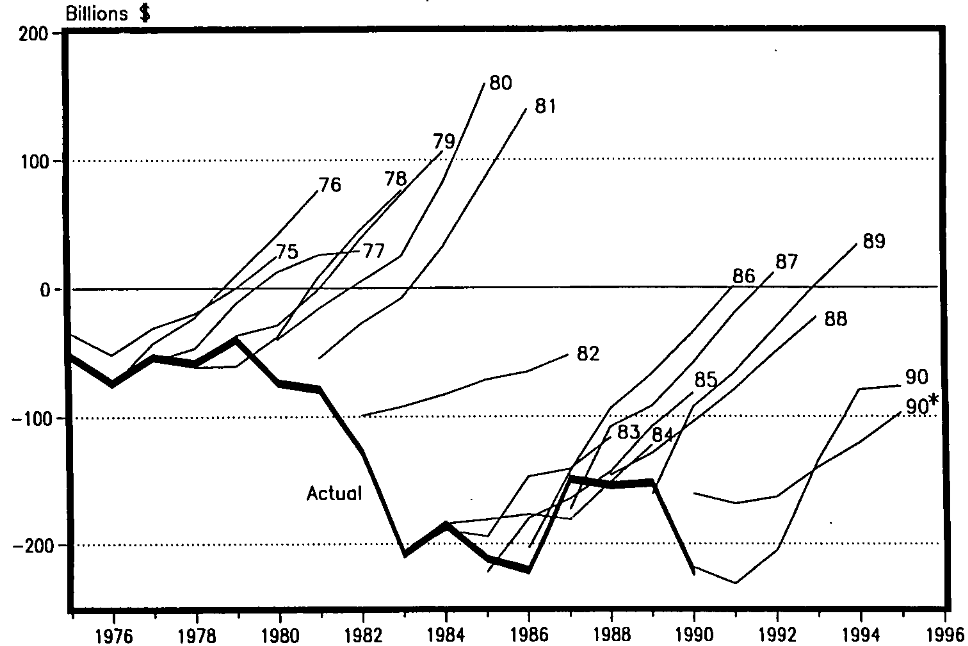


SOURCE: Bureau of Labor Statistics.

Exhibit I

Budget Estimates of the Presidents

Surplus or Deficit



SOURCE: Office of Management & Budget. * does not include RTC

Exhibit J

BUSH ADMINISTRATION ECONOMIC ASSUMPTIONS (as of 10/1/90)

	1989	1990	1991	1992	1993	1994	1995
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Real GNP *	1.8	0.7	1.3	3.8	4.1	3.7	3.6
GNP Deflator *	3.7	5.2	4.6	3.4	3.2	3.0	2.8
Unemployment	5.3	5.6	6.1	6.4	5.6	5.3	5.1
13-Week T-Bills	8.1	7.7	7.2	5.7	4.9	4.4	4.2
10-Year T-Notes	8.7	8.7	8.3	7.1	6.1	5.6	5.3

* fourth quarter to fourth quarter

SOURCE: Office of Management and Budget

Exhibit K

Economic Assumptions of the Presidents: Real GNP (% Change)
Calendar Years

Date & Source	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
2/75 Ford	-3.3	4.8	5.6	6.5	6.5	6.5															
1/76 Ford		6.2	5.7	3.9	6.5	6.5	6.5														
1/77 Ford			5.2	5.1	5.9	5.5	3.9	3.5													
1/78 Carter				4.7	4.8	4.8	5.0	4.7	4.2												
1/79 Carter					3.3	2.5	4.2	4.7	4.4	3.4											
1/80 Carter						-0.6	1.7	4.3	5.0	4.9	4.7										
1/81 Carter							0.9	3.5	3.5	3.7	3.7	3.7									
2/82 Reagan								0.2	5.2	5.0	4.7	4.4	4.3								
1/83 Reagan									1.4	3.9	4.0	4.0	4.0	4.0							
2/84 Reagan										5.3	4.1	4.0	4.0	4.0	3.9						
2/85 Reagan											3.9	4.0	4.0	4.0	3.9	3.6					
2/86 Reagan												3.4	4.0	4.0	3.9	3.6	3.6				
1/87 Reagan													3.1	3.5	3.6	3.6	3.5	3.4			
2/88 Reagan														2.9	3.1	3.5	3.4	3.3	3.2		
2/89 Bush															3.2	3.2	3.3	3.2	3.2	3.2	
2/90 Bush																2.4	3.2	3.2	3.1	3.0	3.0
7/90 Bush																2.2	2.9	3.3	3.2	3.1	3.0
10/90 Bush *																1.2	1.5	2.7	3.7	3.5	3.4
Actual	-1.3	4.9	4.7	5.3	2.5	-0.2	1.9	-2.6	3.6	6.8	3.4	2.7	3.4	4.5	2.5						

