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S. HRG. 101-498

THE ECONOMIC OUTLOOK AT MIDYEAR

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

JULY 20 AND 27, AND AUGUST 1, 1989

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

25-543 WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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[Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.]

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THE ECONOMIC OUTLOOK AT MIDYEAR

THURSDAY, JULY 20, 1989

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

The committee met, pursuant to notice, at 9:32 a.m., in room 2318, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Scheuer, Solarz, Snowe, and Upton; and Senator Roth.

Also present: Joseph J. Minarik, executive director; David R. Malpass, minority staff director; and William Buechner, Chad Stone, Lee Price, Jim Klumpner, and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee will come to order.

We are meeting this morning to begin a series of hearings on the state of the U.S. economy at midyear and the appropriate economic policies for the remainder of 1989 and 1990.

On Tuesday the administration released its midsession review of the budget, along with its shortrun economic forecast for the rest of this year and its longrun projections through 1994. The midsession review indicates that the administration expects the economy to grow 2.7 percent this year and to continue growing through 1994 with a steady long-term decline in inflation, unemployment, and interest rates.

We're very pleased to welcome the Chairman of the Council of Economic Advisers, Mr. Michael Boskin, along with his colleague from the Council, Mr. John Taylor, both of whom are here to testify on the administration's economic forecast and economic policies.

The committee's midyear review of the economy will continue on Thursday, July 27, with a panel of private sector economists, and on Tuesday, August 1, with Mr. Robert Reischauer of the Congressional Budget Office.

Before we begin, Mr. Boskin, Senator Roth and Representative Upton have requested that their written opening statements be placed in the hearing record. Without objection, they will be placed in the record at this point.

[The written opening statements follow:]

WRITTEN OPENING STATEMENT OF SENATOR ROTH

I AM PLEASED TO JOIN IN WELCOMING DR. BOSKIN BEFORE US TODAY. THE OUTLOOK FOR THE ECONOMY AND THE APPROPRIATE POLICIES FOR LONG TERM ECONOMIC GROWTH ARE IMPORTANT ISSUES FOR THIS CONGRESS.

I WOULD LIKE TO TAKE THIS OPPORTUNITY TO EMPHASIZE MY VIEW THAT THERE IS NO MORE IMPORTANT DOMESTIC POLICY OBJECTIVE THAN INCREASING THE RATE OF PRIVATE SAVING. WHILE REDUCING GOVERNMENT DISSAVING THROUGH FISCAL RESTRAINT IS IMPORTANT, THE INADEQUATE SAVINGS PERFORMANCE OF RECENT YEARS RESULTS FROM SLACK PERSONAL SAVING. PERSONAL SAVING IS AN IMPORTANT COMPONENT OF THE PRIVATE SAVING ESSENTIAL FOR OUR FUTURE ECONOMIC PROSPERITY. THIS IS WHY I HAVE LONG ADVOCATED TAX INCENTIVES FOR SAVING THROUGH INDIVIDUAL RETIREMENT ACCOUNTS.

LAST MONTH I INTRODUCED S. 1256, THE SAVE AMERICA TAX ACT. THIS BILL WOULD IMPROVE THE TAX INCENTIVES FOR PERSONAL SAVING BY ESTABLISHING IRA-PLUS ACCOUNTS. UNDER AN IRA-PLUS ACCOUNT, SAVING COULD GENERATE INTEREST TAX FREE, WHILE WITHDRAWALS AFTER AGE 59 1/2 WOULD BE TAX EXEMPT. ALTHOUGH THE INITIAL CONTRIBUTION WOULD NOT BE TAX DEDUCTIBLE, THE TAX FREE INSIDE BUILD-UP WOULD PROVIDE A POWERFUL INCENTIVE TO STIMULATE PRIVATE SAVING.

FURTHERMORE, MY BILL WOULD PERMIT TAX FREE WITHDRAWALS OF UP TO 25 PERCENT OF AN IRA-PLUS BALANCE, IN THE AGGREGATE, FOR ANY ONE OF THREE QUALIFIED PURPOSES. THESE WOULD INCLUDE PURCHASE OF A HOME, CATASTROPHIC MEDICAL CARE, AND EDUCATION. IN ADDITION, A 25 PERCENT CREDIT FOR LOW AND MODERATE INCOME SAVERS WOULD FURTHER ENCOURAGE SAVING.

PRIVATE SAVING IS ESSENTIAL TO FINANCE NEW INVESTMENT FOR INCREASED PRODUCTIVITY AND INTERNATIONAL COMPETITIVENESS. WE ARE ALL FAMILIAR WITH THE FACT THAT THE U.S. PERSONAL SAVINGS RATE IS MUCH LOWER THAN THAT OF OUR TRADE COMPETITORS. THOUGH THERE ARE OTHER FACTORS AT WORK, AND THE PRECISE IMPACT OF TAX POLICY IS NOT ENTIRELY CLEAR, IT IS TRUE THAT THE STRUCTURE OF U.S. TAXATION IS NOT CONDUCIVE TO SAVING RELATIVE TO CONSUMPTION.

AS HAS BEEN POINTED OUT MANY TIMES BEFORE, ONE FUNDAMENTAL PROBLEM IS THE BIAS AGAINST SAVING IN ANY INCOME TAX SYSTEM, AS THE U.S. TREASURY'S CLASSIC STUDY, BLUEPRINTS FOR BASIC TAX REFORM, POINTED OUT IN 1977. UNDER AN INCOME TAXN, SAVING IS TAXED AS INCOME FIRST, AND THEN THE RETURN TO SAVING IS TAXED YET AGAIN. THIS DOUBLE TAXATION INCREASES THE PRICE OF SAVING RELATIVE TO CONSUMPTION BECAUSE EACH DOLLAR OF CONSUMED INCOME IS TAXED ONLY ONCE. IN RECENT YEARS OUR HYBRID TAX SYSTEM HAS MOVED FURTHER IN THIS DIRECTION, AS ADDITIONAL FORMS OF SAVING HAVE BEEN INCLUDED IN THE INCOME TAX BASE. THIS DESPITE CONSIDERABLE EVIDENCE IN SEVERAL NATIONAL BUREAU OF ECONOMIC RESEARCH (NBER) STUDIES THAT TAX INCENTIVES FOR SAVING HAVE BEEN EFFECTIVE.

UNFORTUNATELY, AS SECRETARY BRADY ACKNOWLEDGED YESTERDAY, TAX INCENTIVES FOR IRAS WERE ELIMINATED OR CURTAILED FOR MANY TAXPAYERS IN THE 1986 TAX REFORM ACT. IN MY VIEW, THIS WAS A SERIOUS POLICY MISTAKE. THE ECONOMIC ANALYSIS OF THE BLUEPRINTS FOR BASIC TAX REFORM AND THE EMPIRICAL EVIDENCE OF THE NBER STUDIES ARE SUPPORTIVE OF THE IDEA THAT TAX INCENTIVES CAN ENCOURAGE SAVING.

WRITTEN OPENING STATEMENT OF REPRESENTATIVE UPTON

I TOO WOULD LIKE TO JOIN IN WELCOMING DR. BOSKIN BEFORE US THIS MORNING.

IN RECENT YEARS WE HAVE MADE CONSIDERABLE PROGRESS IN RESTRAINING THE GROWTH OF FEDERAL SPENDING AND BRINGING THE DEFICIT DOWN. HOWEVER, THOUGH MUCH HAS BEEN ACCOMPLISHED, WE OBVIOUSLY STILL HAVE A LONG WAY TO GO. ACCORDING TO THE MID-SESSION REVIEW, IF THE BIPARTISAN BUDGET AGREEMENT IS IMPLEMENTED ALONG WITH A MODICUM OF FISCAL RESTRAINT, THE PROJECTED 1990 DEFICIT, AT $110 BILLION, WOULD BARELY AVOID SEQUESTRATION. FIRM SPENDING RESTRAINT WILL BE NEEDED OVER THE NEXT SEVERAL YEARS TO REDUCE THE DEFICIT TO WHERE IT BELONGS--ZERO.

NOT ONLY MUST WE CONTROL EXISTING PROGRAM OUTLAYS, BUT WE MUST RESIST THE TEMPTATION TO AUTHORIZE EXCESSIVE NEW SPENDING AND CREATE OR EXPAND ADDITIONAL PROGRAMS. CONGRESS MUST AVOID MAKING OPEN ENDED COMMITMENTS FOR ADDITIONAL ENTITLEMENT OBLIGATIONS. IN COMING YEARS THERE WILL BE TREMENDOUS PRESSURE UPON THE CONGRESS TO PUSH FEDERAL SPENDING EVEN HIGHER THAN PROJECTED.

ACCORDING TO OMB, FEDERAL SPENDING WILL TOTAL ONE TRILLION, ONE HUNDRED, SEVENTY NINE BILLION DOLLARS IN FISCAL 1990. THOUGH THIS SEEMS LIKE A HUGE AMOUNT OF MONEY TO THE AVERAGE AMERICAN, THERE ARE THOSE WHO WOULD ADVOCATE EVEN HIGHER SPENDING LEVELS. NONETHELESS, IT SEEMS TO ME THAT WE SHOULD PROCEED CAUTIOUSLY BEFORE COMMITTING THE TAXPAYER FURTHER.

Representative HAMILTON. We will begin with the testimony from Mr. Boskin.

Mr. Boskin, I think I was not here during your first appearance before the committee. I apologize to you for that, but we are very pleased to welcome you as the Chairman of the Council and to welcome you this morning for your testimony.

You may begin, sir.

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY JOHN B. TAYLOR, MEMBER

Mr. BOSKIN. Chairman Hamilton, thank you very much. It is always a pleasure to testify before the Joint Economic Committee and it has been a particular pleasure since I've become Chairman of the President's Council of Economic Advisers, since the Council of Economic Advisers and the Joint Economic Committee were created simultaneously with the Employment Act of 1946. Also I certainly understand you had other pressing business the last time I testified and I appreciated the courtesies shown to me by Senator Sarbanes and others in your absence.

What I want to speak about briefly before taking questions, Mr. Chairman, is the administration's economic projections which were prepared to develop the midsession review of the budget.

Since I last appeared before this committee, economic conditions have changed significantly. We've had an, shall we say, interesting first few months of 1989. As I promised then, we have incorporated not only this new information on the economy, but we have performed a most careful, thorough analysis of likely trends in real growth, productivity, the labor force, unemployment, inflation, and interest rates. The Council of Economic Advisers, working jointly with our colleagues at Treasury and OMB, through what is called the troika, developed what amounts to the first full set of Bush administration economic assumptions.

As you know, sir, the President presented his original budget proposals just 3 weeks after his inauguration, and therefore we were more or less constrained to adopt, with minor modifications, the economic assumptions prepared in the last Reagan administration budget.

As you know, it takes some time to prepare a set of economic assumptions and then it takes a considerable amount of time for the agencies to cost out programs based on that, and had we gone through that full process then, it would have taken a matter of months rather than a matter of weeks for the President to present his budget proposals and for negotiations on the bipartisan budget accord to begin.

A number of other government agencies, I should add, especially the Commerce Department, also participated in the process, and many views and opinions have been discussed, including those of academic and private sector economists.

These projections reflect current economic conditions, they incorporate internally consistent relationships among the many factors and variables which enter such a forecast. We believe we have brought together the best available techniques and methods, but I always like to caution that forecasts are built on historical relationships that are subject to unforeseen changes in behavior as well as unforeseen events and that economic forecasting, while an important and necessary science and one in which there is a substantial private industry, will remain imprecise necessarily.

As one of my favorite philosophers, Yogi Berra, once said to reporters asking about the pennant race, "predicting isn't very difficult except when it involves the future."

Let me spend a few moments on the near-term outlook, which you mentioned, Mr. Chairman. I remain confident about the U.S. economic outlook. The U.S. economy has completed a remarkable 79 months of economic expansion, creating more new jobs in that period than Japan and the nations of Western Europe combined.

Indeed, the total number of jobs created in this period is as large as the total number of jobs created over the other major industrialized economies, such as Italy and France.

To put our performance in perspective, real GNP per capita and output per worker in the United States remain higher than that of any other major industrialized nation. For example, according to the data prepared by the Organization for Economic Cooperation and Development, last year U.S. output per capita was over 25 percent higher than it was in Germany and Japan.

It is our view that the economy appears to be making and is likely to make a successful transition from the rapid 4-plus percent average real growth during 1987 and 1988 to a more sustainable long-term pace. I am optimistic that other adjustments in the economy will also continue to occur: raising national saving, for example, via continued progress in reducing the budget deficit.

Our forecast, as you indicated, is for real GNP to grow 2.1 percent during 1989 and 2.6 percent during 1990. That 2.1 percent removes the special factors, six-tenths of a percentage point added back in because of last year's drought and the assumption that we will have a relatively normal farm year. So it's 2.7 percent actual, 2.1 percent excluding the drought.

Those correspond to the first quarter's numbers of 4.4 percent real growth including the drought—the Commerce Department put all of the rebound from the drought into the first quarter—and 1.9 percent excluding the drought.

Slower growth in the near term can be traced to a number of factors. For example, beginning in March 1988, the Federal Reserve, in an attempt to try to prevent inflation from accelerating out of control, slowed growth in monetary aggregates and raised interest rates.

The cumulative effects of this restraint—which is one of the reasons why it looks like the outlook for inflation is pretty good for the second half of this year and next relative to the first half of this year—are expected to continue to have some dampening effect on economic activity for a few more quarters, obviously especially in credit-sensitive sectors such as consumer durables and housing. There is a reason for this: even though there has been a recent easing, a slight easing by the Fed, monetary policy works, as you know, sir, with a long and variable lag in its effects on the economy.

We also anticipate a more modest stimulus from the improvement in real net exports, because we expect growth abroad to be strong but not as robust as in the last year or 18 months. In 1988, we also had a substantial effect of the substantial decline in the dollar in the period from 1985 to 1988 and no one is predicting anything like that to be repeated. Our own administration position is that we would like to see exchange rates relatively stable, as you know.

We also anticipate that we will continue to see an adjustment in our imbalance between national saving and investment. As you know, in recent years while we have had investment that is pretty substantial, national saving—the sum of what the Government saves and the private sector saves, both personal and business—has been below our investment level.

The personal saving rate has rebounded from its low of 3.2 percent in 1987: it was 4.2 percent last year and it has been higher in the first few months of this year. Partly due to the fiscal discipline of Gramm-Rudman-Hollings, we have also seen the Federal budget deficit decline from 5.4 percent of GNP in fiscal year 1985 to an estimated 2.9 percent of GNP this fiscal year. A continuation of these trends will help to raise the national saving rate further and would be good for the economy.

The slower growth in personal consumption which we have experienced in the early part of this year should continue to be partly offset by strong investment spending. In the first quarter, as real growth in personal consumption slowed to an annual growth rate of 1.3 percent, real business fixed investment rose 7.6 percent. During 1988, real business fixed investment increased 5.7 percent, and recent capital spending plan surveys suggest business investment remains strong and plans for investment remain strong.

Given our assumed labor force growth, the projected rate of real GNP growth in the near term would maintain relatively low unemployment rates. Unemployment is projected in our forecast to average 5.2 percent for this year, around its current level, and 5.4 percent in 1990. That compares to 5.4 percent last year and 6.1 percent in 1987 and leaves us with unemployment in relatively good shape by our historical standards. Obviously we'd like to do even better, a point I'll return to at the end of my remarks.

In the latter half of this year and next, a moderation in food and energy prices, along with the slowdown in demand, are expected to ease pressures on prices and wages and lead to a reduction in the inflation rate. Inflation, as measured by the GNP implicit price deflators, is projected at 4.2 percent during 1989, and 4.1 percent during 1990.

As measured by the CPI–U, inflation is expected to be 5 percent this year—it was substantially higher than that in the first half, but that was primarily due to food and energy price increases that are not expected to be repeated—and 4.1 percent during 1990.

Let me just emphasize that these special features, for example, the very large jump in crude petroleum prices, is a special factor and a quite severe special factor, and unless one were to anticipate yet another very large increase in crude oil prices or some such other severe supply shock to the economy—some external shock in a major sector—it is unlikely that inflation would continue at the elevated rates in the first part of the year that were primarily due to these special causes.

As we've seen this month in both the Consumer Price Index and the Producer Price Index, we may—and let me emphasize "may"—have already begun to see a moderation in inflation. Obviously we'd like to see this over a span of time and not a lot should be made of 1 month's numbers.

The annualized rate for June is 2 percent for the Consumer Price Index; our forecast is in the low 4 percent range, which, when averaged with the 5.9 in the first half of the year, would give us about 5 percent for the whole year.

Interest rates peaked in last March and happily both short- and long-term rates have dropped by over 120 basis points. We anticipate that lower inflation and interest rates and slower growth will contribute to further declines in interest rates. We are projecting that short-term rates on 3-month Treasury bills will fall from an average of 8 percent in 1989 to 6.7 percent next year; 10-year Treasury notes are projected to drop from an average of 8.5 percent this year to 7.7 percent next year, slightly below where they are now. These declines in inflation and interest rates are expected to set the stage for growth to pick up again in later 1990.

The projected decline in interest rates, and progress toward growth near the economy's long-term potential of around 3 percent, is contingent upon sound macroeconomic policies. A monetary policy that fosters growth while controlling inflation, and continued progress in reducing the budget deficit are essential. Also essential, in our view, are further progress toward freer and fairer trade and the avoidance of unnecessary and inefficient regulation.

Our longer term projection—obviously uncertainty increases as you move further out, but we have a longer term projection which largely reflects expected demographic and productivity trends.

Labor force growth is expected to slow a little as the generation following the postwar baby boom enters the work force and we expect that the improved productivity growth we've had in this expansion will continue and will offset some of this slowdown in labor force growth.

Based on these longer term demographic and productivity projections, real GNP should grow at around 3 percent. During the postwar era, real GNP has grown at an average annual rate of 3¼ percent, a period over the last 40 years that has included episodes of much more rapid growth as well as some recessions. Based on assumed labor force growth, the long-term real GNP growth of around 3 percent would cause the unemployment rate to decline to about 5 percent.

Further progress in reducing the budget deficit and in steadily reducing inflation should allow nominal interest rates to decline gradually in the years after 1990.

Let me say one or two words about our comparison to other projections, because they're always interesting, and a perspective on the outlook and conclude there, sir, and take questions.

Our forecast reflects changed economic conditions and is significantly less optimistic than the Reagan administration's last forecast. Let me stress that we remain confident about the economy. Real GNP growth for 1989 is projected to be 2.7 percent compared to the Reagan forecast of 3.5 percent while growth for 1990 is 2.6 percent compared to the 3.4 percent forecast in the last Reagan forecast.

The Bush administration forecast also embodies slightly higher expected inflation and interest rates than the Reagan forecast and a more gradual path over time toward the goal of price stability, which is a goal the administration shares with the Federal Reserve.

The administration is slightly more optimistic than the Blue Chip average of private forecasters, but well within the spread of those forecasts. Among private forecasters, there is now a wide range of opinions about the outlook—usually private forecasters at the very early stage of an expansion have a fairly tight cluster and, as an expansion progresses, that tends to spread out.

Let me make the point I'm trying to make with the aid of a chart.

Among private forecasters, the top 10—or the highest 10 Blue Chip average forecasters for 1990 revealed real GNP growth on a year over year basis of 2.6 percent. On a year over year basis—as opposed to the fourth quarter over fourth quarter I've just given you—our estimate is three-tenths of a percent lower than this at 2.3 percent. The bottom 10 Blue Chip forecasters, as you can see from this chart for 1990, the one on the furthest left, are quite a bit more pessimistic and have real growth below 1 percent. The solid green bar is where we are, somewhere between the average of the Blue Chip and the top 10. So we're well within the range. The same is true of our estimates of the other items we are forecasting.

As an example, our inflation forecast is also bracketed by the Blue Chip forecasters: the top 10 project 5.6 percent, the bottom 10 3.6 percent; we estimate 4.2 percent.

We have made the best forecast we could develop, but let me just repeat the statement I made earlier that forecasting by the administration, by the Congress, by the private forecasters, remains an important but imprecise science.

If we wanted some calibration of this, if we look at the average since 1981, the average of the Blue Chip real growth forecast had an error of about 1.2 percentage points 1 year out in real growth, the exact same average error was made by the administration and that is in line with the errors of most other forecasts.

The economy—let me give you a couple of perspectives on this—has done better than most private forecasters and the administration predicted for the last 2 years and it could well outpace expectations once again later this year or in 1990.

As an example, in 1988 the administration forecast 2.4 percent growth and the Blue Chip averaged 1.8 percent, but growth came in at 3.5 percent. In 1987, the administration forecast 3.2 percent, the Blue Chip 2.8 percent, and real growth came in at 5 percent.

But just as the economy could well outperform our projections so, too, there are downside risks to the economy. Among them are external shocks or policy mistakes.

The age of the expansion, in my view, however, is not a risk. There is no economic law that requires expansions to die of old age or to run out of gas. There is no statistical study that correlates effectively the probability of a downturn to the age of recovery or an expansion. Some expansions have been very long lived, others very short lived.

This did not become the longest postwar peacetime economic expansion by running out of gas when it hit the length of the second longest, that from March 1975 to January 1980.

Most expansions have ended because of severe external shocks—a good example—bad for our economy, but a good example to make the point, was the quadrupling of oil prices in 1973–74, or because of major policy errors. There have been several times when growth slowed, pundits predicted a recession was in process—or progress, but the economy continued to grow for a substantial length of time. Recent examples include 1985–86 and 1966–67.

I believe that with continued adjustments in our economy, maintaining a flexible economy, sensible economic policy, and the absence of any severe external shock, the current U.S. expansion can continue for some time to come.

And let me finally conclude, sir, by saying these projections should not indicate that we are complacent about the economy. Our aspirations are to do still better and it is our goal in the administration to work effectively with Congress to implement policies that will foster growth, reduce unemployment, and promote price stability.

Thank you very much for your forbearance while I entered those remarks.

[The prepared statement of Mr. Boskin, together with attached tables, follows:]

PREPARED STATEMENT OF HON. MICHAEL J. BOSKIN

Administration Economic Projections

Chairman Hamilton, Senator Sarbanes, and distinguished members of the Committee, it is a pleasure to appear before you to present the Administration's economic projections, prepared to develop the mid-session review of the budget.

Since I last appeared before this Committee, economic conditions have changed significantly. As I promised then, we have incorporated not only this new information on the economy, but have performed a most careful, thorough analysis of likely trends in real growth, productivity, labor force, unemployment, inflation and interest rates. The Council of Economic Advisers, working jointly with our colleagues at Treasury and OMB, through what is called the "Troika", developed what amounts to the first full set of Bush Administration economic assumptions. (As you know, the President presented his budget proposals just three weeks after his inauguration, and therefore we were constrained to adopt, with minor modifications, the economic assumptions prepared in the last Reagan Administration budget.) A number of other government agencies, especially Commerce, also participated in the process, and many views and opinions have been discussed, including those of academic and private sector economists.

These projections reflect current economic conditions and incorporate internally consistent relationships among the many factors and variables which enter such a forecast. We have brought together the best available techniques and methods, but since forecasts are built on historical relationships that are subject to unforseen changes--as well as unforseen events--economic forecasting will remain an imprecise science. As one of my favorite philosophers, Yogi Berra, once said to reporters asking about the pennant race, "predicting isn't difficult except when it involves the future."

Near-Term Outlook: 1989-1990

I remain confident about the U.S. economic outlook. The U.S. economy has completed a remarkable 79 months of economic expansion, creating more new jobs than Japan and the nations of Western Europe combined. Real GNP per capita and output per worker in the United States remain higher than any of the other major industrialized nations. For example, according to data from the OECD, in 1988 U.S. output per capita was over 25 percent higher than it was in Germany and Japan.

The U.S. economy currently appears to be making a successful transition from the rapid 4 plus percent average growth during 1987 and 1988 to a more sustainable pace. I am optimistic that other adjustments in the economy will also continue to occur:

continued progress in reducing the budget deficit and in increasing the national saving rate, and continued progress in reducing the trade deficit.

(a) Real GNP Growth

The Administration's forecast for this year and 1990 projects continued growth of the U.S. economy but at a more moderate rate than the very fast pace set over the last two years. If the effects of last summer's drought are excluded, over the four quarters of last year real GNP grew 3.5 percent. During 1987, growth was 5.0 percent. Excluding the effect of the rebound of farm output from the drought, real GNP is projected to grow 2.1 percent during 1989 and 2.6 percent during 1990. (See Table 1.)

The slower growth in the near-term can be traced to a number of factors. Beginning in March of last year, the Federal Reserve--in an attempt to keep inflation under control--slowed growth in the monetary aggregates and raised interest rates. The cumulative effects of this monetary restraint are expected to continue to dampen economic activity in coming quarters, especially in credit sensitive sectors such as housing and consumer durables. We expect this continued impact on economic activity despite a recent easing by the FED, mainly because of the long and variable lags in the effect of changes in monetary policy on the economy.

The projection also anticipates a more modest stimulus from improvements in real net exports. This is partly the result of slower expected growth abroad and of the expectation that declines in the value of the dollar as large as those between 1985 and 1988 are unlikely to be repeated.

We also anticipate that we will continue to see an adjustment in our national saving-investment balance. The personal saving rate has rebounded from its recent low of 3.2 percent in 1987. Partly due to the fiscal discipline of Gramm-Rudman-Hollings, we have also seen the federal budget deficit decline from 5.4 percent of GNP in fiscal year 1985 to an estimated 2.9 percent this fiscal year. A continuation of these trends will help to raise the national saving rate further.

The slower growth in personal consumption should continue to be partly offset by strong investment spending. In the first quarter, as real growth in personal consumption slowed to an annual rate of 1.3 percent, real business fixed investment rose 7.6 percent. During 1988, real business fixed investment increased 5.7 percent, and recent capital spending plans by business remain strong.

(b) Unemployment

Given the assumed labor force growth, the projected rate of real GNP growth in the near term would maintain relatively low unemployment rates. Unemployment is projected to average 5.2 percent this year, its current level, and 5.4 percent in 1990, as compared to 5.4 percent in 1988 and 6.1 percent in 1987.

(c) Inflation

In the latter half of this year and next a moderation in food and energy prices along with the slowdown in demand are expected to ease pressures on prices and wages and lead to a reduction in the inflation rate. Inflation, as measured by the GNP implicit price deflator, is projected to be 4.2 percent during 1989, and 4.1 percent during 1990. As measured by the CPI-U, inflation is projected at 5.0 percent during 1989 and 4.1 percent during 1990.

These price projections reflect the fact that higher food prices brought on by last year's drought and a large jump in energy prices accounted for most of the rise in overall CPI inflation in recent months. It is unlikely that special factors as severe as the drought and the large increase in crude oil prices will be repeated.

Based on the June CPI and PPI estimates, we may have already begun to see a moderation in inflation. Although inflation is unlikely to continue at June's 0.2 percent monthly rate for the rest of the year, we anticipate CPI inflation in the low 4 percent range which should, when averaged with the 5.9 percent annual rate of increase we have seen in the first half, produce an average rate of increase of about 5 percent for 1989.

(d) Interest rates

Interest rates peaked in late March and short- and long-term rates have dropped by over 120 basis points. We anticipate that lower inflation and slower growth will contribute to further declines in interest rates. We are projecting that short-term rates on 3-month Treasury bills will fall from an average of 8.0 in 1989 to 6.7 percent in 1990, while 10 year Treasury notes are projected to drop from an average of 8.5 to 7.7 percent. These declines in inflation and interest rates are expected to set the stage for growth to accelerate in late 1990.

The projected decline in interest rates, and progress towards growth near the economy's long-term potential of about 3 percent, is contingent upon sound macroeconomic policies. A monetary policy that fosters growth while controlling inflation, and continued progress in reducing the budget deficit are essential. Also essential are further progress towards freer and fairer trade and the avoidance of unnecessary and inefficient regulation.

Longer-Term Outlook: 1991-1994

Turning to the Administration's long-term projection, it largely reflects expected demographic and productivity trends. Labor force growth is expected to slow as the generation following the postwar baby boom enters the work force. Improved productivity growth is expected to offset this slowdown in labor force growth.

Based on these longer-term demographic and productivity projections, real GNP should grow at or a little above 3.0 percent. (See Table 2.) During the postwar era real GNP has grown at an average annual rate of 3-1/4 percent. Based on assumed labor force growth, long-term real GNP growth of around 3.0 percent would cause the unemployment rate gradually to decline to 5.0 percent.

Further progress in reducing the federal budget deficit and in steadily reducing inflation should allow nominal interest rates to decline gradually in the years after 1990.

Comparison to Other Projections

The Bush Administration's forecast reflects altered economic conditions and is significantly less optimistic than the Reagan Administration's last forecast. Real GNP growth for 1989 has been revised down from 3.5 percent to 2.7 percent while growth for 1990 has been revised down from 3.4 to 2.6 percent. The Bush Administration forecast also embodies higher expected inflation and interest rates than the Reagan forecast, with a more gradual path over time toward the goal of price stability.

The Bush Administration is slightly more optimistic than the Blue Chip average of private forecasters but well within the spread of those forecasts. Among private forecasters, there is now a wide range of opinion about the outlook; for example 2.6 percent is the average of the highest ten Blue Chip forecasters for 1990 real GNP growth on a year over year basis; 0.3 percent is the average of the bottom ten. The Administration's real GNP forecast for 1990 of 2.3 percent, year over year, is about 3/4 of a percentage point higher than the Blue Chip average, but well below the average of the top 10. The Administration projection for CPI-U inflation in 1990, 4.2 percent, is also bracketed by the Blue Chip forecasters, with the top 10 projecting 5.6 percent and the bottom 10 projecting 3.6 percent.

We have made the best forecast we could develop but, as I stated earlier, forecasting--both by the Administration and others--remains an imprecise science. Over recent history--since 1981--the average Blue Chip real growth forecasts and the Administration's forecasts have both averaged an error of about 1.2 percentage points. This is in line with the errors of most other forecasts over this period.

Perspective on the Outlook

The economy has done better than most private forecasters and the Administration predicted over the last two years, and it could well outpace expectations once again. In 1988, real GNP, excluding the effect of the drought, grew 3.5 percent; in January the Administration forecast was for 2.4 percent and the Blue Chip average 1.8 percent. In 1987 real GNP grew 5.0 percent; in January the Administration forecast was for 3.2 percent and the Blue Chip average 2.8 percent.

Just as the economy could well outperform our projections, so too there are downside risks to the economy. Among them are external shocks or policy mistakes. However, the age of the expansion is not a risk. There is no economic law that requires expansions to die of "old age" or "run out of gas." Some expansions have been very long-lived; others very short-lived.

Most expansions have ended because of severe external shocks, such as the quadrupling of oil prices in 1973-74, or because of policy errors. There have been several times when growth slowed, pundits predicted a recession was in process, but the economy continued to grow for a substantial length of time. Recent examples include 1985/86 and 1966/67. I believe that with continued adjustments in our economy, sensible economic policy, and no severe external shocks, the current U.S. expansion can continue for some time.

These projections should not indicate that we are complacent about the economy. Our aspirations are to do still better. It is our goal to work with Congress to implement policies that will foster growth, reduce unemployment, and promote price stability.

Table 1

ADMINISTRATION NEAR-TERM OUTLOOK
(Calendar Years)

	Actual 1988	1989	1990
	(Percent Change, 4th Quarter to 4th Quarter)		
Real GNP	2.8	2.7	2.6
Ex-Drought*	(3.5)	(2.1)	
GNP Implicit Price Deflator	4.3	4.2	4.1
CPI-U	4.3	5.0	4.1
	(Annual Average)		
Unemployment Rate (Total)	5.4	5.2	5.4
3-Month Treasury Bill Rate	6.7	8.0	6.7
10-Year Treasury Note Rate	8.8	8.5	7.7

*Excludes the one-time effect of last summer's drought. The drought lowered real GNP growth in 1988 by .7 percent as farm output declined and raised growth in 1989 by .6 percent as farm output was assumed to rebound to normal levels.

Table 2

ADMINISTRATION ECONOMIC PROJECTIONS
(Calendar Years)

	Actual 1988	1989	1990	1991	1992	1993	1994
	(Percent Change, 4th Quarter to 4th Quarter)						
Real GNP	2.8	2.7	2.6	3.3	3.2	3.1	3.0
Ex-Drought*	(3.5)	(2.1)					
GNP Implicit Price Deflator	4.3	4.2	4.1	3.8	3.5	3.2	2.9
CPI-U	4.3	5.0	4.1	3.8	3.5	3.2	2.9
	(Annual Average)						
Unemployment Rate (Total	5.4	5.2	5.4	5.3	5.2	5.1	5.0
3-Month Treasury Bill Rate	6.7	8.0	6.7	5.3	5.0	4.7	4.4
10-Year Treasury Note Rate	8.8	8.5	7.7	6.8	6.0	5.7	5.4

*Excludes the one-time effect of last summer's drought. The drought lowered real GNP growth in 1988 by .7 percent as farm output declined and raised growth in 1989 by .6 percent as farm output rebounded.

Representative HAMILTON. Thank you, Mr. Boskin.

I might say to my colleagues from the House that we're anticipating a vote shortly after 10 a.m. that may or may not come, as you know. If that occurs there will be a brief interruption, at least for those of us in the House.

Mr. Boskin, I want to begin with the general proposition that the economic forecast plays a very important role, does it not, in our approach to deficit reduction?

Mr. BOSKIN. Certainly.

Representative HAMILTON. And if we adopt an optimistic forecast or a highly optimistic forecast, then our deficit reduction task looks easier, not only in the short term but maybe especially in the long term. You would agree with that, I presume?

Mr. BOSKIN. Yes, although we might disagree on what was an optimistic forecast.

Representative HAMILTON. I understand that.

Now what worries me, frankly, is that both the administration and the Congress are very, very good at hitting the Gramm-Rudman targets, but we're not very good at reducing the deficit. We really haven't made all that much progress in reducing the deficit in recent years: $155 billion in 1988, $149 billion in 1987, 1989 is going to be about $148 to $150 billion.

If you look at the record of the executive branch—not just the Bush administration—as well as the record of the Congress in recent years, we've been fairly good sometimes as you point out in your statement with respect to economic forecasting, but neither of us have been very good it seems to me at forecasting the budget deficits, the actual deficits. And I emphasize that the Congress has not done any better than the executive branch.

Now how do you account for the fact that our optimistic economic assumptions have rather consistently been a major factor in underpredicting the budget deficit?

Mr. BOSKIN. Well, first let me repeat what I said earlier, that both the administration—I don't have the numbers in front of me, I assume the Congressional Budget Office and certainly private forecasters underpredicted real growth in 1987 and 1988.

There are many parts of a forecast that go into affecting the budget deficit: real growth affects revenues quite a bit, it also affects outlays—because the economy is strong, employment will be strong, there will be less unemployment payments and things of that sort—but also interest rates affect interest outlays, which are the third largest component and so on. So my own view is that the deficit estimates must be based on the most realistic and most credible set of assumptions that are available.

And it's also very important——

Representative HAMILTON. Well, why then would you come in with an optimistic set of assumptions, as Mr. Darman indicated yesterday?

Mr. BOSKIN. Well, Mr. Darman, as I understand it, said they might be considered slightly optimistic. My view is they are quite credible and realistic. In the spectrum I gave you, they would be maybe in the 75th percentile of the Blue Chip, but also there are various incentives for the Blue Chip forecasters, the private forecasters to——

Representative HAMILTON. Here's my point, Mr. Boskin: It seems to me that the evidence of the past few years shows that there is a bias in the budget process that leads the administration and the Congress to underestimate the budget deficit by adopting overly optimistic economic assumptions.

The result of that is that we do very, very well in getting Gramm-Rudman down, but we don't do very well in what really counts which is getting the deficit down. Do you agree with that?

Mr. BOSKIN. Well, I would certainly agree that what really counts is getting the deficit down and I do agree that there has, on occasion——

Representative HAMILTON. Do you agree that the overly optimistic economic assumptions make it more difficult to get the deficit down?

Mr. BOSKIN. I would agree that if the economic assumptions were overly optimistic that it might be easier to do that. I would not characterize——

Representative HAMILTON. Do you agree that they have been optimistic in the past several years?

Mr. BOSKIN. I would suggest that for some variables at times they have, yes.

Representative HAMILTON. You see, the dynamic of this thing is that the President comes in with optimistic economic assumptions, which are defensible—I mean your economic assumptions that you've given us yesterday or the day before are certainly defensible, I'm not quarreling with you about that. But the dynamic of it is that these optimistic economic assumptions that the administration puts forward are then adopted by the Congress—because our basic position is once you've put those economic assumptions in there we have to adopt them, because if we don't we're going to have to end up cutting the budget a lot more. But the dynamic of that is, it seems to me, that we end up with continuing large deficits. We fool ourselves, in effect. We kid ourselves into thinking that we're going to do better on budget reduction than we actually do. That's my reaction.

Mr. BOSKIN. Well, Mr. Chairman, I certainly appreciate your point of view and I understand where you're coming from and it may well have some considerable validity. I would not characterize this set of economic assumptions as overly optimistic. I am confident and optimistic about the course of the economy, but I do believe these economic assumptions are quite reasonable and credible and have substantial upside as well as downside potential.

I am very, very much appreciative of the fact that it may well be helpful in the future for Congress and the administration to look at the likely effect on the deficit of alternative paths of the economy, some of which might be more optimistic and some which might be considered more pessimistic, so they have more information about that. Currently, we just have these little tables in the CBO and administration budget documents that say what happens if interest rates are 1 percentage point higher or lower.

So I certainly would be sympathetic to that as a guide to understanding under what conditions more or less would have to be done to either meet the Gramm-Rudman-Hollings targets or to get desired amounts—or any given amount of deficit reduction.

Let me also say that we have received a bit of good news: the news has not been always unambiguously where the deficit is higher than anticipated. The OMB now estimates the deficit will be about $16 billion less for this year than it had been.

Representative HAMILTON. Well, there's good news but we're still going to end up with a deficit in the $150 billion range.

Mr. BOSKIN. That's correct. That's the estimate.

Representative HAMILTON. And the point that I'm trying to make here is that the process that we follow has a bias in it. The political dynamics of the situation force the President and force the Congress into underestimating the budget deficit. We've done that now consistently year after year after year.

And we persuade ourselves that we're making a lot of progress on the budget deficit because we're getting the Gramm-Rudman-Hollings targets down—which we are doing through all kinds of means and methods, including optimistic economic assumptions—but in the process of doing that the big deficits continue at $150 billion level approximately and we're really not making much progress with respect to that.

I'm not criticizing the Bush administration or the Reagan administration or the Carter administration, because the dynamics of it are just built into the process. It worries me. This bias is built into it. And what I think then happens is that you erode the long-term economic strength of the country.

I presume you agree that it's desirable to move the budget deficit down as the Gramm-Rudman-Hollings deficit targets suggest.

Mr. BOSKIN. I certainly do.

Representative HAMILTON. And you agree that the harm that comes from the Federal budget deficit is the drain on national saving and its impact on future economic growth. You agree to that?

Mr. BOSKIN. Sure.

Representative HAMILTON. We all agree to that.

And I think what we're doing, frankly, and what bothers me is that with the best of intentions we're ending up with very little progress, if any, in reducing the deficit year after year and all of us recognize that the deficit ought to come down.

That's my concern that I'm trying to get across here to you and I'm not blaming you, I'm not blaming the administration. I think we're all caught up in the same process and it really bothers me, the result of it.

Mr. BOSKIN. I appreciate your concern, sir. I will take it under advisement and relay it to my colleagues involved in the process.

Let me also say two points: One is that the deficit has come down from 5.4 percent of GNP in 1985 to 2.9 percent this year. Under our projections, there will be a substantial reduction in fiscal year 1990. Even if one were to take projections that were somewhat more pessimistic than ours, there would still be—unless you got very pessimistic, there would still be a considerable reduction between 1989 and 1990.

Now it is my own view that realistic economic assumptions are very important as part of the process and we believe that we have produced those. So I guess I am more sympathetic to your point of view as representing some things that may have happened historically than I would be as a characterization of where we are now and I hope we can go forward.

Representative HAMILTON. Well, you'll pardon my skepticism I have about projections on reductions in deficits. Because in every single year: 1985, 1986, 1987, 1988, and 1989, we've always had these projections about a sharp reduction in the deficit, a significant improvement in deficit reduction, and when the end of the game comes, the deficit ends up $150 billion.

Congressman Upton.

Representative UPTON. Thank you, Mr. Chairman.

Welcome back, Mr. Boskin.

Mr. BOSKIN. Thank you, sir.

Representative UPTON. We appreciate your timely appearance before us.

You know, I must admit that as a former OMB official who has watched some of the evening night scenarios in the dark rooms, et cetera—smoke-filled rooms, I have always sort of believed that liars can figure and figures can lie.

And I look at real interest with this forecast that you have with regard to real GNP growth forecast, how it compares for the Blue Chip bottom 10 as well as the top 10.

One question that I have is how does the Blue Chip—and going back just a step further, I know that if you look back at the last several years OMB in fact has had the best track record, particularly with the forecasts versus CBO or with the Blue Chippers with regard to real growth, but how does the new administration forecast on the interest rates, the T-bill rate, et cetera, for 1989 and 1990, how does that compare with the same bottom 10 and top 10 with regard to the interest rates, as you've done with the GNP growth rates?

Mr. BOSKIN. Well, I think in all our variables we would be well within the range. We would certainly be well below the top 10 and well above the bottom 10 for all of the variables we've been forecasting.

Representative UPTON. Last February when you testified before this committee we had a brief discussion about IRA's and, as I recall, your testimony was along the lines that you personally supported perhaps the return of the IRA, that was something that the administration would look at in the future. You have indicated in your testimony here this morning that, in fact, the national savings rate has increased for the first several months of this year—as I think you indicated it was 4.4 percent in 1987 and was seeming to come back.

With regard to those increases in the national savings rate, where do you see the administration coming down in the near future with regard to the IRA proposal?

Mr. BOSKIN. Well, first of all, we obviously are pleased that the national saving rate has risen some, we believe it's good for Americans to be putting funds aside to finance productive investment in our future and we are glad that the trend downward in the measured personal saving rate—which hit bottom in 1987—has begun to reverse itself and we hope that process will continue.

With respect to proposals for IRA's, let me just repeat that while the administration is interested in promoting saving and in having the saving rate rise, that we remain very concerned about making sure that the national saving rate rises so that we'd be very, very cautious that any saving proposal not lose the Treasury any revenue or be likely to generate enough additional private saving to swamp any potential loss of revenue to the Treasury.

And let me also say that the administration has not developed at this point in time a series of proposals beyond the ones that are now on the table. The capital gains proposal should encourage business saving, for example, but that will not preclude the possibility of us doing so in the future, but all discussion of likely future administration policy on this score would be premature at this stage.

Representative UPTON. As you know, Treasury has reported a bulge of unexpected revenue in this fiscal year. Is your view such that the higher float of the Treasury will continue in the future?

Mr. BOSKIN. Congressman Upton, the Treasury is currently intensively studying this matter and we took as close a look as possible in preparation for the midsession review, even though that came just at the time the Treasury was getting the numbers and we didn't have time to get into detail on the returns. There are several competing hypotheses as to why that occurred and undoubtedly each contributed something and Treasury is trying to partition them.

My view is that some of that is likely to continue; perhaps not all, but certainly some reasonable fraction of its is likely to continue at least for a while.