Source: Budget of the U.S. Government, various years.

* Real GNP annual percentage change calculated by Merrill Lynch

Note: Reading across any row shows the assumption of a particular president made on the specified date for the next six years.

Reading down any column shows the various growth assumptions for a particular year made over the space of six years.

Exhibit L

Our GNP "Potential"

	1965	1990	2000
Labor Force	1.8%	1.3%	1.0%
Productivity	2.7	1.4	1.0
Workweek	-0.2	-0.2	-0.2
Total	4.3	2.5	1.8

Real GNP Growth

00's = 4.6%
10;s = 1.5
20's = 2.7
30's = 2.1
40's = 4.3
50's = 3.2
60's = 2.9
70's = 2.8
80's = 2.8
90's = ?

Representative SOLARZ. Thank you very much.

Mr. Chimerine and Mr. Straszheim, in no more than 2 minutes each, can you tell us why you believe we are in a recession, and then Mr. Kudlow, perhaps you can tell us, based on what they have said, why you disagree.

Mr. CHIMERINE. I think it is coming out of the data and partly the information I am getting that isn't yet reflected in the data. What we are seeing in jobs, profit performance, new order rates, the declining trend in retailing, when you add all of that up it means that, at this point anyway, the economy is declining. And that to me is the way you define recession.

Now, are you asking why we are having it or what evidence is there to support it?

Representative SOLARZ. At the moment, just whether we are in one. And you have given your answer.

Mr. Straszheim.

Mr. STRASZHEIM. The consumer sector is two-thirds of the economy. I think that is as far as you really need to look. The consumer goes to the gasoline station and finds that gas prices are up 30 cents a gallon in the last 3 months.

The consumer goes to the cocktail party. Whereas 2 years ago the talk was, "Did you hear how much the house down the street sold for?" The talk now is, "Do you realize how many houses are on the market, none of which are selling?"

The consumer, as worker, goes to the office or the factory, and hears cost cutting, hiring freezes, and cutbacks. This is not the environment in which people add a deck on the back of the house, replace the carpeting or buy a new car.

It is a hunker-down sort of mentality. And precisely the same sort of conditions are relevant in the capital spending sector as well. Business sees the slowing response of consumers. They are concerned about what has been going on in Washington. They don't know what is going to happen in the Mideast either. That also is a hunker-down, be cautious, be conservative mentality.

Representative SOLARZ. I was under the impression that the technical definition of a recession is two or three quarters of negative growth. But the information we seem to be getting, all of this anecdotal evidence which you both cited notwithstanding, is that the latest figures continue to indicate the GNP is increasing, however modestly, rather than decreasing.

If that is the case, how do you respond to the argument that maybe some sectors of the economy aren't doing so well but overall the economy insofar as it continues to grow is not yet in a recession.

Mr. CHIMERINE. It is a question of definition, obviously, Congressman Solarz. First of all, that it is pretty clear to me the economy is now declining and, as a result, at least fourth-quarter GNP will be down. Now, we can speculate about next year. So by the standard definition, I think that a recession has already started because I think this will extend into next year.

But as I said earlier, and in fact you mentioned in your opening remarks, we have had seven quarters now of barely any growth whatsoever, ultimately reaching the point where labor markets have softened dramatically and, as a result, if we get one or two quarters of decline in GNP following such a long period where we have had marginal growth, that would qualify as a recession.

So I think that—was it Gertrude Stein, whoever you quoted from—this is a recession. It feels like one, and it will be verified in the data in the months ahead because it appears right now that the economy is falling quite rapidly.

Mr. KUDLOW. It is still a forecasted recession because you're right, this year for the first three quarters real GNP grew 1.3 percent at an annual rate.