We were in a transition because of the 1986 Tax Reform Act and there are a variety of other reasons this occurred and there were many complicated changes, as you know, in the 1986 Tax Reform Act from changing the passive loss rules to the phasedown of the tax rates which may have led some people to try to shift income into a year with lower tax rates.

So we believe that some of it will continue but we have not yet been able to determine exactly how much over the length of time. Treasury has made the best estimate they could for the current period but they are intensively studying the matter.

We at CEA and certainly Treasury will be glad to get back to you as soon as that study is completed in detail.

Representative UPTON. I note that after adjusting for all of the economic technical and policy changes over the last several months it appears that the midsession review projects the deficit exactly on target needed to forestall sequestration. Is that, in your view, a remarkable coincidence or is that Mr. Darman working overtime?

Mr. BOSKIN. No, I think that there has been a careful cooperative effort among the agencies on the outlay side. There certainly has been a joint effort among Treasury, Council of Economic Advisers, and OMB, and I think if one looks at the likelihood of sequester, one has to understand that there is a very, very little margin of error, that we still have a lot of things to do to make sure that we don't have to sequester. Congress still has some things it has to do and it has to consider and we're in the $105 billion—slightly over $105 billion range is our estimate.

Now the economic assumptions and many of the technical assumptions are now locked in by law. So what very, very, very little room remains will basically reflect congressional action between now and the formal sequester evaluation in August.

Representative UPTON. Thank you.

Representative HAMILTON. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Well I enjoyed your testimony very much.

Mr. BOSKIN. Thank you, sir.

Representative SCHEUER. It has been very illuminating.

You heard from our chairman, Congressman Hamilton, that he had some concern about a bias that was of concern to him and it's of concern to us and I'm sure you, too.

There's another bias that is of concern to me. This bias relates to a remark you just made, or you certainly pointed up, where you said—and quite correctly so—that it was your hope and our hope that individual private citizens will increase their savings rate so that they will be putting funds aside—and I'm more or less quoting you now—to finance productive investments in our future.

Right?

Mr. BOSKIN. Yes.

Representative SCHEUER. We all hope that.

The first thing I'd like to ask you is how do we increase the national savings rate from the current 3 or 4 percent of personal income to the 18 or 19 or 20 percent that the Japanese enjoy?

Mr. BOSKIN. Well let me——

Representative SCHEUER. What public policy thrusts should we be thinking about?

Mr. BOSKIN. Well let me just first say that I would not necessarily suggest that we should raise our national saving rate to that of any other country. I think perhaps a more sensible, at least shorter medium-term benchmark would be to have eoonomic policy more neutral with respect to spending versus savings and investment and then——

Representative SCHEUER. Well wait a minute, excuse me, Mr. Boskin. I only have just a few minutes, so let me try and focus our discussion.

Mr. BOSKIN. Sure.

Representative SCHEUER. With public policy neutral on this subject you get the current level——

Mr. BOSKIN. No, no——

Representative SCHEUER [continuing]. Of saving——

Mr. BOSKIN [continuing]. With all due respect, sir——

Representative SCHEUER [continuing]. Of, you know, 2.5 to 3 percent. And many people, like myself, have characterized our present savings rate and our consumer expenditure rate as a country engaged in a consumer binge. That's what happens when our public policy is neutral on this subject.

What I'm asking you is, assuming that you'd like to see that rate of savings invested in productive investments in our future, if you'd like to increase that, what public policies could do that?

And I don't say Japan has to be that benchmark, let's do what's best for our country.

Mr. BOSKIN. OK. All I was leading up to was reducing the budget deficit and balancing the budget. Let me just say that that is the first and most important reason. I do not believe that public policy is neutral, the Federal Government is borrowing——

Representative SCHEUER. You don't believe that public policy is what?

Mr. BOSKIN. Is neutral on national saving, the Federal Government is borrowing 3 percent of GNP, and if we could move to a balanced budget steadily and solidly, that would be the single best thing we could do to have a substantial increase in our national saving rate. It would obviously be necessary to do that in a manner which did not retard or impede or reduce private saving. So I would say that is the single most important thing to do.

Also, because of our knowledge about the factors associated with private saving and so on, there probably is more certainty that we would get exactly the increase in national saving roughly dollar for dollar by reducing the deficit than there would be by anything we would think of doing on the private saving side, although the private saving side is something we ought to be looking at down the road.

Representative SCHEUER. OK. Now let me just continue that——

Mr. BOSKIN. But reducing the budget deficit is the most important thing by far.

Representative SCHEUER. Reducing the deficit, I think we would all agree on that.

We're agreed that private investment in productive enterprise is a desideratum. Some of us also feel that public investment, an increased level of public investment in productive enterprise is just as desirable and should be just as much of a national goal. Failing to make those public investments in our productive and competitive future is a wrongheaded policy.

Now yesterday we had a panel here composed of Professors James Tobin of Yale, Alan Blinder of Princeton, Mr. Jack Meyer of the Ford Foundation and Donald Straszheim of Merrill, Lynch, Pierce, Fenner, and Smith. And with few exceptions there was consensus that we're underinvesting in our public economy.

I chatted with them about a recent Presidential Commission on Higher Education and I'm sure you're familiar with it, that recommended that we extend the public school system from the present grades 1 to 12 to 1 to 14 and that another 2 years be considered an entitlement. They considered it an entitlement, that mandatory free universal public education be extended 2 years.

If your memory fails you, that was the Truman Higher Education Commission published in 1947. And if you take the beginning of public education in 1910—from kindergarten to 12—to the present, that was approximately in the middle, when they recommended extending free public universal education 2 years.

You might say that in terms of the exponential increase in skills and literacy and computer capability that has taken place since 1910 that 1947 report probably was the halfway point and, in terms of the needs of our society for an educated citizenry, you could say we ought to go to 4 years of entitlement to postsecondary education.

And I asked them would that be productive? They had just spoken of how productive it would be and what a contribution it would make to our economy to have major investments in infrastructure. They said when you take out expenditures in military infrastructure, the cost-benefit factor even increases and when you take out education it increases even more.

So I was a little piqued and I asked them, what do you mean when you take out education it increases even more? They said they were talking about education structure, education buildings.

So I said OK, how about just expenditures for education? How about the Head Start program, where today we're making a Head Start experience, an enriched preschool experience, available to less than one kid in six in the country who is urgently at education risk? Well, they thought that could be expanded.

I didn't say then, but I say now, I had the benefit of a Head Start education and I had the benefit of a freebie, a free ticket to as much higher education as I could possibly absorb. And those were two experiments.

My Head Start education was called nursery school in 1923. But middle-class parents were systematically making it available to their kids as they've done for the last three-quarters of a century or more. And I was a beneficiary of the GI bill of rights.

One of our top economists did a cost-benefit study of the GI bill of rights, the first that has been done in the 40 years since the end of World War II—or 35 years since the GI bill was fully functioning.

And the study came up with an approximate cost-benefit calculus that every dollar spent on postsecondary education through the GI bill produced somewhere between $7 and $13 of benefits to the country. It produced a trained cadre of manpower all the way from skilled workers to science, math and engineering talent that projected us into the postmanufacturing, the postindustrial era. It paid off 6 or 7 to 1. And we're just now beginning to compute that because most of the guys who were in the GI bill of rights who had their wits together have since retired.

I'm an unfortunate aberrational hangover, someone who wasn't smart enough to seize the nettle, although I'm old enough.

So that's a cost-benefit calculus of somewhere between 7 and 13 to 1.

We have done cost-benefit surveys of Head Start and they indicate a payback to the Government of about 5 or 6 to 1. And that doesn't even count the negative costs of failure, of dropoutism, of criminal justice expenditures, of welfare, and so forth. That 5 or 6 to 1 would go up dramatically if you really figured the full benefits and the full expenditures avoided by the Federal Government.

Now, I think you would say in the private sector where an individual can make an investment that has a payoff of anywhere from 5 or 6 to 13 to 1, that's a very good investment opportunity.

When the Government has a chance to make an investment to improve its human capability, to produce that much more of a productive, competitive work force, isn't that an investment in our productive future that the Government ought to make?

My bias is that somehow or other as we're fighting desperately to balance the budget, with a given being no new taxes, no new revenues, we're crippling ourselves by not making investments in our future economic potential and in our labor force that, looked upon

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as an investment, would be an investment we can't afford not to make.

How can you devise a public policy to get us out of that dilemma that will enable our country to make investments in our future that have such a high payoff that it seems doubtful that a society that isn't aberrational could not afford not to make and would make?

Mr. BOSKIN. Congressman Scheuer, thank you very much for those remarks.

First of all, I want to make sure that we get the benefit of these exciting new studies, these benefit-cost studies and we very much hope to be able to get them this afternoon or in the near future and study them in detail.

Let me also say that when I speak about productive investment I always include human as well as what's sometimes called tangible capital: machinery and capacity, plant——

Representative SCHEUER. What kind of capital?

Mr. BOSKIN. Human capital as well as plant and equipment——

Representative SCHEUER. Plant and equipment, right.

Mr. BOSKIN [continuing]. And things like that.

So I by no means meant to exclude human investment, whether of a formal education variety or other.

Let me also say that the President has made it clear that he believes that vast improvements can and should be made in the productivity of our existing national expenditures in education.

We spend as a nation $330 billion currently, obviously most of that is not by the Federal Government, the Federal Government is about 6 or 7 percent of that, $20-odd billion. Most of it is at the State and local level.

And we believe that making that investment more productive by improving choice, accountability, and so forth, rewarding excellence, rewarding achievement, the magnet school program, merit pay, and all that sort of stuff that the President had in his education proposals, would be a very, very significant long-term improvement in our education system. So I think philosophically we're on the same wavelength, that it is very important to improve the quality and the output of our education system.

With respect to these benefit-cost ratios that JEC staff has developed and these studies, I would respectfully request to be able to analyze them and perhaps get back to you later about them.

Representative SCHEUER. Very good.

Mr. BOSKIN. And let me also say that in the original Presidential budget proposals that we submitted on February 9 and in the statements that the President has made and that his advisers have made, Budget Director Darman, Secretary Brady, and myself, we've all—despite the fact we realize we are in a relatively tight budget environment, we have tried to emphasize at the margin investing in human beings: some modest increases in education expenditures and also focusing on improving what we're getting from the money we're now spending, decreasing drug abuse—which I think should be seen as an investment in human beings——

Representative SCHEUER. Absolutely.

Mr. BOSKIN [continuing]. As well as a variety of things to focus on research and the more traditional private capital you spoke of.

I believe that we have stated that in the future we want to make sure that our benefit-cost analyses and in our budget proposals that we would provide some enhanced information about and place greater emphasis on public investment as well.

I believe that there will be an attempt to expand and elaborate the special analysis of the budget—I've forgotten whether it is D or F—which deals with government investment-type expenditures. So this is an internal concern in the administration.

Representative SCHEUER. Mr. Boskin, my time is up.

I do appreciate your reaction. I'd be very happy to have both of these cost-benefit analyses sent on to you, the one that JEC staff did on the GI bill as well as the cost-benefit analyses of the Head Start program.

I will say that the four professors yesterday narrowed my focus a little bit, when they said they didn't think a GI bill approach would be the most cost-effective approach. They said the top priorities on which we should focus with a high-powered rifle and an 8-power scope would be Head Start expenditures, expenditures devoted to literacy pointed at an adult work force that's 25 percent illiterate, and expenditures in postsecondary and graduate science, math and engineering.

If you would address your thoughts to an approach that would target these three areas for special investments—not expenditures but investments in our future, I'd be very grateful and when you're ready to chat, when you've had a chance to review the GI bill cost-benefit analysis and the one on the Head Start program, perhaps we could sit down and chat.

Mr. BOSKIN. I would enjoy that very much, sir.

Representative SCHEUER. Thank you very, very much.

Thank you, Mr. Chairman.

Representative HAMILTON. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

Mr. Boskin, I notice in your testimony this morning you did not address yourself to the trade deficit and, as you know, there was a 20 percent increase in June over May. And in 1988, there essentially has been an export-led growth in our economy.

Can you tell us what you project for a trade deficit for the remainder of this year and why there was such a substantial increase in the trade deficit for the month of June?

Mr. BOSKIN. Certainly, Congresswoman Snowe.

Let me first say that it's quite understandable that there is a slight misunderstanding. The number that came out was the May deficit, not the June deficit. It's a peculiarity of our trade numbers that they lag 1 month behind for various reasons.

There are several reasons: First of all, the April deficit was one of the lowest in recent memory, so therefore it's very easy to have a big percentage increase from a very low base. Average for the first 5 months of the year the deficit has been lower than it was for the last quarter of last year.

The primary increase was an increase in oil imports in terms of—and most of it was on the import side, exports were down slightly, an amount that can be accounted for by whether Boeing ships a few planes at the end of the month or the beginning of the next month.

We expect to see continued improvement in our trade deficit, although we had very rapid improvement last year and we, like most private forecasters, are operating on the assumption that we will continue to have improvement but at a more moderate rate than last year.

We believe that there are many factors associated, many reasons why the trade deficit occurs and is doing what it's doing. And we believe that various policies we have proposed: macroeconomic policies attempting to continue to redress the saving-investment imbalance; that in our international policy coordination that Treasury leads on, as Secretary Brady has emphasized repeatedly, that the responsibility of the surplus countries, the ones that are currently running trade surpluses or current account surpluses to have strong domestic demand-led growth remains a key responsibility for those countries, as our progress in reducing the deficit; and we have made a variety of structural trade policy decisions and moves.

But I think that everybody understands that while it's important to make those moves and it's important to try to lead the world to fairer and freer trade in the Uruguay Round of the GATT on getting these 15 areas that are not covered by our rule-based trading system in, including agriculture and intellectual property and investment and services and so on.

While we have the 301 decisions I think it is generally agreed by all of us in the administration, including those who are our leaders in the trade negotiations, Ambassador Hills and others, that only a modest fraction of the trade deficit can be attributed to what might be called the structural trade issues.

So we believe we will see some continued improvement, some gradual improvement through time and we continue to press to have that improvement made.

Representative SNOWE. You don't expect then any other major increases in the trade deficit in the coming months?

Mr. BOSKIN. Well, I've been around long enough—perhaps too long—to know that these numbers tend to flip around. I would likewise if there is a move in June back to the April number, I would not declare victory in reducing the trade deficit. I think that they are likely to bounce around and the longer term average I expect to show considerable continued improvement, although not as rapidly as in 1988.

Representative SNOWE. You mentioned also in your testimony about the inflation rate, that in the final analysis we will have an average rate of increase of about 5 percent for 1989.

Would you expect that the Federal Reserve Board would tolerate a rate of 5 percent inflation? Because Alan Greenspan has said in the past that 4 to 5 percent may be too high.

Mr. BOSKIN. I believe the Federal Reserve's long-term goal, shared by the administration, is price stability. And I believe that they have made that statement as often as have we.

If they thought that inflation was likely to stay at that high a rate, given what is going on in the economy and what they have done previously, I would imagine that they would take a different course of action.

I believe that they, like we, understand that the bulk of the increase in inflation in the first half of the year was due to the very special factors of the agricultural prices from the drought and, more importantly, the energy price increase due to the crude oil price rises.

It's a perfect mirror image of what happened in 1986: we had been going along at sort of the 4.5 percent rate and then all of a sudden oil prices collapsed and the CPI was under 2 percent. And what has happened now is we have had a rebound so temporarily there will be a higher inflation rate.

I believe they see things roughly in the same way we do in this regard and I believe they believe that inflation must be reduced over the long run but they believe that later this year and next that the signs are that it will not be nearly as bad as it was in the first half of the year.

Representative SNOWE. To what extent are you and others in the administration concerned about the possibilities of a recession?

Mr. BOSKIN. Well, I always try to make sure—and that's one of the reasons I emphasized in my testimony that there are always risks to the economy up and down—I always try to make sure that I make it clear that no one can be absolutely sure where the economy is going.

I think the most likely course of the economy is what we have projected. I think the economy could do better; it could do worse. Can we absolutely rule out the possibility of a recession? No. Do I think one is likely? No.

One way to get a handle on that is if one looked at that chart I handed out. Among the most pessimistic of the Blue Chip forecasters, even of those, very few predict an outright recession—two negative quarters—but even those that do predict it to be very brief and very mild. We would not be pleased with that, but I think that the overwhelming bulk of the forecasters predict growth will continue and we think that is the most likely outcome.

We wouldn't rule out a recession—you know, it's not absolutely impossible for one to occur—but we would hope to head one off, and we hope the Federal Reserve—if the economy started to slow more than it has in the first half of this year—would move to head one off and we assume that they—from their public statements—would if that was likely to be the case. But I also believe that there is a certain symmetry: we could, as in 1987 and 1988, find 1990 looking better than we're forecasting as well.

Representative SNOWE. Well, in terms of the Federal Reserve Board—I know you said that you don't want to preach to the Federal Reserve Board—on the other hand, at what point does the Federal Reserve Board have to make a decision on the reduction in interest rates?

I mean obviously—is it not likely your assumption is predicated on the belief that the Federal Reserve Board will reduce interest rates in the near future?

Mr. BOSKIN. Well, I think that the Federal Reserve—as a matter of fact I know, since I convey the economic statistics nightly to Chairman Greenspan or to Vice Chairman Johnson—studies the data on the economy just as carefully as we do and they are concerned about maximizing the sustainable rate of economic growth and they believe that getting inflation under control is important to do that.

So I believe that they will take action when they believe that doing so will increase the possibility that our economy will grow at its maximum rate without accelerating inflation and that is consistent with their goal of getting inflation even lower.

So I don't want to put precise dates or precise statements, the Federal Reserve is independent; we exchange information on the course of the economy and we try to understand their view and try to have them understand the technical view of the Council of Economic Advisers. We meet with them periodically and exchange on a professional economics basis this information.

So I believe that—and we have great confidence in the administration and the people of the Federal Reserve, we think they are very capable and we think thus far they have done a very good job.

There certainly has been a substantial—as I mentioned in my testimony, a substantial cumulative amount of monetary tightening in the pipeline from March 1988 to January 1989 and that is one of the reasons the economy has been slowing down.

They did that in order to try to head off what they saw as incipient inflationary pressures, aside from these special factors I mentioned about energy. And I think that one of the reasons the outlook for inflation in the second half of this year and next year is somewhat more sanguine was that they did that.

On the other hand, they've begun to ease—they've made two definitive moves, a quarter point each in recent weeks, and I believe they will take whatever action they believe is necessary to sustain the growth of the economy so long as it is consistent with their long-term goal of price stability.

Representative SNOWE. Thank you.

Mr. BOSKIN. You're welcome.

Representative HAMILTON. Congressman Solarz.

Representative SOLARZ. Thank you very much, Mr. Chairman.

Mr. Boskin, do you think that as we approach the end of the 20th century we have now solved the problem of the business cycle and have created an economic perpetual motion machine which guarantees the country uninterrupted economic progress with relatively low rates of inflation and unemployment, or must we at some point anticipate, sooner or later, that there will be a recession?

Mr. BOSKIN. Thank you for asking that, Congressman Solarz. Let me try to answer that in three parts:

First of all, I think there is no economic law that suggests there must be any downturn any time soon.

If you ask me what will an economic or other historian write 50 years from now about the next 50 years, it would be remarkable were there not recessions in that period. So I think that we have not eliminated tendencies of the economy to have faster growth spurts and slowdowns at various times.

I do believe—so that's point one.

I also very strongly believe that the term "business cycle" conveys the notion of so much regularity to the timing and the size and the severity that there's sort of a kind of a sine wave that has the same amplitude and periodicity, that that isn't warranted. I know that's not what you had in mind.

So I don't think that there's any reason why every x number of years there must be a downturn or anything of that sort. But I certainly do believe it would be very surprising if at some point in the future there was not a period of two consecutive quarters of real growth, which is the technical definition of a recession.

But hopefully we would be able to move and have learned enough that we could, under most circumstances, prevent incipient recessions from forming. But if we had an episode like in the early 1970's where all of a sudden there was a huge oil embargo and there was an enormous runup in energy prices and the measured inflation rate including that and so on, it would not be easy to prevent a recession from occurring.

Representative SOLARZ. OK.

My recollection is that in the 1930's the development which precipitated the global depression was the failure of some Viennese bank, I think.

Mr. BOSKIN. The Credit Anstalt was one of the precursors, that's right.

Representative SOLARZ. Do you see any possibility that as a result of the debt crisis in the Third World that you could have a situation where a default by a major debtor country or a series of them could precipitate a collapse of the international financial system, or are there mechanisms built into the system which would protect us from such a scenario?

Mr. BOSKIN. Oh, I think the system is quite a bit different than in the 1930's. There were a lot of other things, the Smoot-Hawley tariff, the Federal Reserve raised interest rates when the economy started to slow, there was a big tax increase in the early stages of the 1930's and so on.

But my own personal belief is that our banking system is in much better shape than it was in the early 1980's, that most of the banks have made some substantial progress in improving their balance sheets and reserves against potential losses from Third World loans.

So I do not believe that it would be likely that we would have a major international economic crisis on the order of what happened in the 1930's.

What I would very much be concerned about directly would be what potential harm it would do to the particular country that followed that policy you hypothesized and what it would do to its ability to participate in the world capital market in the future and what harm that might do to its own economy in the long run.

Representative SOLARZ. Now you indicated in your testimony that the deficit as a percentage of GNP has fallen rather dramatically.

Mr. BOSKIN. Well, I'd say steadily.

Representative SOLARZ. And it's now down to, what, about 2 percent or so?

Mr. BOSKIN. The Federal deficit is projected at 2.9 percent. There is a modest State and local surplus. So if you compare us internationally, since we're more fiscally Federal, if you want to look at the total impact of all government units on credit markets you might look at the 2 percent number, if you want to look just at the Federal Government, it would be closer to 3 percent.

Representative SOLARZ. Well, in historic terms and also in comparative terms in relationship to the deficit as a percentage of

GNP of the other major industrial countries, is that about where it ought to be, or is that a source of real concern?

Mr. BOSKIN. Well, it is a source of concern to me. I believe the Government ought not to be running a deficit, that we ought to be moving toward budget balance. That is my own personal and professional opinion, in addition to the administration's official position. It's one that I have espoused for some time. And certainly one ought to have a longer term notion of that.

There have been times we've run larger deficits. Those large deficits have usually been associated with troughs of recessions when revenues fail and also GNP wasn't growing as rapidly or with wartime, things of that sort.

If you look at it internationally and you include—to look at it internationally, as I indicated, Congressman Solarz, I think we ought to include the modest State and local surplus, because other than Canada most other countries are much more centralized than we are——

Representative SOLARZ. Right.

Mr. BOSKIN. Our deficit is about 2 percent, the Canadians are 3 percent, the French are 1.3 percent, the Germans are also 2 percent, Italy is 10 percent, the United Kingdom is running a small surplus but their private saving has collapsed so they have had a big trade deficit——

Representative SOLARZ. And Japan?

Mr. BOSKIN. And Japan is running a small surplus, 1 percent.

Representative SOLARZ. Now we heard some interesting testimony yesterday—Congressman Scheuer referred to it—which suggested that there was a relationship between the decline in public investment over the last decade or so and the continuing decline in productivity, which has been a longer term problem.

Obviously, we have an interest in improving the productivity of the American work force if we're going to maintain a healthy economy in the long run.

What's your reaction to this observation? Do you think it has any merit, that there is a connection between the decline in public investment and the continuing decline in productivity rates?

Mr. BOSKIN. I think the fairest statement would be that there are many contributors to productivity growth or productivity decline and that public investment may well be one of them, but that the economics profession and of course a very large number of studies comes to very different conclusions.

And I think there is no definitive study. Certainly there are many examples where public investment has helped not only produce public output but also has been complimentary to private labor and capital in producing private output: the interstate highway system and so on. So I would certainly suggest that public investment is one of the things one ought to look at.

Representative SOLARZ. Well, how would you respond to the argument that we need to be more concerned about the decline in productivity than the continuation of the deficit at 2 percent of GNP, when you take State and local spending into account and, to the extent that increased public investment can help with the problem of productivity, it would be better to either spend more, even if that results in a somewhat increased deficit, or—as some of the witnesses testified—have revenue neutral increases in spending on public investment by having some additional revenues that are in effect earmarked for that purpose, so at least that doesn't increase the deficit, but to get more spending on public investment in both infrastructure as well as human resources if we're going to turn around this declining productivity in our country.

Mr. BOSKIN. Well, let me just say that productivity has rebounded in the 1980's, about a third to one-half the way from where we—in retrospect, looks like the golden years of the fifties and sixties where we had very high productivity growth from the abysmal performance of the 1970's where we had virtually none. We would like to see us do even better.

And also obviously the long-term standard of living of Americans will be based primarily on how our productivity does.

We also have some problems in measuring productivity in areas of the economy that are growing rapidly; in many services it's very difficult to measure quality change and the input of new products and things of that sort.

All that aside, I still think you're quite correct that increasing productivity is an important national priority and that public investment has a role to play. In our budget proposals we have placed some emphasis—perhaps less than you would like to see—on public investment.

Let me also say that when you increase the deficit you also decrease the resources, the saving, the national saving available for private investment.

So just as I wouldn't want to see private saving stimulated at the expense of more public borrowing, because that would be a wash, I wouldn't want to see productive private investment, which is subject to the market test, reduced because of a larger budget deficit to finance public investment.

But I certainly would agree that when the cost-benefit analyses are done carefully and we have productive public investment that they are a potentially important contributor to productivity growth.

Representative SOLARZ. Mr. Chairman, one final question if I might:

How would you respond to the observation that when you look at the decline in public investment as a percentage of GNP and also the large deficits we've been running, that what will characterize the 1980's from an economic point of view will be the extent to which, perhaps for the first time in American history, instead of investing for the future we largely consumed our own profits?

It was a kind of exercise in hedonism, saddling future generations with large bills in interest on the debt while at the same time consigning them to a lesser standard of living than they otherwise might have enjoyed because of our failure to invest in infrastructure and human resources while simultaneously saddling them with large debts which will have to be paid off. How do you respond to that?

Mr. BOSKIN. Well, let me just say that I have always and continue to oppose deficits, Federal Government deficits, and strongly support the proposition that we move expeditiously to budget balance and thereafter perhaps even to surplus.

So on that side of the thing we're in perfect agreement, I believe. And so we certainly have accumulated a string of substantial deficits, as Representative Hamilton indicated earlier.

One point I would like to make, however, sir, is that investment in the United States has been quite strong. That while the borrowing side of that story is correct, real investment in the United States has been quite strong in the 1980's.

In the last couple of years, for example, real investment as a share of our growing GNP in this expansion has been quite high by historical standards, about a little over 17 percent of GNP on average for the last couple of years, as opposed to the fifties, sixties, seventies average of a couple of percentage points below that.

Now among the reasons for that have been that while we're spending about the same number of dollars as a share of our dollar GNP, we're getting more capital for it because the investment good prices are not rising as rapidly as the overall price level and in some cases are falling.

A simple example is for, let's say, $10,000 today spent on a computer, you would get a lot more computing than you would for $10,000 spent a few years ago.

So I believe that there has been substantial investment, I believe it would have been—it's better still for Americans to do a larger amount of saving, both publicly and privately, and finance that level and perhaps more themselves.

Representative SOLARZ. Thank you very much.

Representative HAMILTON. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Is it true that a large part of that investment is foreign investment, and if so is that bad or good?

Some people argue, of course, that foreign investment and the Japanese putting so much money in the U.S. economy is a strong indication that the people who are supposed to be the best today see our economy as strong.

Should we be concerned about the amount of foreign investment?

Mr. BOSKIN. Well, my primary reaction to the amount of foreign investment is it's a reflection of confidence in the strength and the expected returns and the security and safety and freedom in the United States.

But certainly the fact that we are running this deficit and draining national saving has led to a situation where, to maintain high levels of investment, we've had to make up the difference by borrowing from abroad.

Now I believe that that investment has been productive and the return to it will be more than ample to pay future interest dividends and rents to the people who have invested in the United States and will benefit our society on balance.

Undoubtedly there are some particular—this is just investment in general, most of which is what's called portfolio investment.

Now there has also been a substantial amount of foreign direct investment in the United States, and my own belief is that again signals some of the same types of activities—we did a lot of that in the 1950's and 1960's in Europe, for example, when it was rebuilding after the war and so forth. And at that time there was a lot of consternation in Europe, saying this is horrible for Europe, et cetera, and it turned out to be one of the best things that ever happened to Europe.

My own personal opinion is on balance we are much better with that foreign investment than without it. It would be better still if Americans financed—or if Americans saved more, both publicly—publicly borrowed less, saved more privately, and financed a higher level of investment.

Perhaps there would be such a strong desire—one possibility is there would be such a strong desire by foreigners that they would still invest quite a bit, the same gross amount, in the United States and the level of total investment might rise if we saved more. Another possibility is we would just have Americans saving—financing that investment displacing the foreign saving.

Senator ROTH. Well, I'm concerned, as I listen to various witnesses for the administration, on what they have to say about savings.

I say I'm concerned because there seems to be a general concensus, agreement, that savings is important, but too often I get the impression when they talk about savings they're talking about national savings by reducing the deficit—which, of course, is important, I agree. We had some business people before another committee and about all I heard there was, well, we put too much savings in housing.

Frankly, I would strongly oppose any tax change in housing. I think home ownership is the great American dream and I think it would be a mistake to try to cut back on the incentives to own your own home.

But I'm bothered that when it comes to talking about trying to build some incentives into personal saving here I don't hear too much positive being said. Yet, I think it's critically important that we have private savings. The amount is very low. I think it's important not only from the standpoint of the national welfare but as a means of providing cheaper capital, and also I think it's important from the security of the family.

I have read many of your statements in the past. Would you personally agree that it's important to try to provide some kind of incentive for personal saving?

Mr. BOSKIN. Well, I certainly do believe that personal saving is very important and I'm glad to see it rebound and I certainly do applaud the role you, Senator, played over the years in promoting that idea and policies to promote saving.

I do believe that in the current tight budgetary situation we have to be rather prudent in what types of policies we consider, but I certainly do believe that private saving and personal saving are very important and that it will be important that we turn our attention to consideration of various potential options in that area some time soon.

Senator ROTH. It's my understanding that savings in the IRA's have dropped from $38 billion to $14 billion. Now we all know part of that probably is saved otherwise. But there also have been studies that show that there is new savings.

Mr. BOSKIN. That's correct.

Senator ROTH. Mr. Boskin, what do you think of the concept of backloading, so to speak, IRA tax incentives so that withdrawals are tax free? Wouldn't the tax-exempt inside buildup provide a good incentive for personal savings?

Mr. BOSKIN. Senator, as I mentioned to you when I spoke to you earlier and we've seen your proposal, which we think has a lot of interesting components to it and we are studying it.

And I think Treasury is trying to figure out what it might do to revenue and the various components of it. I think that is one potentially interesting avenue to consider, I think precisely because it does reduce the up front costs to the Treasury. There are a whole bunch of issues one would consider about how effective this might be. For people who were very carefully calculating the present values of everything, it ought to work out about the same whether they put in aftertax dollars, which then built up and were not taxed at the end as if they got a tax deduction at the front and paid their taxes later. In present-value terms that ought to be approximately the same. There are many other aspects of the effectiveness of saving incentives, you know; for example, concern that the laws might change in-between so that they might feel that getting it up front it couldn't be taken away from them and so forth.

But I think it's a very interesting idea.

Senator ROTH. Perhaps if you build some kind——

Mr. BOSKIN. I think it's a very interesting idea and it's worthy of further study, certainly.

Senator ROTH. On that latter point, and I think that is a problem, perhaps we ought to build some kind of requirement that if they try to change the law they would get the benefit then or something so that they have a legal right to prevent Congress from backing and filling on these proposals. Because I think consistency is very important.

Mr. BOSKIN. I share your concern with that, sir.

Senator ROTH. I look forward to working with you.

I don't know whether you've seen this or not, Congressman Hamilton—but what I propose, among other things, is a 25-percent tax credit for those on the low end of the economic scale, so that we can provide some additional incentive for those to save, because one of the criticisms, as you know, in the past has been that the middle class and more affluent will save but there's not enough incentive.

But I think, for example, if you take our proposal that you get 25 percent up to $25,000 for a couple, if they saved $1,000 a year for 20 years, it would really cost them $750 because they would get the 25 percent credit. That family would have something like $200,000—that's very rough—at the end of that period, which I think is significant from the point of view of family security and certainly would provide a tremendous new amount of capital saving.

Mr. Boskin, I'd like to go back to some questions which I think the chairman very properly pointed out that I'm concerned that under Gramm-Rudman that we're not making real savings but doing it by smoke and mirrors.

One of the reasons I think that's true—and I voted against the legislation—though I won't say that there hasn't been some benefit, because I think it has emphasized the problem and gotten Congress and the administration at least thinking about it.

But isn't part of the problem that you have one target day, October 1, as long as you meet that challenge, that target, that day, you can do anything else you want to the rest of the year?

Mr. BOSKIN. Well, Senator, as you know, there have been—in the past there apparently were some surprises and I would not like to imply any pejorative comment on anybody in previous administrations who operated under those laws, but certainly the structure of the law is that one has to project that you will make it under the target plus the 10, and then what happens after that happens after that.

So I think that it is—because of the importance of reducing the budget deficit it is very important that the projections be based on the soundest economics, the soundest technical estimates of the flow of outlays from budget authority and obligations, the best estimates of revenues and that the administration and Congress afterwards for the bulk of the year try to operate with that goal in mind as opposed to feeling free of the constraint of having passed the sequester deadline.

Senator ROTH. Well, what I'm really trying to get at is as long as you meet this target October 1, where you can play around with when you pay things and Gramm-Rudman has no impact, it's a Mickey Mouse game—and I'm not asking you to comment, but frankly it's a Mickey Mouse game.

But we have certain targets that the actual deficit is supposed to be reduced: this year it's supposed to be $100 billion plus the $10 billion leeway and next year, what is it, $64 billion or something.

In any event, I have introduced what I call a Deficit Reduction Guarantee Act where I would give the President the power in 1993 to make recisions to ensure that the targets are actually met.

In other words, my bill would set a limit on the public debt of $2.3 trillion. We're presently at about $2.1 trillion. Now if we actually meet our targets the next several years, so that we continue below that $2.3 trillion, there would be no power of recision in the President.

But if in fact we don't meet it or we just meet it on October 1, then in fact spend it, it would give the President the authority—whoever that President would be in 1993—to actually rescind spending until we've reached that goal.

Do you think that would put any teeth in the whole proposition?

Mr. BOSKIN. Well, I certainly share your goal of meeting the targets and I certainly believe that enhanced recision authority would be a desirable and useful thing for the Nation for the President to be able to exercise some enhanced recision authority and for Congress to have some tighter procedures they'd have to do to reconfirm their spending decisions.

I would argue that would be a good idea even if we were running a budget surplus to make sure that unnecessary spending that was not in the national interest couldn't get snuck in and so on.

Senator ROTH. My reason for going——

Mr. BOSKIN. So I understand and I very much support the general notion of doing what we can to put teeth in, meeting the Gramm-Rudman targets and obviously the best place to start is with administration and congressional decisions that meet them.

I haven't had an opportunity to explore in detail your bill, which I will do and get back to you in detail, but I generically support the type of thing you're trying to accomplish, sir.

Senator ROTH. Well, I appreciate that.

The reason for this approach is the Congress, of course, has been concerned if you give broad authority to the President it cuts back on its power to control the purse strings. But here Congress has taken—has established a goal and says it wants to reach each year a reduction in the amount of deficit. So it seems to me Congress has spoken as to what its purpose is, all I'm trying to do is put some teeth into it.

Let me, if I may, Mr. Chairman, ask one more question I raised yesterday before the Secretary of the Treasury. It seems to me we're involved in this old spring ritual dance or whatever your annual ritual—where we all dance around—not "we," I don't want to include myself—but where the groundwork is slowly being laid for a so-called compromise which will include a significant tax increase. I'm concerned that that's the way we're going to go once again, if not this year, next year.

It seems to me that one of the reasons we have 79 months of continuous growth, the creation of 20 million jobs, has been the tax cut that was enacted back in 1981, particularly that which Jack Kemp and myself did.

I'm very concerned that we are going right back the other route, that taxes are going to be raised, they're going to be raised on the theory either that they're going to reduce the deficit or that taxes are going to be raised to build infrastructure which will increase productivity or any number of reasons.

Do you see that as a danger and, as an economist, do you think that's the way to go?

Mr. BOSKIN. Well, let me just say that I fully support as an economist and as a member of the administration the President's position, which he's made absolutely clear. We do not intend to raise taxes or to bring taxes to the negotiating table, but we have also made it clear that we understand that the American people sent the Congress and the President here to govern not to bicker.

And we expect and hope to be—once we have the fiscal year 1990 process completed, we think it would be in the Nation's interest to have us enter some discussions and negotiations on the fiscal year 1991 budget, even ahead of the normal budget schedule for that year.

And while we wouldn't expect to bring taxes to the table, we will listen and discuss any proposal on its merits. We don't currently see, for some of the reasons you mentioned, the merits of a tax increase.

Senator ROTH. Well, I had a study made a year or so ago and it showed that for every dollar of increased revenue that we have spent $1.58. So I don't want to read this hogwash about how we're going to raise taxes to reduce deficits. Because I can guarantee—I don't care whether you take the liberals in the domestic area or the conservatives on the defense, they will all find good ways and means of spending it.

I think the most critical problem we have as a nation is becoming competitive in this emerging global economy and we'd better not forget it or we could face the problems of the Soviet Union of becoming a Third World economy.

Thank you, Mr. Chairman.

Mr. BOSKIN. Thank you very much, Senator.

Representative HAMILTON. Mr. Boskin, let me proceed with the tax question.

Your statement a moment ago was that the President has made his position clear. I'm not sure that's right. He's made it clear with respect to 1989: no taxes—no new taxes. What is not clear to me is the future and how long that Presidential pledge extends. Can you help me?

Mr. BOSKIN. Well, the President has said that it was his desire to see that pledge extended and we certainly do not plan to bring taxes to the table for fiscal year 1991.

Representative HAMILTON. Well, that's an interesting phrase, that you don't plan to bring taxes to the table. But it's quite a jump to go from read my lips and no new taxes, on the one hand, to you don't plan to bring taxes to the table but you'll look at those tax proposals on the merits. That's a very different position.

The reason it's different is because in the first case when you say no new taxes you take taxes off the table, they're not on the table, there will be no taxes. In the other position you're saying that you're open to persuasion, or at least you'll listen and discuss the merits. And that seems to suggest that you might be open to the possibility of some additional taxes. That's a very different position.

Mr. BOSKIN. Well, let me——

Senator ROTH. Could I just make a comment, sir?

Representative HAMILTON. Sure.

Senator ROTH. I would say it goes even one step further, it almost invites——

Representative HAMILTON. OK.

Mr. BOSKIN. We are not looking to invite anybody to bring taxes to the table, let me just be very clear on this. I'm sorry if that was the impression that anybody was getting.

The President has said—for some of the reasons that Senator Roth said—that he believes that we need to move forward in addressing the deficit by slowing the growth of spending. We believe that the amount that will be necessary in 1991 will be about the same order of magnitude as was necessary for the fiscal year 1990 budget and we believe we should move forward with the same kind of process. That process has worked well for fiscal year 1990 and has enabled us to get there without taxes and it looks like it will enable us to get there without new taxes and we would hope to repeat that process again in 1991.

Representative HAMILTON. But would you——

Mr. BOSKIN. So what I was trying to say is we're reasonable people. If there are discussions and negotiations—as I have said before and, more importantly, as Director Darman and Secretary Brady, both of whom are our chief budget negotiators, have said before, we will listen to what other people have to say. We don't think that we need a tax increase, we don't think that it's desirable but we're respectful of other people's opinions.

Representative HAMILTON. But would you agree with me that the posture you're now striking, that you will consider the proposals of others who might bring taxes to the table, is a very different position from the position previously taken by the President where he says no new taxes, period.

Mr. BOSKIN. Mr. Chairman, with all due respect, it's exactly the position we took prior to the fiscal year 1990 budget negotiations. We said exactly the same thing and we had our position that we opposed a tax increase, as we do now for fiscal year 1991, and we were able in the bipartisan process to come up with what I believe to be a very good package and that's now working its way through the process. So I don't think that's any change from what we did in the fiscal year 1990 budget negotiations.

Representative HAMILTON. Well, to many of us up here, there appear—and obviously to Senator Roth as well—there appears to be a shift and the shift is as I've tried to explain it from a very hard line position, if I may state it that way, of no new taxes, to a position of we'll sit at the table and consider proposals from others. And that seems to me to be a shift in position.

Now you indicate that it is not, maybe that's why I'm saying to you as I did initially that the President's position has not been all that clear to me.

Mr. BOSKIN. Well, I will take that advice back to the President and all I can say is this is exactly the same position we took prior to the negotiations for the fiscal year 1990 budget and I did not mean in any way to suggest that we were weakening our position against a tax increase.

Representative HAMILTON. So far as you know the President's position on no tax increase applies throughout his first term?

Mr. BOSKIN. So far as I know that is the President's desire, yes.

Representative HAMILTON. Concerning Senator Roth's point about the date being important in Gramm-Rudman, I was somewhat amused at one of the sentences in the Midsession Review of the Budget. On page 8, it has this sentence:

> Second, the decision by the Secretary of Defense to avoid unnecessary hardship to military families by paying military personnel on Friday, September 29, the last work day of 1989, instead of in October, as previously assumed, increases 1989 outlays and reduces 1990 outlays by $2.9 billion.

That's an illustration, I think, of the point you were making. And whoever wrote the phrase "to avoid unnecessary hardship" must have done so with tongue in cheek.

Now let me move on to some other——

Senator ROTH. Could I just make one further comment?

Representative HAMILTON. Sure.

Senator ROTH. Before I spoke about this spring ritual dance. And I watched it many years in the prior administration. It's like asking the girl to kiss you and she says "no, no, no" sounds like "yes, yes, yes."

I'm concerned that that's the kind of message—and I'm not speaking, Mr. Chairman, about you but the whole atmosphere that seems to be created—or is being created, that the groundwork is really being laid that somewhere down the road the administration is going to be sand bagged. Obviously, when you are negotiating with an equal body you have to be willing to talk about anything they want to lay on the table, that's part of good faith negotiations, I wouldn't argue that point.

But I have to say that I get the feeling that the environment is being created—again I'm not talking about your testimony, but the environment is being created that yes, we're willing to consider a tax increase. If we do that, we're going to have more spending and we aren't going to have deficit reduction. And I would hope that message gets through loud and clear in the White House that there seems to be another message coming out of it.

Mr. BOSKIN. Well, I will make sure that your concerns are relayed to the President, sir, and I appreciate your excluding my testimony from contributing to that—to what you perceive to be this aura or atmosphere.

Representative HAMILTON. I wanted to follow up with another question asked by Congressman Solarz and the question related to the recession.

If a recession comes, will it be because of a policy mistake?

Mr. BOSKIN. Mr. Chairman, that's always a lot easier to tell ex post than ex ante. I think there are sort of three—taxonomically, there tend to be three causes of recessions: one is a severe external shock—I mentioned the quadrupling of oil prices and the Arab oil embargo in the early 1970's as one example.

Second would be a policy mistake, the Federal Reserve being too tight for too long or, on the inflation front, them being too loose for too long or something of that sort and not taking action at an appropriate time.