Representative SOLARZ. In real terms?

Mr. KUDLOW. In real terms, adjusted for inflation. It is not adequate growth, but it is growth, slow growth. And my argument is very simply, No. 1, the consumer is not dead, slow but still walking. Actually, retail sales have accelerated, and so have car sales.

No. 2, the capital goods area is still rising. Shipments are holding at a very high level. Nondefense capital goods shipments.

No. 3, we have had stimulus from net exports, and I expect more stimulus. The dollar is very low, and as I said, we are quite competitive globally.

No. 4, we have had mild monetary stimulus for the past 12 or 15 months from the Federal Reserve.

No. 5, the inflation-interest rate situation is balanced.

No. 6, consumers have a cushion of asset and wealth accumulation which will get them through the slump.

And I think these factors do not necessarily add up to a recession yet. But I will reiterate my earlier point. What bothers me most about the outlook is the tax increase in this budget bill which may threaten consumer confidence. It may threaten consumer confidence. And on that point I agree with Larry Chimerine, consumer confidence is quite fragile at the moment.

Representative SOLARZ. Whether or not we are actually in a recession, I gather you will agree the economy leaves a lot to be desired and there are aspects which are a source of very serious concern. I assume, Mr. Kudlow, even you would agree that there is a very real possibility of a recession.

Mr. KUDLOW. Yes.

Representative SOLARZ. The other witnesses would argue we are already in one. I would like to ask each of you once again, briefly, about what you think we can and should do to either get us out of this recession as quickly as possible or prevent it from occurring in the first place. Do you have any thoughts on this, or are we at least in the short term the unwilling victims of larger economic forces which we cannot realistically hope to affect? Is there anything we can do that would really make a difference; and if so, what is it?

Mr. CHIMERINE. I think our flexibility is extremely limited because we didn't address some of the problems when we had the opportunity to do so in recent years. I agree with Larry Kudlow, this is not the best time to raise taxes.

We should have done it when the economy was stronger, throughout the 1980's, when it was clear to anyone who looked at the numbers carefully and made honest, objective assumptions that we still had an enormous deficit problem that would in fact get worse. But we didn't face up to it when we should have, and as a result we have very limited flexibility right now.

The only thing I would suggest is that the Fed ease as quickly as they can to provide some cushion against the risks.

Representative SOLARZ. Forgive me for interrupting, but from a macroeconomic point of view, is there any significant difference between an increase in taxes and a comparable reduction in spending?

Mr. CHIMERINE. Very little. To some extent, there is a marginal tax effect on incentives, but that has been overstated for years. Both of them will restrict the economy in the short term. And what disturbs me is we are going to be in this mode for years and years, of cutting spending and raising taxes to reduce deficits.

Representative SOLARZ. If we focus for a minute not on the longer term economic challenges and problems confronting the country, but rather on the short-term consequences of a recession, you are saying that the one thing that can realistically be done that could cushion the blow, as it were, would be to reduce interest rates?

Mr. CHIMERINE. Yes. To the extent the Fed can, to the extent that long-term markets permit them to do so. I think the inflation scare is way overblown. The health of the financial system requires some easing. And that is about the only thing in the short run that can be done.

Representative SOLARZ. Mr. Kudlow.

Mr. KUDLOW. I would make four points: No. 1, do not force the Fed into premature easing or easier money. Instead, let the Fed operate to gradually lower the inflation rate, which will permanently lower interest rates. Easy money right now will backfire, in my view.

No. 2, Congress and the administration should stay away from burdensome cost increases on businesses with respect to regulatory initiatives. This is a growing concern to me.

No. 3, I would like to see us resume tax reform, which I understood to be a reduction of marginal tax rates in return for an elimination of tax deductions and subsidies. It seems to me that we are going in the wrong direction now. We are taking the deductions away and we are raising rates.

And finally, No. 4, as far as the spending effect is concerned, Congressman Solarz, I do not see any traditional Keynesian suppressants, because my reading of the preliminary budget numbers is that in 1991 the rate of overall budget spending is going to rise significantly over the level of 1990. And as I learned the Keynesian multiplier in college, you had to reduce the level of spending. All this budget has done is reduce the rate of increase from an inflated baseline. So I did not regard spending as a threat. So I would say lower inflation, less regulation, and more progrowth tax reform.