A third would be—and I'm not suggesting—I'm going to say in a moment that I don't think any of these are in the works right now—the third is some imbalances get created in the economy, for example, inventories start to pile up in many sectors and then simultaneously in several important sectors of the economy production plans are scaled back and workers are laid off and that spreads to many sectors of the economy.

Thus far inventory-sales ratios, while they've crept up a little bit, are in pretty good shape, other than in the auto industry, which is cutting back some. And I believe that the Federal Reserve has done a good job and will act prudently in dealing with the prospect of any decline in the economy.

So I don't anticipate any of those three things from what I see now. But I'm reminded that in the mid-1970's it turned out that—when the recession hit, it turned out that we found out about it first when the Commerce Department revised some data. So there are all kinds of surprises, even including data revision, that can creep in.

I don't really see a major policy mistake likely at this time, but, of course, one couldn't rule it out. Monetary policy does work, sir, as you know with a long lag that is difficult to predict in its timing and its impact.

Representative HAMILTON. Do you think the Federal Reserve backed off too soon in its fight against inflation?

Mr. BOSKIN. No, I believe they have acted prudently in their recent easing.

Representative HAMILTON. What's your feeling about the proper stance for Fed monetary policy right at the moment?

Mr. BOSKIN. Well, I do believe that if one looks at the balance of risks in the economy that while—when the economy was growing very rapidly in 1987 and 1988 and unemployment was falling rapidly and there was some fear that there would be pressure from both capacity and labor market to see inflation accelerate, that it was wise for them to err on the side of fighting inflation.

But I do believe that a more balanced approach and some greater concern with the prospect of a slowdown in the economy is certainly warranted now and I do believe that is approximately what they are in the process of doing to the extent that I know about it.

I mean, I don't——

Representative HAMILTON. That's fine. In other words, I read that you're supportive of what they're doing.

Mr. BOSKIN. I'm supportive of what they're doing and I believe they have become concerned about the slower growth of the economy and they are paying some attention to the possibility that——

Representative HAMILTON. Would you favor them loosening somewhat more at this point?

Mr. BOSKIN. Well, again, I don't like to preach to the Federal Reserve in public, I like to compare notes on how the economy is doing and we certainly are supportive of their goals of trying to walk what is a very tough tightrope making sure that we keep inflation under control and ultimately reducing and sustaining growth.

I certainly don't believe any tightening is warranted and I do believe that if the economy softens any further that some easing would be desirable. But that's a conditional statement and I believe they'll be looking at the same figures that I will and that private forecasters will and that they would probably act accordingly. But I don't want to get in a position of predicting their future action. They have stated publicly that they're concerned about——

Representative HAMILTON. Suppose the inflation rate stays where is is, about 6 percent. What then would you like to see the Fed do?

Mr. BOSKIN. I think it's very unlikely the inflation rate will stay where it has been in the first half of the year, as I explained earlier, sir.

Representative HAMILTON. I understand.

Mr. BOSKIN. If the inflation rate stayed there for some length of time I would look at why it stayed there. If it was a few more months of some energy surprises then I think that that again is likely not to work its way into a long-term inflationary spiral.

If it were some other endemic cause that it would be more likely to see inflation accelerate, then I believe that they should very carefully consider that in making any further moves to ease.

Representative HAMILTON. Now I want to go to your longrun projections.

Your shortrun projection has, as you indicated earlier in your testimony, certainly come more into line with those of other forecasters. Your longrun estimates continue, I think, to be more optimistic with respect to growth and inflation and interest rates.

Your forecast shows both inflation and unemployment falling gradually but steadily between 1990 and 1994, going down to 5 percent on unemployment in 1994 and 3 percent inflation. CBO's longterm projections, just by way of contrast, are 5.6 percent for unemployment and 4.4 percent for inflation.

Now is there any precedent in our postwar history for predicting a gradual steady decline in both inflation and unemployment, like you're doing?

Mr. BOSKIN. Well, there certainly have been episodes where that has occurred. In the 1980's we have seen a remarkable decline in unemployment and a substantial reduction in inflation from where it was in the late 1970's and early 1980's that is far more dramatic than this, sir.

Representative HAMILTON. On what basis are you predicting favorable movements in both inflation and unemployment after 1990 in an economy that is already very close to full employment?

Mr. BOSKIN. Well, first of all the reductions in the unemployment rate are rather modest, and we believe that we're going to grow a little bit below our potential for a few quarters, partly as a result of the Fed's attempt to head off an acceleration of inflation. And we believe that that, combined with the credibility of the monetary policy and the fact that inflation, other than the special factors for energy, remains steady, will gradually reduce inflationary expectations, and that this will see us move to a slightly more sanguine position in both unemployment and inflation.

And, Mr. Taylor, would you like to add something to that? I've been——

Mr. TAYLOR. The gradual decline in inflation is something which we think is something which the Federal Reserve will be able to accomplish in these long number of years after the relatively modest slowdown we have in the short term occurs. In fact, my feeling is that the credibility that will be established after this long expansion with keeping inflation under control, going through this moderate slowdown, keeping inflation under control will lay the foundation for the kind of gradual reduction in inflation that's in our forecast while we maintain growth around 3 percent.

Representative HAMILTON. Now, you're both very respected professional economists. You're both comfortable and believe this projected path for the next 4 years is a sound and prudent path——

Mr. BOSKIN. Yes.

Representative HAMILTON [continuing]. And responsible? We had Joel Popkin testify. Do you know his name?

Mr. BOSKIN. Yes, sir, I know him.

Representative HAMILTON. He testified before us not long ago and pointed out that if you take out the food and energy items that you've mentioned several times here, the core inflation has never declined in the past 40 years in this country except in case of severe recession.

Mr. BOSKIN. There has been during the——

Representative HAMILTON. Do you just reject his testimony or what? Do you think it's invalid or did I misstate it, or what's the situation?

Mr. TAYLOR. Well, the core inflation in the 1970's was much higher than we have now. The core unemployment or sort of the natural rate of unemployment in the 1970's was higher than most people project we have now.

If you want to consider a secular movement from the 1970's to where we are now—roughly a 10-year period—and compare the similar states of the economy—relatively full employment—you see a difference in both inflation down and unemployment down as comparing similar stages in the business cycle.

So I think that would be the way to refute that simple statement that you always have to have a slower growing economy to get lower unemployment. If you compare long spans of time you'll see periods where inflation has come down and unemployment has come down. And I think that's what the——

Representative HAMILTON. That's what you're in now in your judgment?

Mr. TAYLOR [continuing]. Longer spans indicate, yes.

Representative HAMILTON. On interest rates, you're a good bit more optimistic than CBO about long-term real interest rates as well. Let me just ask you to explain that.

Mr. BOSKIN. Actually, sir, if I may, while we're a little more optimistic about nominal——

Representative HAMILTON. Yes.

Mr. BOSKIN [continuing]. Real——

Representative HAMILTON. I'm talking about both of them, nominal and real here.

Mr. BOSKIN. We're pretty close on real.

Representative HAMILTON. Yes.

Mr. BOSKIN. It's partly because we have inflation coming down a little bit each year and, hence, cumulatively by 1994 we have about——

Representative HAMILTON. Why are you much more optimistic about the long-term real interest rates?

Mr. BOSKIN. Well, I was just trying to say that we're not very much more optimistic about long-term interest rates. I think we're fairly close; we're off by a fraction of a percentage point on real interest rates.

It's nominal interest rates that are different, and that's because we believe that inflation gradually will come down a little bit and therefore real interest rates—nominal interest rates will come down with our assumed real interest rates, which is fairly close to the CBO number. It's within a fraction of a percentage point.

Representative HAMILTON. Now, you were predicting that productivity will accelerate, were you not earlier?

Mr. BOSKIN. Well, it depends on what you mean by accelerate, sir. We're predicting it will average over—well, there are a variety of ways of thinking about it.

While we don't have an explicit productivity forecast now, we will in our annual economic report which you will see in a few months.

Underlying the longer term growth assumptions, which are slightly—which are about 3 percent as kind of the long-term growth potential, we feel, relative to the Reagan administration's 3.2 percent—I don't know what the new CBO numbers will be, but in the past they've been about a half a percentage point below that. We believe that a combination of productivity growth and labor force growth will produce that 3 percent.

If we look at the last 40 years, 1948 to 1988 period—that has had very good productivity growth in the 1950's and 1960's, abysmal, almost nonexistent in the 1970's, and a rebound in the 1980's—the long-term average has been 1.8 percent. One of the ways we think about this 3 percent is it will have about that rate of productivity growth and a slightly lower rate of growth of the labor force than we've had recently.

Representative HAMILTON. So you're predicting that productivity will grow at the numbers you've indicated as the expansion continues through 1993; is that right?

Mr. BOSKIN. That's the underlying long term—that's one of the foundations of the underlying long term——

Representative HAMILTON. Is that based on solid experience that productivity increases as expansion continues?

Mr. BOSKIN. Well, there are a variety of factors. Sometimes as an expansion continues for—first of all, let me back up and be a little bit more precise:

This expansion is unusual for a variety of reasons. One is its remarkable length. Another is the remarkable number of new jobs that were created.

And one of the things we know is that as the labor force enters the work force they do some on-the-job investment in human capital, implicit or explicit, and that generally in the early stages of work experience, in the first decade of work experience, for example, that the experience productivity profile is very steep. So that will contribute some.

Real investment has been quite high. So I think there are reasons to be guardedly optimistic. We're projecting that——

Representative HAMILTON. It is solidly based in——

Mr. BOSKIN. Yes, it's the——

Representative HAMILTON [continuing]. The history that productivity will accelerate——

Mr. BOSKIN. It's the exact——

Representative HAMILTON [continuing]. As expansion continues?

Mr. BOSKIN. Well, we're not predicting an acceleration. We're predicting it to continue at the rate it has since the expansion began.

Representative HAMILTON. Level?

Mr. BOSKIN. Yes.

Representative HAMILTON. You're saying productivity is not going to increase, that it's going to be flat.

Mr. BOSKIN. We're saying it's going to be 1.8 percent. One of the foundations of the 3 percent number is the productivity growth estimate of around 1.8 percent, which is the average since this expansion began. It's also the average over the last 40 years.

Mr. TAYLOR. Just for the record, the 1.8 percent does refer to the sector of the economy which we refer to as the nonfarm business sector where productivity is a little bit larger than in the overall economy, of course.

Mr. BOSKIN. That's correct.

Mr. TAYLOR. I would also just add that the 3 percent growth forecast we have for the longer term in the economy is, of course, another variable which is forecast with considerable uncertainty as we go at these numbers. And an economist's forecasts of productivity are, of course, difficult.

And this will be our best estimate. But what could be a very——

Representative HAMILTON. Well, what I'm really getting at here, I've always thought that productivity slowed down as an expansion continued, and you're telling me that's not going to happen now, that if it's going to go up it's at least going to stay steady.

Now in fact since 1985 it has been dropping, hasn't it?

Mr. BOSKIN. Well, in 1986, sir, it was 2 percent. It went up between 1985 and 1986.

Representative HAMILTON. Are you looking——

Mr. BOSKIN. In 1987 it was down a little bit; in 1988 it was back up a little bit. The first quarter of this year was not——

Representative HAMILTON. But substantially lower than in the mid-1980's.

Mr. TAYLOR. The productivity growth rate accelerates quite a bit as you're coming right out of a recession.

Representative HAMILTON. Yes.

Mr. TAYLOR. So that if you look at 1983 and 1984 you see extraordinarily high growth rates. Of course, we can't maintain those for the long term, so you'll see a slowdown relative to that.

But basically our forecast period is more of a recovery from the slowdown. So you'll get a little bit from that.

Representative HAMILTON. You were talking about growth a moment ago and the components of that growth, productivity and then the labor force.

In most years of the recovery real growth has been greater than the administration or private forecasters were expecting. How much of that was due to larger than expected reductions in unemployment and how much of it was due to increases in productivity?

Mr. BOSKIN. Well, it was due in part to both of those. It was also partly due to a larger than expected increase in the labor force.

When you refer to reductions in unemployment I assume you're referring to of the given labor force.

Representative HAMILTON. Yes.

Mr. BOSKIN. But certainly all those factors played a role.

In the last several years, obviously, the continued decline of unemployment to levels that we hadn't seen in 15 years surprised many private forecasters. We believe the economy, because of its flexibility and because of some demographic changes, is better able to sustain low employment without generating inflationary pressures.

If I might give one indication of that—do we have that chart that sort of indicates that, with the unemployment rates of men and women, or the prime age? I don't know——

Mr. TAYLOR. No.

Mr. BOSKIN. Well, if you, say, go back to the 1960's and early 1970's and you think of a period where overall unemployment, Mr. Chairman, was in the low 5 percent range, it was associated with an unemployment rate for the group which was then—whether appropriately or not in terms of the terminology—was considered the core attached labor force generally associated with prime age males, and they had unemployment rates in the high 3 percents.

Happily, in recent years the unemployment rate of adult women has been very similar. Their experience has been much more similar to that of adult men. And so we're not looking at—and they have more of an attachment to the labor force; there are not any more of them in it, but they're more attached and there is less turnover.

And so we believe that unemployment in the low 5 percent is likely to be somewhat less inflationary. And it may be possible—our hope is that it is possible without accelerating inflation to do even better than is being forecast. But, of course, only time will tell whether that is possible.

Representative HAMILTON. Your forecast is that the economy is capable of a sustained 3 percent annual growth in real GNP——

Mr. BOSKIN. That's correct.

Representative HAMILTON [continuing]. Without rising inflation?

Mr. BOSKIN. That is correct.

Representative HAMILTON. And the CBO comes in at a figure of 2.3 percent.

What do you see in the economy's potential for growth that the CBO is missing? I mean the unemployment rate is not going to drop all that sharply. What is the difference between your analysis and the CBO's analysis at this point? You're much more optimistic at this point than the CBO.

Mr. BOSKIN. Well, I mean one might also say the CBO is much more pessimistic.

Representative HAMILTON. OK.

Mr. BOSKIN. I mean it's a relative statement, sir, if I can be symmetric.

Obviously we believe productivity growth will be somewhat larger than they do. They are more pessimistic on productivity growth.

I was under the impression that their long-term growth forecast was a little bit above that, but I may be wrong.

Representative HAMILTON. OK.

Mr. BOSKIN. Most private forecasters put it in the 2½ percent to 3 percent range. That has certainly been—the statement the Chairman of the Federal Reserve Board made in his last testimony was in that range.

Representative HAMILTON. Why are you more optimistic and the CBO, to be symmetrical about it, more pessimistic with respect to productivity?

Mr. BOSKIN. Well, there are lots of factors to consider.

Let me first say that the ability to predict within a fraction of a percentage point is asking an awful lot of the science. And anybody who went back over the history of predicting productivity episodes, even correcting for the business cycle or not, would find that the difference in our estimates are much smaller than the range of difference in the estimate—in the projections.

Second, there are two things we think of—there are two factors which we give some considerable weight to make us guardedly optimistic about this:

One, as I indicated earlier, is that a large—this very large number of people who have recently entered the labor force and whose current productivity level may not be that high are likely to see substantial improvements in their productivity as they acquire experience on their job. That is a common finding in the labor economics subfield of economics.

And, second, real investment. The dollars we spent divided by the investment goods deflator divided by real GNP—that is, how much capital we're actually getting for our dollar spent has been quite high in the last several years by historical standards.

Representative HAMILTON. Do you sit down with CBO and discuss these things, or do you produce yours on your own and they produce theirs on their own?

Mr. BOSKIN. We certainly have interaction. And we try to understand these differences.

And we have a professional interaction, as does OMB and Treasury and so on, with the counterparts in CBO and congressional staff that do the types of things that they're responsible for.

Representative HAMILTON. You're much more optimistic; they're much more pessimistic—I want to keep this symmetrical—with regard to profits, for example, corporate profits. Why is that?

Mr. BOSKIN. Well, I don't want——

Mr. TAYLOR. We don't really know their corporate profits forecast at all.

Representative HAMILTON. Well, it's the profits where——

Mr. BOSKIN. I think part of that must be that if they have slower——

Representative HAMILTON. I'll give it to you: CBO projects a long-term level of profits at 6 percent of GNP. You're projecting them to rise to 7.8 percent by 1993. Those are the figures.

That's quite a difference.

Mr. BOSKIN. I think part of that explanation must be—and we'll get back to you with more detail if you desire, sir—that since they're projecting somewhat weaker growth that would naturally reflect itself in somewhat lower profits.

Representative HAMILTON. OK.

Now I notice that the term "flexible freeze" didn't show up in this new budget study, the midsession review. What conclusions are we to draw from that? Is the flexible freeze dead as debt reduction strategy?

Mr. BOSKIN. Well, as I stated earlier, our goal is to reduce the deficit by slowing the growth of spending. Certainly within the executive branch the President and Director Darman have been telling the agencies that if they want to—if they have some high-priority items that they think they should be increasing spending on they should be looking for ways to offset it in the spirit of the flexible freeze.

So, I would say kind of, the spirit lives on if not necessarily the terminology.

Also we had a bipartisan budget accord which had various features to it. And we intend to be full partners in that and live up to our commitments under it.

Representative HAMILTON. The thing that strikes me about it is that it really shows the impact of these economic assumptions we were talking about earlier.

The flexible freeze would require cuts in the programs subject to the flexible freeze of $40 billion in 1993 compared to the baseline spending. If CBO figures are taken then you're going to have to find $100 billion in ordered cuts in 1993. So, in the outyears these assumptions really have quite a significant impact.

Mr. BOSKIN. Well, you're certainly correct that what are very modest differences, when accumulated, have more of an impact further out when compounded.

Representative HAMILTON. Do you think it's prudent to hinge your deficit reduction strategy on the optimistic or slightly optimistic assumptions that you've made? Is that a prudent thing to do?

Mr. BOSKIN. We believe so. We believe we've made very reasonable economic assumptions. And we believe the technical assumptions that have complemented them from OMB and Treasury have been quite reasonable. So we believe that this is prudent.

But we also believe it would be prudent to bear in mind that other scenarios are possible. And, as I indicated earlier, I think in both my testimony and Director Darman's—perhaps Secretary Brady's I'm not sure—that we have indicated in the future that we would like to portray greater information in this regard for the actual decisionmakers so that they understand in more detail what these differences might entail: A better performing or a more poorly performing economy in various dimensions rather than just the simple notions that a 1 percentage point higher interest rate would do *x* or whatever. So we will try to be doing that.

But we believe it is a reasonable set of estimates.

Representative HAMILTON. I know you've been testifying for quite a while. I want to hit just a few other topics rather quickly, if I may.

We had a Bureau of Labor Statistics release on international comparisons of manufacturing productivity and labor costs for 1988. It showed that in productivity gains and unit labor costs U.S. industry did no better than average during 1988 compared to 11 of our major trading partners; 6 of the 11 had equal or faster productivity growth; 5 did better on unit labor costs. The same kind of pattern held for the entire period 1979–88.

The only way U.S. industry improved its competitiveness in recent years was as a result of the decline in the value of the dollar.

Now, if the United States continues to have no better than average productivity growth, what's that going to mean with respect to our competitiveness in the markets?

Mr. BOSKIN. Well, I think the United States has become much more competitive for a variety of reasons, and obviously this varies from industry to industry so it's hard to make a specific generalization. When one looks at these international comparisons it's always important to realize that we started from a much higher absolute level of productivity, so in a sense it's easier to have higher gains starting from much lower productivity and it's more difficult to continue productivity improvements at a rapid rate when you're at the higher level of productivity that we are at.

But I believe that we've seen some major improvements in productivity in U.S. manufacturing, and that in most sectors U.S. manufacturing is quite competitive. So I'm cautiously optimistic on that score.

Representative HAMILTON. It's your general impression that we are becoming more competitive with our major trading partners?

Mr. BOSKIN. Certainly in the manufacturing sector I would argue that. I would also argue that American business has finally begun to adopt a more international perspective and realized that they have to compete in a global market.

Representative HAMILTON. Do you think our——

Mr. BOSKIN. And I would like to see that accelerate.

Representative HAMILTON. If you're projecting out the trade deficit, do you think it will be coming down steadily now for the next 4 or 5 years?

Mr. BOSKIN. Well, I would always——

Representative HAMILTON. Is there a way to get away from the month-to-month jumping around?

Mr. BOSKIN. All right. That was the point I was trying to make. Fair enough.

We believe that we will steadily improve.

Representative HAMILTON. Yes.

Mr. BOSKIN. There may be a quarter where it deteriorates and another quarter where it does very well, and so on. But we believe it will gradually improve.

Representative HAMILTON. All right.

Do you think we'll hit a soft landing in the economy or are hitting it?

Mr. BOSKIN. Well, Mr. Chairman, to be perfectly honest, I'm getting—this is the third round of transportation analogies. And with all due respect to my good friend, the Secretary of Transportation, Sam Skinner, I guess between running out of gas and losing steam and soft landings, I expect, given the President's speech later today and the 20th anniversary of the landing on the—the first walk on the Moon, I would hope that the next round isn't about space travel as opposed to steam or automobiles or airplanes.

If one interprets the soft landing as the economy moving from very rapid growth to more modest growth, inflation being brought under control and gradually reduced without a recession, and continued more modest growth, then that's fine.

If one puts the runway lower than that I would say that there is really no need for the economy to make a landing for some time to come. And barring a policy mistake or an external shock, the economy will continue to fly for some time to come.

Representative HAMILTON. Do we then need a period of slow growth and rising unemployment in order to keep the inflation rate from accelerating?

Mr. BOSKIN. I think what is already in the pipeline is likely to see us have somewhat more moderate growth for the next several quarters for this year lasting into next year, as in our forecast, a little bit below the potential growth of the economy. And that in our forecast has the unemployment rate rising a little bit. But it still winds up at levels that are quite low by historical standards, and then it starts to decline once the economy rebounds back toward its potential later in 1990.

We believe that relatively low unemployment, historically low by U.S. standards relative to the last 15 years, is quite consistent with stable and eventually falling inflation.

Representative HAMILTON. One of our witnesses a few days ago said that—jumping now to the trade deficit for just a moment—that he thought we were in the $100 billion range on trade deficits for as far as the eye could see. That's contrary to your view.

You would expect us to move that trade deficit down. You testified a moment ago to the glide path, and we would be below the $100 billion level soon, within a few years.

Mr. BOSKIN. That's correct.

I believe that the trade deficit and flows of capital are determined simultaneously, and that as we get our deficit, our budget deficit under control—which we very, very much want to do and hope to be able to work cooperatively with Congress to do—that we will—that that will be one of the contributors to a reduction in our trade deficit.

And we also believe that when the surplus, the trade surplus countries like Japan and Germany continue their domestically led demand growth and bear their share of the responsibility for these adjustments that we will continue to see our trade deficit improve.

Representative HAMILTON. Let me conclude with a question or two about the Federal statistics that you know this committee has an interest in, and I know you do too.

Commissioner Norwood said the other day that she had cut all the peripheral programs during the budget cuts of recent years and that if she had to sustain a further 5-percent cut that would hurt her basic BLS statistical programs.

Now is that your feeling too with regard to the quality of the statistical programs——

Mr. BOSKIN. No——

Representative HAMILTON [continuing]. That if they have to take that kind of a cut that there will be some impact on the quality of those statistics?

Mr. BOSKIN. Let me first say that we very much appreciate the interest of the Joint Economic Committee. And let me state for the record that I very much appreciated your personal attention to our request for suggestions, and that of Senator Sarbanes. They were very useful and they were being considered by the Economic Policy Council Working Group on Economic Statistics. So we're very much grateful for that. Thank you.

And we are very, very much interested in preserving and improving the quality of the statistics. And while I would have to have a more detailed evaluation with Commissioner Norwood to find out exactly what she has in mind in that regard, it is our view that—and the President's view as enunciated in his February 9 message—improving the quality of government statistics is one of the priority items in a tight budget situation.

So we would hope that the importance of quality statistics would be one of the major considerations given were there to be any budget cuts—in this case in the Labor Department. As different claims competed for the scarce resources we would hope that the importance of the statistics would be given high priority by the Secretary of Labor and by the President and the OMB, et cetera.

Representative HAMILTON. I suppose you will confer, will you not, with the heads of BLS and the Census Bureau and the Department of Labor and the other bureaus and agencies and departments that produce statistics in your consideration of these matters?

Mr. BOSKIN. Yes. We are in the process of doing that. We started off with a couple of meetings where we talked about what the highest priorities were for improving the quality of the statistics in the short run and also on a longer run basis. And we now have them evaluating what the potential costs and options and opportunities are to implement those, and then we will be meeting to discuss them.

Representative HAMILTON. Let me ask you about one of those statistics, the one that those of us who are not economists hear a lot about: The leading indicators statistics.

You often hear complaints about the leading indicators. Are you doing anything to try to improve the quality of that particular item?

Mr. BOSKIN. Mr. Chairman, the Commerce Department recently did make some improvements. They changed the components a little bit and they made some other adjustments. And we will just have to see how much of an improvement that is.

Representative HAMILTON. As an economist, how much confidence do you have in that particular index?

Mr. BOSKIN. Well, speaking purely as a professional economist, I believe that it is a useful piece of information, but that it gets too much attention as a single predictor. After all, 8 of the 11 components are usually released prior to the release of the index. And I think it is very difficult to summarize a complex economy and its movements in one particular measure.

Representative HAMILTON. OK.

Well, thank you very much for the testimony, Mr. Boskin and Mr. Taylor. We're very pleased to have you. We wish you well in your assignment, and we look forward to future opportunities to visit with you in this committee.

Mr. BOSKIN. Thank you very much, Mr. Chairman.

Mr. TAYLOR. Thank you.

Representative HAMILTON. The committee stands adjourned.

[Whereupon, at 11:51 a.m., the committee adjourned, subject to the call of the Chair.]

[The following written questions and answers were subsequently supplied for the record:]

RESPONSES OF HON. MICHAEL J. BOSKIN TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE HAMILTON

Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)

Washington, DC 20510
August 10, 1989

The Honorable Michael J. Boskin
Chairman
Council of Economic Advisers
Old Executive Office Building
Washington, D.C. 20510

Dear Professor Boskin:

Thank you for your recent testimony before the Joint Economic Committee. The Committee would very much appreciate, at your earliest convenience, a written response to the following questions on some of the most difficult points raised in the hearing.

1. According to your projections, favorable economic performance, together with full enactment of the current budget agreement, will allow the deficit to fall from $150 billion in FY 1989 to $25 billion in FY 1994. The somewhat less optimistic medium-term projections of the Congressional Budget Office seem to imply a deficit closer to $100 billion if not higher in 1994, even assuming enactment of the current budget agreement.

    * How do you respond to the argument that, although each of your economic assumptions is plausible in light of current economic conditions and historical relationships -- albeit probably toward the optimistic end of the range of plausibility -- the net effect is to produce an overall economic forecast that is implausibly optimistic?

    * Do you find CBO's medium-term economic projections implausible in light of current economic conditions and historical relationships?

    * Do you find the behavior of the budget deficit implicit in CBO's medium-term projections to be unduly alarmist about what will happen to the budget deficit if there are no further policy actions beyond full enactment of the current budget agreement?

Hon. Michael J. Boskin
August 10, 1989
Page Two

* Are you confident that the deficit behavior implicit in your economic forecast gives the most accurate forecast available about what will happen to the budget deficit over the next several years if there are no further actions to reduce the budget deficit beyond full enactment of the current budget agreement?

2. Often in past business cycle recoveries, the core inflation rate (measured by the CPI less food and energy, for example) has fallen in the early stages of recovery, but as the economy continues to expand and the unemployment rate continues to drop, the core inflation rate almost invariably begins to rise.

   * Do you agree with this characterization of the behavior of inflation and unemployment over the business cycle?

   * Is your economic forecast of a sustained gradual decline in both inflation and the unemployment rate after 1990 consistent with this past experience?

   * Please explain the theoretical and empirical analysis that underlies your projections of a decline in the inflation rate and the unemployment rate after 1990. Please also explain how and why your projections differ from a "modified Phillips Curve" analysis in which there is an inverse relationship between inflation and the unemployment rate over the business cycle, and a sustained recession is required to lower expected inflation.

3. Many forecasters, including the CBO, estimate the economy's potential for steady high employment growth without rising inflation to be about 2.5 percent per year. You estimate it to be about 3.0 percent per year. A key element of your forecast for real growth is your assumption that the rate of growth of productivity in the nonfarm business sector will average 1.8 percent per year.

   * Between 1948 and 1988, productivity growth in the nonfarm business sector has averaged 1.8 percent per year, but it has averaged only 1.2 percent per year since the last high employment year, 1979. Please explain the theoretical and empirical analysis that leads you to project that productivity growth will be substantially higher during the next five years than it has been over the previous decade.

* Productivity growth in the current recovery (1982-1988) has averaged 1.8 percent per year, but during the last three years (1985-1988) it has averaged only 1.4 percent per year. Is it not usually the case in an economic recovery that productivity growth is higher in the earlier stages than it is when the economy is close to full employment? On what basis are you projecting more than a 25 percent increase in the rate of productivity growth as the economy continues to operate close to full employment?

We appreciate your cooperation.

With all good wishes,

Sincerely,

Lee H. Hamilton
Chairman

LHH:jmt

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

September 8, 1989

Dear Congressman Hamilton:

Thank you for your letter of August 10. I am pleased to have the opportunity to discuss further my testimony before the Joint Economic Committee and to answer the specific questions in your letter. The questions and my responses are enumerated below.

1. "How do you respond to the argument that, although each of your economic assumptions is plausible in light of current economic conditions and historical relationships--albeit probably toward the optimistic end of the range of plausibility--the net effect is to produce an overall economic forecast that is implausibly optimistic?"

It is easiest to address this question in parts. For 1989, the CEA forecast is similar to many other (including CBO) mainstream forecasts. While our real growth forecast is slightly higher and unemployment and inflation slightly lower--thus far in 1989 we are almost exactly accurate--the differences among forecasts for 1989 are not large. For the years 1991 to 1994, the forecast is dominated by the assumed underlying growth path of the economy. The CEA growth forecast is roughly 0.5 percentage points higher than CBO due to the higher growth rate of productivity, a point that will be discussed further below. The other major difference between the CEA forecast and the CBO path is the more rapid reduction in real interest rates, but the cumulative decline between 1989 and 1994 is quite similar in both cases. It is important to note that historically real interest rates in the United States have not necessarily followed smooth adjustment, but have rather been subject to sharp changes in underlying regimes (see attached chart).

Thus, the critical comparison lies in the forecast for 1990, where CEA forecasts somewhat less slow growth (2.3 percent on a year-over-year basis versus 1.7 percent for the CBO) than some others. Consistent with this prediction are somewhat lower real interest rates (2.5 percent versus 2.8) and unemployment rates (5.2 percent versus 5.3 percent) than in the corresponding CBO forecast. There is nothing to suggest that the forecast is internally inconsistent.

2. "Do you find CBO's medium-term economic projections implausible in light of current economic conditions and historical relationships?"

As discussed above, the important differences between CBO and CEA lie in two areas: the CBO's short-run forecast of a sharp slowdown in 1990 (which the recent evidence suggests may be overstated) and the growth of labor productivity. While CEA disagrees with the CBO conclusions, "implausible" is too strong a characterization of the CBO projections.

3. "Do you find the behavior of the budget deficit implicit in CBO's medium-term projections to be unduly alarmist about what will happen to the budget deficit if there are no further policy actions beyond full enactment of the current budget agreement?"

The President remains committed to achieving the targets set by the Gramm-Rudman-Hollings process. Accordingly, considerable concern does accompany any forecast of sustained budget deficits. While not agreeing with the particulars of the CBO forecast, I do hope that it serves to foster an atmosphere in which Congress and the Administration can work together to implement the reforms necessary to reduce budget deficits and enhance economic growth in the United States.

4. "Are you confident that the deficit behavior implicit in your economic forecast gives the most accurate forecast available about what will happen to the budget deficit over the next several years if there are no further actions to reduce the budget deficit beyond full enactment of the current budget agreement?"

It is important to stress that the budget deficits shown in the Mid-Session Review are based upon not only the progress made through the Bipartisan Budget Agreement, but also on the adoption of the important reforms proposed by the President in February. It is important to adopt these reforms to continue our joint efforts to exert control over the problem of deficit spending.

5. "Often in the past business cycle recoveries, the core inflation rate (measured by the CPI less food and energy, for example) has fallen in the early stages of recovery, but as the economy continues to expand and the unemployment rate continues to drop, the core inflation rate almost invariably begins to rise. Do you agree with this characterization of the behavior of inflation and unemployment over the business cycle?"

As is discussed further below, it is possible to construct an apparent tradeoff between inflation and unemployment in historical data. There are reasons to be cautious about the use of this construct, however. First, it is potentially misleading to use this (or any other) single series as a correct measure of the "underlying" inflation rate. Each historical series will contain elements of both the underlying trend and transitory fluctuations. More importantly, embedded in the historical data are business cycle influences, supply-side shocks, and short-run variations in Federal Reserve policy. Particularly with regard to monetary policy, there is an expectation that the accumulation of experience is producing a more consistent, noninflationary policy.

6. "Is your economic forecast of a sustained gradual decline in both inflation and the unemployment rate after 1990 consistent with this past experience?"

Yes. The long-run trend in inflation will be dominated by the commitment to a steady, noninflationary monetary policy. The Federal Reserve has a stated commitment to such a policy and this policy will be reinforced by a predictable policy of declining budget deficits. In the same way, the long-run average rate of unemployment depends not upon short-run business cycle movements, but rather on growth in both capital accumulation and the labor force, the skills of the labor force, and the flexibility of the labor market in terms of mobility between jobs and the reaction of wages to changes in underlying profitability. We anticipate the picture for both inflation and unemployment to improve over the next several years.

7. "Please explain the theoretical and empirical analysis that underlies your projections of a decline in the inflation rate and the unemployment rate after 1990. Please also explain how and why your projections differ from a "modified Phillips Curve" analysis in which there is an inverse relationship between inflation and the unemployment rate over the business cycle, and a sustained recession is required to lower expected inflation."

The Phillips curve is a very general relationship that takes into account the characteristics of the labor force, the nature of the wage bargaining process, the mechanism of price setting by firms, and fiscal and monetary policy reactions. In some circumstances, the outcome is a negative correlation between measured inflation and the difference between the current rate of unemployment and the "natural"--or full employment--rate of unemployment. Further, in the modified Phillips curve actual inflation is increased due to citizens' expectations concerning future rates of inflation.

The Administration's projections are not inconsistent with the economic theories underlying the Phillips curve relationship. The theories indicate that declines in expected inflation or the natural rate of unemployment, as well as changes in other variables, can result in no perceivable relationship between inflation and unemployment for long periods of time. For example, the rate of inflation excluding food and energy has remained relatively steady for over 6 years even though the unemployment rate has dropped by over 4 percentage points.

Expected inflation depends critically upon a steady, consistently noninflationary monetary policy. As noted above, we support the Federal Reserve's stated commitment to such a policy.

It appears that the natural rate of unemployment has fallen in recent years and can continue to fall as the labor market becomes more flexible and continues to adjust to the aging of baby boom workers, the increased participation rates of groups such as females and second-earners, the structural shift toward greater employment in the services sector, and the restrictions imposed by international competitiveness.

8. "Many forecasters, including the CBO, estimate the economy's potential for steady high employment growth without rising inflation to be about 2.5 percent per year. You estimate it to be about 3.0 percent per year. A key element of your forecast for real growth is your assumption that the rate of growth of productivity in the nonfarm business sector will average 1.8 percent per year. Between 1948 and 1988, productivity growth in the nonfarm business sector has averaged 1.8 percent per year, but it has averaged only 1.2 percent per year since the last high employment year, 1979. Please explain the theoretical and empirical analysis that leads you to project that productivity growth will be substantially higher during the next 5 years than it has been over the previous decade."

This is one of the most important issues in the United States' economic performance and one of the most heartening successes. After poor productivity performance in the 1970's, recently productivity growth has increased. The growth in productivity between 1980 and 1982 was inhibited by the sharp downturn and the need to reduce the rate of inflation. However, between 1982 and 1988, nonfarm business productivity grew at an average rate of 2.0 percent. Even excluding the early part of the recovery leaves an average growth rate of 1.8 percent over the last 3 years.

The growth of labor productivity depends upon the skills of individual workers, the matching of these workers to jobs that suit their skills, the quality of the capital available to these workers, and the market process of weeding out inefficient firms. These processes are at work in the economy. As the baby boom generation matures, each member of this unusually large cohort acquires better skills. With inflation now reduced from recent high levels, wage bargains are now being struck on the basis of underlying productivity, rather than simply to accommodate expected inflation. The result is a labor market that more flexibly responds to changes in underlying profitability and opportunities for advancement. In addition, U.S. firms are responding to the challenge of international competitiveness. The list could go on. In each case, the result is to restore productivity growth to its historical norm.

9. "Productivity growth in the current recovery (1982-1988) has averaged 1.8 percent per year, but during the last 3 years (1985-1988) it has averaged only 1.4 percent per year. Is it not usually the case in an economic recovery that productivity growth is higher in the earlier stages than it is when the economy is close to full employment. On what basis are you projecting more than a 25-percent increase in the rate of productivity growth as the economy continues to operate close to full employment?"

Recently revised data show productivity growth has averaged 1.8 percent per year over the past 3 years, equal to the long-run average since 1948. The Administration projections assume no increase, but instead the same 1.8 percent average annual rate over the medium-term projections period.

As you are well aware, forecasting the behavior of budget receipts and outlays is a difficult process that involves anticipating both movements in economic conditions and the legislative initiatives of both the Congress and the Administration. The budget forecasts presented in the Mid-Session Review of the Budget necessarily include an element of judgment, but I am confident of their foundation in economic analysis and the careful use of the most recent data available during their preparation.

Thank you for this opportunity to further discuss these important issues.

Sincerely,

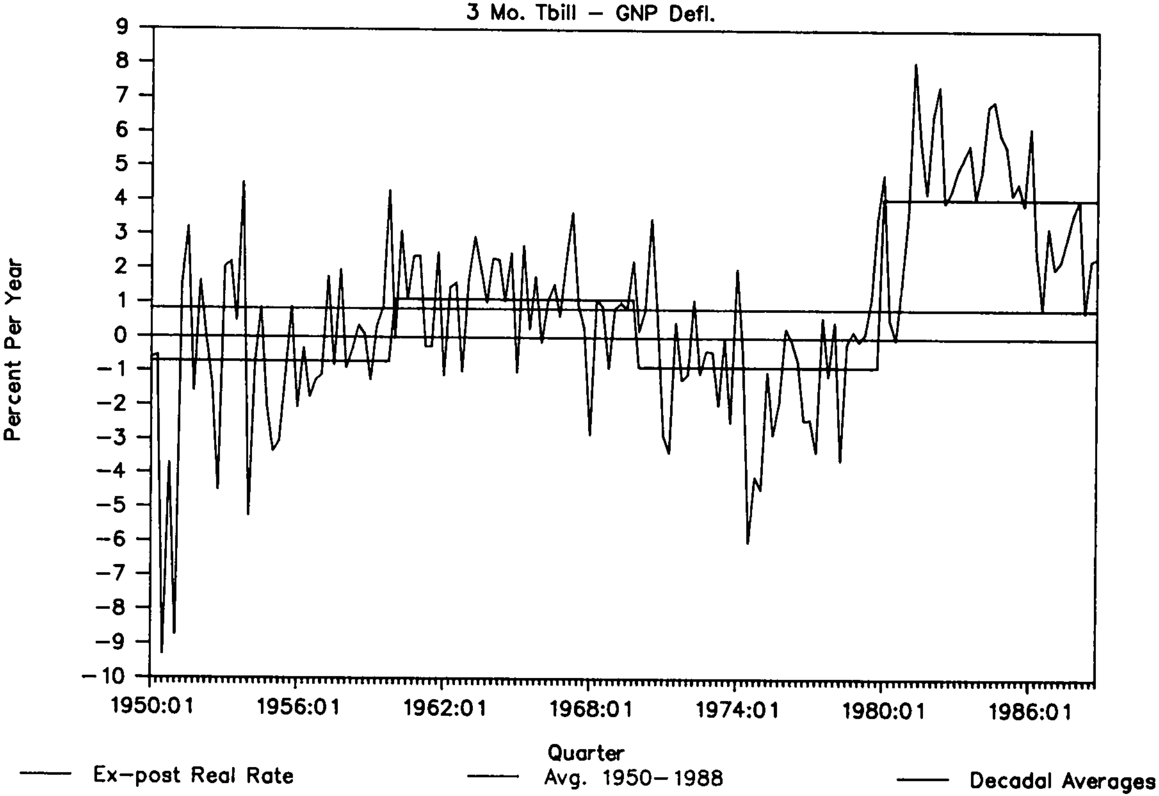
Michael

Michael J. Boskin

The Honorable Lee H. Hamilton
Chairman
Joint Economic Committee
G01 Dirksen Senate Office Building
Washington, D.C. 20510

Attachment

Real Interest Rate



THE ECONOMIC OUTLOOK AT MIDYEAR

THURSDAY, JULY 27, 1989

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

The committee met, pursuant to notice, at 9:30 a.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton and Snowe.

Also present: Joseph J. Minarik, executive director; William Buechner, Chad Stone, and Chris Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The Joint Economic Committee resumes its hearings on the state of the U.S. economy at midyear and the appropriate economic policies for the remainder of 1989 and 1990.

Last Thursday, the committee began this set of hearings with testimony from Michael Boskin, Chairman of the Council of Economic Advisers, who represented the administration's shortrun economic forecast for the rest of this year and its longrun projections through 1994.

Mr. Boskin testified that the administration expects the economy to grow 2.7 percent this year and continue growing through 1994, with a steady, long-term decline in inflation, unemployment, and interest rates.

Based on this forecast, the administration projects a continued steady decline in the budget deficit.

The purpose of today's hearing is to evaluate the administration's economic and budget forecast and its current economic policies.

The committee is very pleased to have three witnesses who are eminently qualified to do this: Mr. Robert Barbera—do I pronounce that right?

Mr. BARBERA. Bar-be-ra.

Chairman HAMILTON. Bar-be-ra. All right, sir.

Chief economist, Shearson Lehman Hutton; Mr. Roger Brinner, chief economist, Data Resources, Inc.; and Mr. Rudolph Penner, senior fellow, the Urban Institute, formerly, of course, the Director of the Congressonal Budget Office.

Each of you have prepared statements which, of course, will be entered into the record in full, and we'll begin with your testimony. I would appreciate your summarizing the prepared statements, if you would, so we could turn to questions.

Mr. Penner, we'll begin with you and just move across the table.

STATEMENT OF RUDOLPH G. PENNER, SENIOR FELLOW, THE URBAN INSTITUTE

Mr. PENNER. Thank you very much, Mr. Chairman. I would like to thank you for this opportunity to testify.

The economy is teetering on the brink of recession. The consensus forecast, as measured by the Blue Chip average, has it close to falling over that brink, but it does not quite tumble and recession is avoided through the end of 1990.

The administration also predicts a significant slowdown, but recession is avoided by a safer margin. CBO's real growth forecast falls between that of the consensus and the administration. I've detailed the three forecasts in a table of my prepared statement.

Now, those three forecasts fall within normal forecasting errors of each other and, therefore, cannot be said to be significantly different; although the administration forecast is eminently reasonable, it's my judgment that the probability that we shall do worse than the administration expects is considerably higher than the probability that we shall do better.