Representative SOLARZ. Mr. Straszheim.

Mr. STRASZHEIM. On the fiscal side it seems to me our hands are tied. We have just gone through this 5-month-long budget process. Economists typically will prescribe fiscal stimulus, lower taxes, increased spending and so forth, to try to lift the economy. That is not an option, it seems to me, right now.

In terms of monetary policy, the other real lever we have, I think it would be appropriate for the Federal Reserve to continue what I think they have already started, which is a series of gradual easing moves of the kind that cut the Fed funds rate earlier this week from 8 to 7.75 percent. I think that was an appropriate measure. It looks to me like we ought to see the Fed funds rate maybe coming down over the next 6 or 9 months from 7.75 to 6.5 percent. That will gradually lift the economy.

Representative SOLARZ. After listening to you all, I am tempted to say that what we really need in this country is not a limitation on the number of terms Congressmen can serve but the number of years that economists can stay in their profession. You disagree as much, apparently, as we do around here.

Let me ask you to compare the impact on the economy of the budget agreement that we came up with to the impact on the economy of a sequestration if we had not reached such an agreement.

Mr. CHIMERINE. It would be considerably less, Congressman Solarz, because as I remember the numbers, sequestration would have cut spending by $80 billion or $85 billion in the current fiscal year. And regardless of whether you believe in spending cuts, tax increases, or whatever, there is no way that the effect of the deficit reduction package in the short term will come close to full sequestration in terms of holding back the economy in the short term.

Mr. KUDLOW. I advocated a partial sequestration of approximately $40 billion.

Representative SOLARZ. I am asking what do you think would have happened to the economy if the full sequestration required by law had taken place?

Mr. KUDLOW. As I understood the numbers, particularly after the huge baseline change around the Andrews Base summit meeting, a full sequestration would have taken the level of all total budget outlays in 1991 back to roughly 1990 levels. Therefore, it would have had a neutral impact on the economy because we would not have cut the prior year's level.

In other words, cuts from the baseline are not real cuts in the level of spending. And my view is that had we gone to a full sequester, we would have merely taken away the projected increase in the baseline but we would not have cut into last year's level of spending.

Representative SOLARZ. Mr. Chimerine.

Mr. CHIMERINE. I don't disagree with what Larry Kudlow just said. I think that in real terms, it would have meant a significant cut in Federal expenditures in the current fiscal year compared with last year; $90 billion would wipe out most or all of the nominal increase and meant a substantial cut in real terms.

Mr. STRASZHEIM. It seems to me the budget deal was a contractionary measure. We raised taxes; that is going to hurt the economy in the short run. The spending side is much more questionable, of course, because of the cuts from preprogram levels and whatnot. It seems to me the sequester would have slowed the economy more in the short run than the budget deal.

Representative SOLARZ. So both of you think that sequester would have had more negative consequences for the economy in the short run?

Mr. KUDLOW. I do.

Mr. CHIMERINE. Absolutely.

Representative SOLARZ. And in the long run, which do you think is better for the economy?

Mr. STRASZHEIM. In the long run, Congressman Solarz, sequester, it seems to me, is just a nonstarter. We ought to be able to make some kind of priority choices. If spending were cut across the board with the sequester, all kinds of unknown effects surely would hurt the economy and hurt it a lot.

Representative SOLARZ. Let me ask you one final question. There are many, many more we could ask, but I do have other engagements, and my colleagues seem to be otherwise occupied today, perhaps for understandable reasons. I am blessed with a "Stealth" opponent who is as invisible as this new aircraft is supposed to be. So I felt I could afford to come down here and conduct this hearing.

Let us assume, for purposes of discussion, that we really go into a deep recession, with a very sharp increase in the unemployment rate over the course of the next several months or year. Under those circumstances, would you advocate a stimulus package, with increased spending to generate jobs or a cut in taxes to stimulate economic activity? Is there anything you think we should do under those circumstances that we ordinarily or otherwise might not do? Or basically do we simply have to ride it out?

Mr. CHIMERINE. I think that you are going to have to ride it out because there is no way that I would advocate at this point making the deficit problem worse for the long term.