Indeed, all of the forecasts may be somewhat optimistic. The key question raised by the consensus forecast is whether the economy can slow down significantly without subsequently sliding into recession.

The internal dynamics of the economy create a strong tendency for slowdowns to be converted into an outright decline. When the economy is growing steadily, businesses must add steadily to their capital and inventory in order to maintain satisfactory capital-output and inventory-sales ratios. When growth slows, they add less to inventories and plant and equipment.

In other words, a slowdown in growth can result in an absolute decline in inventory and plant and equipment spending. Declining plant and equipment and inventory investment can then more than offset continued growth in other sectors, thus causing a decline in total production.

That's one reason why soft landings are so rare in economic history.

It's interesting to note that, since World War II, there has been no calendar year in which growth fell short of 2 percent that was not either associated with a concurrent recession or followed by a decline the next year.

However, that interesting result is occasionally a consequence of the vagaries of averaging, and there have been brief periods of abrupt slowdowns within years that did not evolve into recession. The most recent episode occurred in 1986, when growth exceeded 6 percent in the first quarter, became negative in the second, and fell short of 2 percent for the rest of the year before accelerating in 1987.

The economy is now, however, faced with a number of problems that did not exist in 1986. At that time, the unemployment rate exceeded 6 percent and a great deal of excess capacity was available.

Inflation rates, aided by falling world oil prices, were falling, and the Federal Reserve Board could react vigorously to the slowdown.

Treasury bill rates fell about 2 percentage points from the beginning of 1986 to the fall of that year, and money growth was accelerated.

Today, with the economy operating at full capacity, the Fed has to be much more careful. If it errs on the expansive side, accelerating inflation will become ingrained in the economy and it will take a major recession to break it. Although the Fed has eased recently, the easing has been appropriately cautious.

In 1986, fiscal policy was very expansionary with the NIA Federal budget deficit setting an absolute record in the second quarter of that year. Although our progress in correcting the structural deficit has been disappointingly slow, there has, nevertheless, been some improvement, and fiscal policy will tighten a bit in fiscal 1990.

It's especially ironic to note that our antitax society will experience a substantial tax increase. Passive loss and interest deductions continue to be phased out under the Tax Reform Act of 1986; there will be a payroll tax rate increase, catastrophic health insurance premiums will impose a burden unless altered by the Congress, and, of course, the budget agreement calls for an additional net tax increase of over $5 billion.

As a result of these tax increases, real disposable income will remain virtually unchanged in 1990, if the GNP grows at the pace forecast by the consensus.

The economic expansion will only be sustained in the short run if the personal savings rate falls and that's not a healthy development for the long run.

At the beginning of 1986, the foreign exchange value of the dollar had already been falling for a year and improving net exports contributed to the reacceleration of growth in 1987. In contrast, the dollar's value has risen from November 1988 through the middle of June, and although it has come down slightly from its recent high, real net exports are likely to improve only a little, if at all, between 1989 and 1990.

Given the contractionary influences described above and the natural tendency for slowdowns to evolve into declines, the risk that the current slowdown will eventually become a recession is very high. Indeed, I judge it to be greater than 50 percent.

But I don't see much danger of a very severe recession, say, of 1982 magnitude, because monetary policy is shifting already and is likely to ease more radically as the first clear sign of recession emerges.

A recession could yet be prevented by a variety of forces. It is possible, for example, that monetary policy has shifted in the nick of time and that the interest rate decline experienced thus far may be already sufficient to ward off a recession.

But it's not clear to me that a mild recession would be that much worse than the only available alternative. The Fed cannot safely tolerate real growth above 2.5 percent given current conditions. A growth rate between zero and 2.5 percent implies a gradual rise in unemployment and excruciatingly slow progress on inflation.

What is now called the soft landing used to be called a growth recession, and they are not pleasant. They simply prolong low-intensity pain. A harder landing should cause a more permanent reduction in inflation and lay the foundation for healthier growth in the years to come.

There are, of course, also dangers inherent in a recession. It may turn out to be much worse than any I envision. On the other side is the danger that the Fed will overreact, returning us to an inflationary situation on the other side of the cycle.

It's not easy to be a central banker.

Turning to the administration's longrun economic projections, I do believe that they are more obviously overoptimistic than are the shortrun projections. Consequently, they lead to a serious understatement of the budget problem over the next 5 years.

The projections for the 1991–94 period assumed growth slightly exceeding 3 percent and unemployment falling to 5 percent, while inflation and interest rates decline.

Such a scenario requires much better productivity performance than recently experienced and an unusually low estimate of the unemployment rate at which wage increases begin to accelerate.

No economist can say with certainty that such assumptions are definitely wrong, but they are highly improbable. No corporation would use such assumptions for the purposes of long-term planning. More important, the Fed does not use them for the purposes of formulating monetary policy and, therefore, the Fed is unlikely to sustain the long-term growth rates assumed by the administration.

The problem with the administration assumptions, of course, is that they create the illusion that we can easily grow our way out of the budget problem, a promise that we have heard since 1981.

With these assumptions, the policies inherent in the recent budget agreement result in a 1994 deficit of less than $25 billion. Unfortunately, a great deal of fiscal heroism is likely to be required to do that well and it will not come easily.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Penner follows:]

PFEPARED STATEMENT OF RUDOLPH G. PENNER

THE ECONOMIC OUTLOOK

Mr. Chairman, members of the committee, I would like to thank you for this opportunity to testify.

The economy is teetering on the brink of recession. The consensus forecast, as measured by the Blue Chip average, has it close to falling over that brink, but it does not quite tumble and recession is avoided through the end of 1990. The administration also predicts a significant slowdown, but recession is avoided by a safer margin. The Congressional Budget Office's real growth forecast falls between that of the consensus and that of the administration.

The forecasts for major economic variables are compared in the following table.

TABLE

A COMPARISON OF FORECASTS

	1988 actual	1989	1990
Real GNP growth - Administration	3.9	2.9	2.3
CBO	3.9	2.8	1.7
Blue Chip	3.9	2.6	1.5
GNP implicit deflator - Administration	3.5	4.5	4.2
CBO	3.5	4.5	4.4
Blue Chip	3.5	4.7	4.5
Unemployment rate - Administration	5.5	5.2	5.4
CBO	5.5	5.3	5.5
Blue Chip	5.5	5.3	5.7
91-day Treasury bill rate - Administration	6.7	8.0	6.7
CBO	6.7	8.2	7.4
Blue Chip	6.7	8.2	7.4

The views expressed are those of the author and do not necessarily reflect the views of the trustees, executives, or staff of The Urban Institute.

The three forecasts fall within normal forecasting errors of each other, and therefore, cannot be said to be significantly different. Although the administration forecast is eminently reasonable, it is my judgment that the probability that we shall do worse than the administration expects is considerably higher than the probability that we shall do better. Indeed, all of the forecasts may be somewhat optimistic.

The key question raised by the consensus forecast is whether the economy can slow down significantly without subsequently sliding into a recession. The internal dynamics of the economy create a strong tendency for slowdowns to be converted into outright declines. When an economy is growing steadily, businesses must add steadily to their capital and inventory in order to maintain satisfactory capital-output and inventory-sales ratios. When growth slows, they add less to inventories and to plant and equipment. In other words, a slowdown in growth can result in an absolute decline in inventory and plant and equipment spending. Declining inventory and plant and equipment investment can then more than offset continued growth in other sectors, thus causing a decline in total production. That is one reason why soft landings are so rare in economic history.

It is interesting to note that since World War II, there has been no calendar year in which growth fell short of 2 percent that was not either associated with a concurrent recession or followed by a decline the next year. However, that interesting result is occasionally a consequence of the vagaries of averaging, and there have been brief periods of abrupt slowdowns within years that did not evolve into recessions. The most recent episode occurred in 1986 when growth exceeded 6 percent in the first quarter, became negative in the second, and fell short of 2 percent for the rest of the year before accelerating significantly in 1987.

The economy is, however, faced with a number of problems that did not exist in 1986. At that time, the unemployment rate exceeded 6.0 percent and a great deal of excess capacity was available. Inflation rates, aided by falling world oil prices, were falling, and the Federal Reserve Board could react vigorously to the slowdown. Treasury bill rates fell about 2 percentage points from the beginning of 1986 to the fall of that year, and money growth was accelerated.

Today, with the economy operating at full capacity, the Fed has to be much more careful. If it errs on the expansive side, accelerating inflation will become engrained in the economy and it will take a major recession to break it. Although the Fed has eased recently, the easing has been appropriately cautious. My interpretation is that the Fed has been lagging the market a bit with the Fed funds rate falling somewhat less than the Treasury bill rate from their peaks last spring. The growth in the money aggregates has been extraordinarily weak until very recently, and this slowdown is likely to have long-lasting effects.

In 1986, fiscal policy was expansionary with the NIA Federal budget deficit setting an absolute record in the second quarter of that year. Although our progress in correcting the structural deficit has been disappointingly slow, there has, nevertheless, been some improvement, and fiscal policy will tighten a bit in fiscal 1990. It is especially ironic to note that our anti-tax society will experience a substantial tax increase. Passive loss and personal interest deductions continue to be phased out under the Tax Reform Act of 1986; there will be a payroll tax rate increase; catastrophic health insurance premiums will impose a burden unless altered by the Congress; and the budget agreement calls for an additional net tax increase of over $5 billion. (Any reduction in health insurance premiums will have to be offset.) As a result of these tax increases, real disposable income will remain virtually unchanged in 1990, if the GNP grows at the pace forecast by the consensus. The economic expansion will only be sustained in the short run if the personal saving rate falls and that is not a healthy development for the long run.

I should emphasize that I am not bemoaning the fiscal tightening that is occurring. With even more fiscal tightening, the Fed might feel able to be less cautious. For any given level of economic activity, national savings would then be higher and interest rates lower.

At the beginning of 1986, the foreign exchange value of the dollar had already been falling for a year and improving net exports contributed to the reacceleration of economic growth in 1987. In contrast, the dollar's value rose from November 1988 through the middle of June, and although it has come down slightly from its recent high, real net exports are likely to improve only a little, if at all, between 1989 and 1990.

Given the contractionary influences described above and the natural tendency for slowdowns to evolve into declines, the risk that the current slowdown will eventually become a recession is very high. Indeed, I judge it to be greater than 50 percent. But I do not see much danger of a very severe recession, say of 1982 magnitude, because monetary policy is shifting already and is likely to ease more radically as the first clear sign of recession emerges.

A recession could yet be prevented by a variety of forces. It is possible, for example, that monetary policy has shifted in the nick of time and that the interest rate decline experienced thus far may already be sufficient to thwart a recession. But it is not clear to me that a mild recession would be that much worse than the only available alternative. The Fed cannot safely tolerate real growth above 2.5 percent annually given current conditions. A growth rate between zero and 2.5 percent implies a gradual rise in unemployment and excruciatingly slow progress on inflation. (I am afraid that last month's CPI exaggerates the progress made on inflation thus far.)

What is now called a soft landing used to be called a growth recession and they are not pleasant. They simply prolong low-intensity pain. A harder landing should cause a more permanent reduction in inflation and lay the foundation for healthier growth in the years to come. There are, of course, also dangers inherent in a recession. It could turn out to be much worse than any I envision. Some worry that the unusually high debt load facing the corporate sector could be destabilizing, but I do not see that as much of a problem so long as the recession stays mild in the first place. On the other side is the danger that the Fed will over-react, returning us to an inflationary situation on the other side of the cycle. It is not easy to be a central banker.

Turning to the administration's long-run economic projections, I do believe that they are more obviously overoptimistic than are the short-run projections. Consequently, they lead to a serious understatement of the budget problem over the next five years.

The projections for the 1991-94 period assume growth slightly exceeding 3 percent and unemployment falling to 5 percent while inflation and interest rates decline. Such a scenario requires much better productivity performance than recently experienced and an unusually low estimate of the unemployment rate at which wage increases begin to accelerate. No economist can say with certainty that such assumptions are definitely wrong, but they are highly improbable. No corporation would use such assumptions for the purposes of long-term planning. More important, the Fed does not use them for the purposes of formulating monetary policy, and therefore, the Fed is unlikely to sustain the long-term growth rates assumed by the administration.

The problem with the administration assumptions is that they create the illusion that we can easily grow our way out of the budget problem - a promise that we have heard since 1981. With these assumptions, the policies inherent in the recent budget agreement result in a 1994 deficit of less than $25 billion. Unfortunately, a great deal of fiscal heroism is likely to be required to do that well, and it will not come easily.

Representative HAMILTON. Thank you very much, Mr. Penner. Mr. Brinner, please proceed.

STATEMENT OF ROGER E. BRINNER, CHIEF ECONOMIST AND GROUP VICE PRESIDENT, DRI/McGRAW-HILL

Mr. BRINNER. Thank you. I do appreciate the opportunity to discuss the outlook in the midsession review with the committee. In the remarks that I have submitted, note that I applaud the administration's endorsement of the concept of steady deficit reduction and their slightly more realistic forecast than we've been treated to during the past decade.

But, I do disagree with the assessment that the bipartisan budget accord restricts spending, but generates revenue sufficiently to achieve the deficit goals established by Congress.

In other words, lipservice is paid to the concept but number games are used to conceal the failure to act on this goal with the urgency it deserves.

I will elaborate some of the games—for your amusement, I'm afraid—or perhaps we can get something done about the game.

As most Members of Congress would agree, each dollar by which the Gramm-Rudman-Hollings targets are not met will be another dollar borrowed from abroad to be paid with interest from future generations, or another dollar unavailable for private investment to raise our longrun productivity and living standards.

I, therefore, urge stronger efforts to exceed the guidelines established by the bipartisan budget accord for 1990, and even greater commitments for 1991.

Turning to the administration's outlook, I would characterize that forecast as envisioning a perfect landing that requires an even more fortunate turn of events that the soft landing I and many other analysts expect.

I believe you're quite familiar with the administration's forecast, so I will just move on to a description of my forecast and then a contrast of the two.

Many elements of the administration's forecast could occur individually, particularly with greater fiscal discipline than is now apparent. And then with some compensatory help from the Federal Reserve.

In this respect, the plausibility of the current White House prediction offers a nice contrast to many other midsession reviews in the past decade. Nevertheless, it remains an unlikely scenario for two reasons.

It errs on the side of optimism for every concept; thus, the whole set of forecast numbers could not occur simultaneously and there are significant internal inconsistencies.

The major contrasting features of the soft landing I expect are a slowdown in real GNP to a 1-percent pace from the third quarter of this year through the second quarter of next year before a recovery begins.

I don't, frankly, expect us to have 1 percent each and every quarter. It's quite possible that we could get a negative number in one or two of those quarters.

The economists will term this a growth recession because we won't have any dramatic news of unemployment jumping, for example, by a half a point in one month and then another quarter point the next. So you won't have a sense of freefall in the economy in this 1 percent scenario.

But, for the extra three-quarters of a million people who are unemployed at any point in time by the end of next year, this will seem like a legitimate recession.

The decline in business spending on capital goods, construction and inventories that Mr. Penner mentioned are also in my forecast as the basis of a growth recession, driving the unemployment rate to a peak of 6 percent by the end of 1990.

A temporary easing of inflation to 4 percent in the second half of this year because of a short-term correction in energy prices and no change in food prices will be welcome, but it is only temporary.

A slump in profits the second half of this year, as they must if growth slows and inflation moderates, and then a gradual recovery to the same share of GNP as seen in 1988 is another contrasting element of my feature. The administration, in order to hit very ambitious revenue targets, exaggerates the profit share in GNP.

A balanced cyclical recovery in 1991 brings the unemployment rate back down toward 5.5 percent, just short of consensus for full employment that wouldn't threaten rising inflation.

But, this modest slack does not cause receding inflation. It's more reasonable to expect that we will have rising oil prices and higher prices for other imported goods because of the declining dollar. This will require us to operate the economy at about a 5.5-percent unemployment rate just to cap inflation near the current core rate.

A comparison of these scenarios highlights the inconsistencies I find in the OMB outlook. First, if the administration truly believes its own interest rate forecast, it should bet against the financial markets by selling 90-day Treasury bills rather than bonds to finance the current deficit and the refinancing obligations.

Why would any prudent borrower sell 10-year bonds paying 8 percent if he honestly expects short-term rates to drop toward 4 percent and long-term rates toward 5 percent in the near future?

I have raised this point in the past with administration officials during testimony. They have sent delegations up to our headquarters to discuss this with me. And their explanation is plain:

They insist they must follow the market rather than lead it. They insist that if they tried to sell more Treasury bills rather than bonds, Treasury bill rates would rise and bond rates would decline.

I say: Exactly right—temporarily, until you get the deficit fixed. But, the economy would be much healthier because everyone agrees the long-term rates have much more to do with the strength of housing and business fixed investment than do short-term rates.

So it would be to the economy's long-term benefit to flatten out the yield curve. That's true of the whole 1980's and it would be true of the 1990's as well.

Treasury debt management has been poor.

Second, inflation is highly unlikely to ease with booming profits, or conversely, profits are unlikely to soar with declining inflation.

Compensation per hour has already shifted up to a 5.5 percent inflation rate in the first half of this year. It would undoubtedly go much higher if profit margins continued to widen as the administration expects, particularly with unemployment rates falling toward 5 percent.

Employees would naturally, logically, and fairly demand large wage increases to maintain their share of the economic pie.

The OMB forecasts for real GNP and unemployment do imply I believe a reasonable 1.5 percent productivity gain. But, if you subtract that productivity gain from the compensation increases that would ensue in such an environment, you wouldn't have inflation receding down to 3 percent, you'd have it moving up steadily year after year toward 6 percent.

The motivation for the OMB forecast anomalies is all too obvious. The threat of Gramm-Rudman-Hollings sequestration is serious unless some tricks are employed. Thus, the inflation outlook is made artificially favorable to justify a falling interest rate scenario that they themselves don't believe—at least, they're not willing to bet on it in the Treasury debt management.

Likewise, the profit share of GNP is extraordinarily enhanced. They can do arithmetic. They know that each dollar of exaggerated profit produces 34 cents in profits taxes and at least 6 cents in personal dividend taxes.

The same dollar of GNP, if contributed to wages, would yield only half as much Federal revenue.

I was at the Council of Economic Advisers in the late 1970's. This is an old game. They are employing it to the hilt.

These tricks come from the same creative minds who claimed that predating a military paycheck in September 1989 rather than October 1989 was done not to evade the spirit of the budget legislation to the tune of $2.9 billion but to, "avoid unnecessary hardships to military families."

I understand that the language actually is taken from some mid-sixties legislation, but this clearly is abusing the spirit of that legislation.

Well, moving to the budget outlook, I do expect the deficits for 1990 and 1991 to grossly overshoot the target of the Gramm-Rudman-Hollings legislation. Our forecast anticipates a $146 billion deficit in 1989, slightly below the OMB prediction, but not a significant difference, followed by $136 billion in 1990 and $121 billion in 1991.

So do I predict sequestration?

No, I predict more games and changing of the targets rather than sequestration.

For several reasons, I do not urge the committee to challenge the administration's top line, that is, real GNP forecast, that the economy will avoid a recession.

The most important reason is that any revenue weakness traceable to economic sluggishness is not a good reason to reset fiscal policy.

Your mission is to reduce the Nation's structural deficit, not to fine tune the taxes, to offset tax losses in a downturn, or spend tax windfalls in a boom.

Other reasons not to challenge the 2.6 and 2.7 short-term forecast are that it could be right—about one chance in five. And that few Presidents have been willing to predict a recession of any magnitude during their term.

I do, however, urge you to recognize that, even with that real GNP growth, if you didn't have the gamesmanship on profits and interest rates, the deficit would be $20 billion higher than the administration suggests in 1990, and $30 to $35 billion higher in 1991.

In other words, you're making much less progress in reducing the structural deficit problem than you promised yourselves and the public.

What do I recommend that you do?

Please keep in mind why deficits are a problem as you search for programs to trim.

They tend to reduce investment in new homes, factories, and productive equipment, or force foreign ownership following from such investments.

The current deficit was created by two rounds of personal tax cuts—the initial Reagan revolution and the tax reform legislation. Consequently, the Federal deficits of the 1980's have largely financed private consumer spending rather than private investment. As you attempt to redress the problem, you will, therefore, fundamentally fail if you trim, or allow sequestration to trim, legitimate public investments in infrastructure, education, basic scientific research or similar projects regardless of whether you close the deficit by such action.

Essentially, you must close the deficit by reducing public subsidization of consumers. If you can't find the will to cut such programs and you believe there is no further opportunity to cut defense spending, then, logically, you should pass a personal tax increase.

A 5-percent surcharge on personal tax payments would accomplish this task very nicely, raising $25 billion per year in the process.

It would not upset any of the delicate compromises negotiated during tax reform. It would not put the poor back on the tax rolls, as would be the case with heavier levies on alcoholic beverages or energy. It would maintain exactly the same progressivity as the tax reform bill, since everyone would receive a proportional increase in tax rate.

And because I'm talking about a surcharge of 5 percent, not a 5-percent increase in the marginal tax rate, you can see from my testimony that the marginal tax rates would rise from 15 to 15.75 percent, 28 to 29.40 percent, and 33 to 34.65 percent.

President Reagan's original proposals had much higher marginal tax rates. If he is the great supply sider, nobody could claim that this would turn over the supply-side revolution.

I can assure Congress that the Federal deficit reduction pursued in this manner would maximize reduction of the U.S. overseas trade deficit. It would work on both sides—exports and imports.

The encouragement of domestically owned capital formation would improve the competitiveness of U.S. industry, thus cutting the share of imports and raising our exports.

Imports would be further trimmed in response to the personal tax surcharge.

I believe that Congress does possess the necessary budgetary expertise to close the deficit without cutting solid public investment programs or weakening the safety net.