The only thing I would suggest is that some targeted programs, either expanding unemployment benefits or something that eases the pain of unemployment, would be worth considering and that is not likely to have a giant effect on the deficit.

But a widespread stimulative program, I don't see how we can do it. We already have a structural budget deficit of several hundred billion dollars a year.

Representative SOLARZ. Mr. Kudlow.

Mr. KUDLOW. I would advocate a mild dose of tax reduction. I would role back the payroll tax increases for Social Security and Medicare. I would reduce the corporate tax rate. I would roll back the income tax rate increase. And I would also explore some kind of saving incentives with respect to interest and dividend tax rates.

Representative SOLARZ. Let me ask you, in 1980 the top marginal tax rate in this country, if I recall correctly, was 70 percent. Even with this modest increase from 28 to 31 percent, the wealthiest Americans would be paying less than half the marginal tax rate than they were at the beginning of the decade. They are infinitely better off in those terms now than they were then.

Do you want their taxes cut even more?

Mr. KUDLOW. No. I agree with what you are saying. I don't think that the rise in the top rate is by itself a disaster.

But I would note two points on this that I hear again and again: No. 1, it violates the 1986 tax reform compact, where tax rates fell in return for lost deductions; and No. 2, many people believe that this is going to be the first of many steps toward higher tax rates.

Representative SOLARZ. Did you oppose the President's request for a reduction in the capital gains tax on the grounds that it would violate the 1986 act?

Mr. KUDLOW. No. I favored the reduction in the capital gains tax rate.

Representative SOLARZ. You tell me that you oppose an increase in the rates because that would violate the 1986 agreement. But in the same breath you say that you favor a reduction in capital gains tax rates even though that also violates the 1986 agreement.

Mr. KUDLOW. Because I think in the 1986 agreement taxation on capital was unfairly singled out, in two ways: Deductions, I mean losses are not deductible except for $3,000; and second, it was not indexed. If it had been indexed, then I might have taken a different view with respect to the rate reduction. But I don't think that we should penalize either capital formation or the suppliers of capital, because I think that that is antigrowth.

Representative SOLARZ. Perhaps it is, although I gather that there is some dispute in the profession about that. My point is simply that if one is going to oppose an increase in rates on the grounds that it violates the 1986 agreement, then that line of reasoning I think would apply to creating new tax benefits.

Mr. KUDLOW. If I knew then at the begining of this process what I know now, and I am no political expert, I would have argued to leave the capital gains tax rate in place to tax all income equally but to index all of it. That would have been my point of view.

Representative SOLARZ. Mr. Straszheim, on the question of what we should do if we move into a deep recession, what is your advice?

Mr. STRASZHEIM. I would not increase spending as a countercyclical measure. It seems to me that we already spend plenty. I would leave the Tax Code alone. The business and consuming public need some kind of certainty. We have just made an enormous change in the Tax Code. To change it again next March or April I think would be counterproductive.

I think the responsibility for any sort of countercyclical measures will have to lie with the Fed.

Representative SOLARZ. If you all agree, which I gather you do, that this budget agreement notwithstanding we still have a continuing structural deficit, higher than it is in our interest to accept, would you also share a view that I have, which is that if we are going to remain fully competitive with Japan, unified Germany, and an increasingly united Europe, we are going to have to invest much more in our human resources and our physicial infrastructure in terms of education, job training, roads, airports, mass transit, like kinds of things that the private sector can't really do by itself.

It seems to me that the only way to do this would be through some new measure which would include increases in targeted spending in these areas while at the same time making further reductions in other spending—whether it is defense spending, entitlement spending, or other, less essential forms of domestic spending—and presumably some increase in revenues as well, because politically that is part of the reality of this place.

Now, are you all saying, and I guess this is my last question, that leaving aside for a moment whether it would be possible to achieve sufficient political support to get such an omnibus package through the Congress—and obviously it would not be easy, perhaps impossible, given what we have just gone through—but in terms of substance, in terms of sound policy, given where the country is right now, given what we have just gone through, given what lies ahead, do you think it would be a good idea or a bad idea to enact a measure next year which would provide some significant additional resources for human resources and physical infrastructure, while providing for further real deficit reduction, that would have to include some increases in revenue and some additional reductions in other forms of spending? Or should we put that off for the next few years while we wait for the present situation to play itself out?

Mr. CHIMERINE. I will try to answer that very quickly. First of all, the priority now should be to improve productivity and our competitiveness in the 1990's. That should be the overriding objective of economic policy. And it seems to me that you are probably right, some programs are being underfunded relative to that goal. I haven't evaluated all of them; I don't know whether human resource programs or how much we spend in R&D, or on infrastructure, should be reevaluated.

But somebody has to make those decisions: What do we need to spend more on in order to improve productivity?

At the same time, I advocate much larger cuts in defense and entitlement spending to pay for a lot of that and, hopefully, for more than that, and use the rest of those cuts to reduce the deficit. And if there is still a gap, we have to do the rest on the revenue side, and that should be done in a way that disrupts the economy as little as possible.

When do we do it? I think the sooner we do it the better because the problem gets larger and larger as we go out into the future as the interest compounds.

But if we are in the midst of a real deep recession in 12 months, it may be desirable to hold it off for another 12 months. But the point is that we are going to need several more doses of this in the 1990's.

Representative SOLARZ. Mr. Kudlow.

Mr. KUDLOW. I think the history of countercyclical spending initiatives at the Federal level is not promising either with respect to long-term fiscal trends or economic growth. And I fear that higher taxes will be used to fund them and that will further depress incentives for growth.

I do agree with you, however, that in the areas of infrastructure, for example, and possibly education, steps can be taken. But I am not confident that these steps should be taken at the Federal level and would be far more confident if these steps were taken at the local levels where State or local taxes become much closer. Those decisions become much closer to the citizens and taxpayers.

And one other point, with regard to bridges and tunnels and airports, I really am increasingly of the mind that the private sector can do that more efficiently than the public sector.

Mr. STRASZHEIM. Congressman Solarz, I would start such a program in 1991. The reason is that it would take some time, even if enacted in 1991, before that you got this thing to take effect. So if it happens in 1992 or 1993, by that time I think the economy would be doing better.

The money is in defense. The money is in entitlements. I believe if you asked the general American public, "Does the Federal Government undertax you or do they overspend?" I think that they would say overspending. So there has to be a reordering of priorities.

I think it is in those two areas: education and infrastructure. Our high school dropout rate is 25 percent nationwide, 40 percent in the large cities; and of those 75 percent who do graduate, a significant number cannot read and cannot make the fundamental arithmetic calculations required in daily living. And our infrastructure spending has fallen from 2.2 percent to 1 percent of GNP. More is needed.

Representative SOLARZ. Do you agree that the growth assumptions in the budget agreement are unrealistic and that we are likely to face very large deficits well into the 1990's in spite of this agreement?

Mr. CHIMERINE. They are indefensible, in my judgment.

Mr. STRASZHEIM. Unrealistic. Absolutely.

Representative SOLARZ. Have you done any projections of what you think the deficits are likely to be, even after this agreement, based on more realistic growth assumptions?

Mr. CHIMERINE. A minimum of $150 billion a year by the middle of the decade. And I say a minimum, because it could very well be higher.

Representative SOLARZ. Mr. Kudlow, where do you come out?

Mr. KUDLOW. My estimates, which are contained in the testimony, I think they have overestimated real GNP by $300 billion, which will raise the deficit by $66 billion. And I think they have underestimated inflation and interest rates, which by 1995 will raise the deficit by $79 billion.

So I think by 1995 the deficit will be $145 billion higher than projected, and if I use the so-called consolidated baseline, which was in the Andrews Air Force Base summit, I get a $213 billion deficit in fiscal year 1995.

Representative SOLARZ. Mr. Straszheim.

Mr. STRASZHEIM. With what I regard as a realistic set of assumptions on growth, inflation, interest rates, and unemployment, the short-hand answer, I think, is that the deficit reduction will not be $40 billion over 1 year and $500 billion over its life, but more like $25 billion and $250 billion.

Representative SOLARZ. Gentlemen, I want to thank you very much. It has been quite interesting. I regret the fact that we don't have more time to explore these matters in the much greater depth of which I know you are capable.

But we do appreciate you coming and sharing your experience and your wisdom with us.

The hearing is adjourned.

[Whereupon, at 11:44 a.m., the committee adjourned, subject to the call of the Chair.]

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