The broad public interest must overwhelm special interest lobbies, as was largely accomplished during the tax reform debate and other examples of political leadership by Congress.

The final exhibits of my presentation show you, as an example, a deficit reduction package and what its impacts would be. If I could ask you to turn to the final page, I'll just point out the major impact.

If program reductions were achieved of approximately $7 billion for calendar 1990, $14 billion for 1991, $20 billion for 1992, and scaling up to $50 billion for 1995—this is a correction from the table which inadvertently lumped the program and the interest savings together—you could get the Federal deficit down to $24 billion by 1995.

That is a cumulative reduction of the debt of $370 billion. In that end year alone, it's $104 billion.

To see just how that reduced Federal borrowing helps the Nation, note that:

That $104 billion would permit an extra $21 billion in business investment, an extra $17 billion in housing, and would reduce our foreign borrowing by $65 billion.

In general, for the medium term, every dollar of reduced Federal borrowing would mean 65 cents less borrowing from abroad and 35 cents more investment. The tradeoff is pretty linear. If you want to double the numbers I have in here, you'll get twice the bang. If you halve them, or if you do nothing, you'll get proportionately less.

Thank you very much.

[The prepared statement of Mr. Brinner follows:]

PREPARED STATEMENT OF ROGER E. BRINNER

Fiscal Policy Planning: Assessing the "Mid-Session Review of the Budget"

Thank you for the opportunity to discuss the national economic outlook and its interaction with the federal budget, as presented within the context of my independent assessment of the Office of Management and Budget's "Mid-Session Review." In the remarks that follow, I applaud the renewed endorsement of the concept of steady deficit reduction and the greater commitment to realistic macroeconomic forecasts made by the Administration; unfortunately, I disagree with the Administration's assessment that the Bipartisan Budget Accord restricts spending or generates revenues sufficiently to achieve the 1990 or 1991 deficit goals established by Congress. In other words, "lip service" is paid to the concept of deficit reduction, but number games are then used to conceal the failure to act on this goal with the urgency it deserves.

As most members of the Committee would agree, each dollar by which the Gramm-Rudman-Hollings targets are missed will likely be another dollar borrowed from abroad (and repaid with interest by future generations) or another dollar unavailable for private investment (to raise our long-run productivity and living standards). I therefore urge relentless efforts to exceed the guidelines established in the Bipartisan Budget Accord for 1990, and even greater commitment for 1991.

The Economic Outlook

The Administration's forecast envisions a "perfect landing" that requires a more fortunate turn of events than even the "soft landing" I expect (Chart 1 and Table 1). According to the President's staff,

Chart 1
The OMB "Perfect Landing" vs. The DRI "Soft Landing"
(Year–over–year percent change in real GNP)

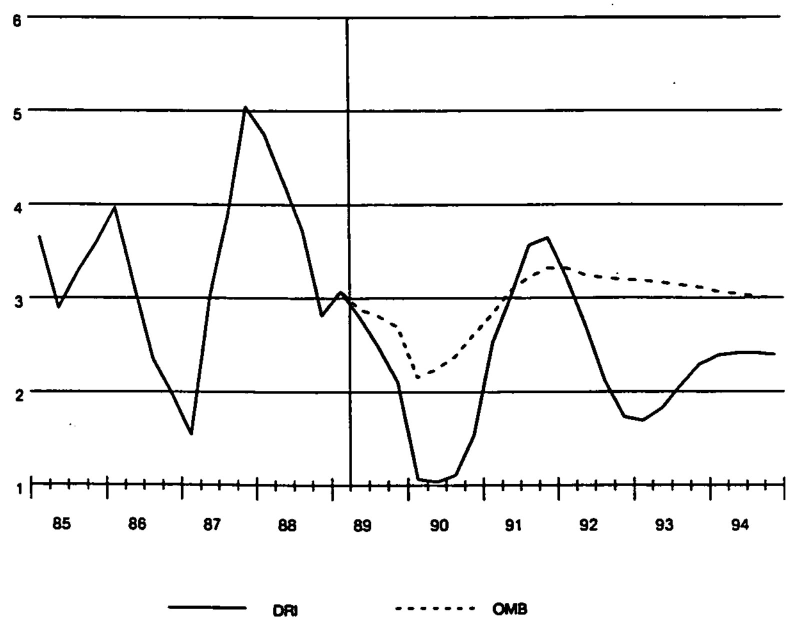


Table 1
Administration and DRI Economic Projections

	1989		1990		1991		1994	
	OMB	DRI	OMB	DRI	OMB	DRI	OMB	DRI
Real GNP (Percent change)................	2.7	2.1	2.6	1.5	3.3	3.6	3.0	2.4
Unemployment Rate (Percent)..............	5.2	5.2	5.4	5.7	5.3	5.7	5.0	5.6
Consumer Price Index* (Percent change)...	4.9	4.9	4.1	4.3	3.8	5.1	2.9	5.2
3-Month Treasury Bill Rate (Percent).....	8.0	8.1	6.7	6.7	5.3	7.6	4.4	6.2
10-Year Government Bond Yield (Percent)..	8.5	8.6	7.7	7.7	6.8	8.4	5.4	8.2

	1988 Actual	1989			1990			1991			1994		
		OMB	DRI	Diff	OMB	DRI	Diff	OMB	DRI	Diff	OMB	DRI	Diff
Nominal GNP...................	4864	5227	5214	13	5573	5495	78	5973	5916	57	7228	7328	-100
Personal Income...............	4062	4403	4418	-15	4674	4668	6	4985	5007	-22	5931	6164	-233
Wages and Salaries............	2437	2634	2639	-5	2803	2806	-3	3007	3020	-13	3625	3744	-119
Corporate Profits Before Tax..	307	342	312	30	377	314	63	429	377	52	564	469	95
Percent of GNP..............	6.3	6.5	6.0	0.6	6.8	5.7	1.1	7.2	6.4	0.8	7.8	6.4	1.4

*CPI for wage earners and clerical workers.

- the 1987–88 boom ends without any bust: GNP shifts smoothly to 2.6–2.7% annual growth, the sustainable long-run growth rate for the U.S. economy.

- the boom ends just as the nation precisely achieves the optimal degree of utilization, with the unemployment rate holding near 5.25% in 1989 and 1990 (the consensus estimate of non-inflationary full employment).

- corporate profits soar, rising from $306 billion in 1988 to $342 billion in 1989, $377 billion in 1990, and $564 billion by 1994—an 11% compound annual growth rate that far outstrips the 7% growth of GNP over the same period and thus contrasts sharply with the postwar trend (Chart 2).

- inflation recedes immediately to about 4% through 1990, and continues to decline (to 2.9% by 1994) despite accelerating GNP growth and tightening labor markets (Chart 3).

- interest rates edge down between now and 1990, and then fall sharply thereafter, presumably as the financial markets applaud the imminent balancing of the budget.

Many elements of this scenario could occur, particularly with greater fiscal discipline than is now apparent and with some compensatory help from the Federal Reserve in the event of such restraint. In this respect, the plausibility of the current White House prediction offers a nice contrast to many other Mid-Session Reviews in the past decade. Nevertheless, this remains an unlikely scenario for two reasons: it errs on the side of optimism for every concept, and there are significant internal inconsistencies.

Chart 2
The Administration's Optimistic Profit Forecast
(Profits as a percent of GNP)

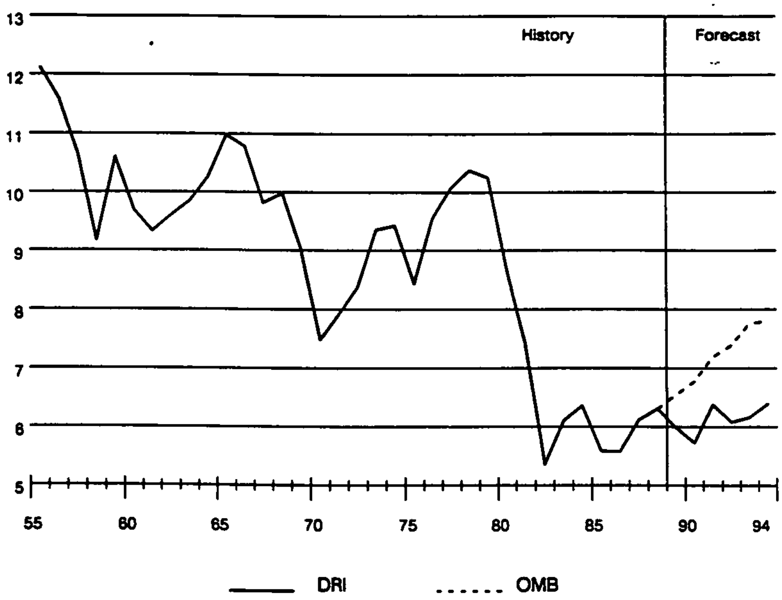
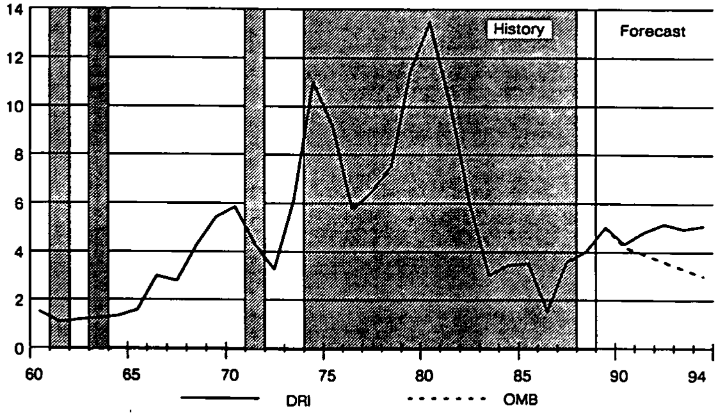
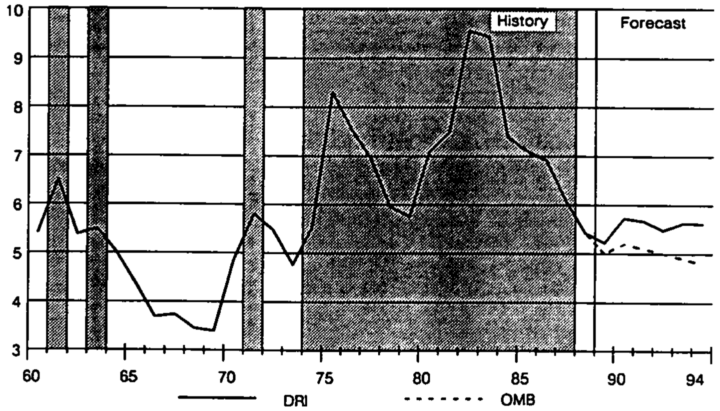


Chart 3
Prospects for Lower Inflation at Current Unemployment Rates

Consumer Price Index for Wage Earners



Unemployment Rate



Note: Shaded areas indicate periods in which the unemployment rate exceeded 5.5%.

The major features of the "soft landing" I expect are:

- a slowdown in real GNP growth to a 1% pace from the third quarter of this year through the second quarter of next year before a recovery begins;
- a decline in business spending on capital goods, construction, and inventories creating this growth recession, driving the unemployment rate up to a 6% peak by the end of 1990;
- a temporary easing of inflation to 4% in the second half of this year because of a short-term correction in energy prices and no change in food prices;
- a slump in profits in the second half of this year—as they must if real growth slows and inflation moderates—and then a gradual recovery (by 1991) to the same share of GNP as seen in 1988; and
- a balanced cyclical recovery in 1991 that pushes the unemployment rate back down toward 5.5%, just short of full employment. (This modest slack does not imply receding inflation, however, because of an expectation of rising oil prices and the adverse impact of a declining dollar on import prices.)

A comparison of these two scenarios quickly highlights the inconsistencies I find in the OMB outlook. First, if the Administration truly believed its own interest rate forecasts, it should bet against the financial markets by primarily selling 90-day Treasury bills rather than bonds to finance the current deficit and to meet refinancing obligations: why would any prudent borrower sell 10-year bonds paying 8% if he honestly expects short-term rates to drop toward 4% and long-term rates toward 5% within five years?

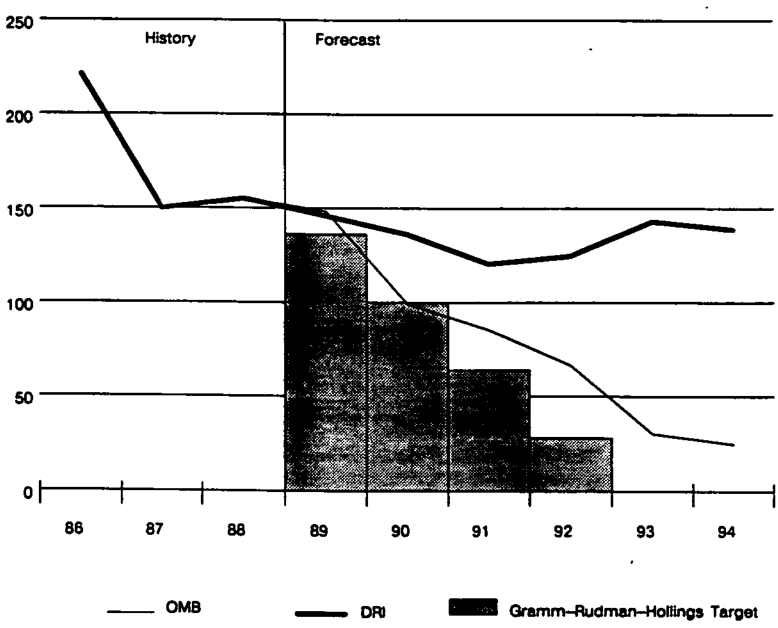
Second, inflation is highly unlikely to ease with booming profits (or conversely, profits are unlikely to soar with declining inflation). Compensation per hour has already shifted up to a 5.5% inflation rate in the first half of this year and would undoubtedly go much higher if profit margins continued to widen and unemployment rates fell, as the Administration predicts. Employees would demand large wage increases to maintain their share of the economic pie. The OMB forecasts for real GNP and unemployment imply a reasonable 1.5% productivity gain; inflation rates for unit labor costs and hence prices would thus tend to accelerate from 4% today (5.5% compensation minus 1.5% productivity) toward 6%, rather than tapering off benignly to 3%.

The motivation for these forecast anomalies is all too obvious: the threat of Gramm–Rudman–Hollings sequestration is serious unless some tricks are employed. Thus, the inflation outlook is made artificially favorable to justify a falling interest rate scenario that would save on projected federal financing costs. Likewise, the profit share of GNP is extraordinarily enhanced because each dollar of exaggerated profits produces 34 cents in profit taxes and at least 6 cents in personal (dividend) taxes; the same dollar of GNP, if attributed to wages, would yield only half as much federal revenue. These tricks come from the same creative minds who claim that the pre–dating of military paychecks to September 1989 rather than October 1989 was done not to evade the spirit of the budget legislation to the tune of $2.9 billion, but "to avoid unnecessary hardship to military families" (p. 8, *Mid–Session Review*).

The Budget Outlook

I expect the deficits for 1990 or 1991 to grossly overshoot the targets of the Gramm–Rudman–Hollings legislation (Chart 4). The DRI forecast distributed to all our financial, industrial, and government clients anticipates a $146 billion deficit in 1989 (actually $2 billion closer than the OMB prediction in the Mid–Session Review), followed by $136

Chart 4
Projected Failure to Meet the Gramm-Rudman-Hollings Targets
(Unified budget deficit, billions of dollars, fiscal years)



billion in 1990 and $121 billion in 1991. Past experience has taught me that either tricks will be employed or the targets will be changed, making sequestration out of the question.

The comparison of the DRI and Administration budget forecasts in Table 2 echoes the accusations made above that interest expenses have been artificially depressed and corporate tax collections artfully enhanced to trim $35–40 billion over the next two years from an otherwise realistically assessed deficit.

Recommended Actions

For several reasons, I do not urge the Committee to challenge the Administration's "top–line" forecast that the economy will avoid a growth recession. The most important is that any revenue weakness traceable to economic sluggishness is not a good reason to reset fiscal policy. Your mission is to reduce the nation's structural deficit, not to fine–tune spending and tax laws to offset tax losses in a downturn or to spend tax windfalls in a boom. Other reasons not to challenge the 2.6–2.7% real GNP growth forecast are that it could be right (I would guess there is at least one chance in five), and that few presidents have been willing to predict a recession of any magnitude during their terms.

I do, however, urge you to recognize that, even with such real GNP growth, the deficit would be about $20 billion higher in 1990 and perhaps $30–35 billion higher in 1991 than the Administration would like you to believe. In other words, you are making much less progress in reducing the structural or long–run deficit problem than you promised yourselves and the public. Please keep this firmly in mind as votes are taken in committee and on the floor to flesh out and extend the Bipartisan Agreement.

Table 2
Administration and DRI Assessments of Near-Term Budget Prospects

	Actual 1988	1989 OMB	1989 DRI	1989 Difference	1990 OMB	1990 DRI	1990 Difference	1991 OMB	1991 DRI	1991 Difference
Outlays.........	1064	1144	1133	11	1179	1183	-4	1237	1261	-24
Net Interest..	152	169	169	0	176	181	-4	174	194	-20
Receipts........	909	996	987	9	1080	1047	33	1152	1140	12
Corporate.....	95	106	103	3	117	97	20	127	109	18
Deficit.........	155	148	146	2	99	136	-37	85	121	-36

As you search for programs to trim, please also keep in mind why deficits are a problem: they tend to reduce investment in new homes, factories, and productive equipment, or force foreign ownership of the income flowing from such investments. The current deficit was created by two rounds of personal tax cuts—the initial "Reagan Revolution" and the tax reform legislation. Consequently, the federal deficits of the 1980s have largely financed private consumer spending rather than private investment. As you attempt to redress the problem, you will therefore fundamentally fail if you trim legitimate public investments in infrastructure, education, or basic scientific research, regardless of whether you close the federal deficit by such actions. Essentially, you must close the deficit by reducing public subsidization of consumers—through excessive agriculture support payments, poorly supervised housing programs, overly generous retirement benefits to certain employees, AMTRAK largesse, and the like.

If you cannot find the will to cut such programs and you believe there is no further opportunity to cut defense spending, then logically you should pass a personal tax increase. A 5% surcharge on personal tax payments would raise approximately $25 billion per year and would not upset any of the compromises you skillfully negotiated to produce the solid tax reform bill. The poor would not be put back on the tax rolls, as they would be with heavier levies on alcoholic beverages or energy. Since all taxpayers would receive a proportionate increase in their taxes, progressivity would be unchanged. Finally, such a surcharge would trivially raise the marginal tax rates from 15%, 28%, and 33% to 15.75%, 29.40%, and 34.65%. Given that President Reagan originally proposed even higher marginal rates, no one could honestly claim these shifts would reverse the supply-side revolution.

I can also assure the Committee that federal deficit reduction pursued in this manner would maximize reduction of the U.S. overseas trade deficit. The encouragement of do-

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mestically owned capital formation would improve the competitiveness of U.S. industry, thus cutting the share of imports in the U.S. market and raising our exports. Imports would be further trimmed in response to the personal tax surcharge. It is no coincidence that the U.S. government and trade accounts simultaneously deteriorated from near balance in 1980 to similar $140–150 billion deficits by 1987; it will be no accident when they both shrunk if you pursue the fiscal strategy I have outlined above and elaborated in the exhibits at the end of this testimony.

I believe that Congress possesses the budgetary expertise to close the deficit without cutting solid public investment programs or weakening the safety nets for less well-to-do citizens. The broad public interest must overwhelm the special-interest lobbies as was largely accomplished during the tax reform debates and in other examples of political leadership by Congress. Please do not take a cynical view of the public: we will accept the defeat of our own small lobbies in pursuit of balanced deficit reduction; if you lead, the public will take a positive view of its Washington representatives.

Chart 5
The Federal Budget Can Be Balanced
(Billions of dollars, fiscal years)

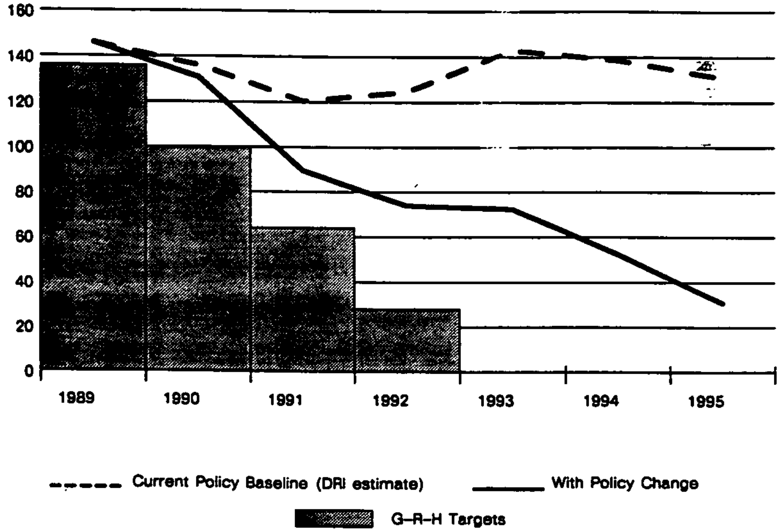


Table 3
THE PAYOFF FOR GENUINE DEFICIT DEDUCTION

Recommended Fiscal Policy Package

- A 1.0 percentage point annual reduction from the baseline growth rate of federal purchases beginning in fiscal year 1990.

- A 0.5 percentage point annual reduction from the baseline growth rate of retirement and medical transfer programs.

- A 5% personal income tax surcharge, raising the bracket rates to 15.75%, 29.40%, and 34.65%, effective January 1991.

Expected Benefits

- Budget close to balance in 1995.

- Reduced federal and overseas borrowing and increased domestic investment: by 1995, each $1 of federal deficit reduction yields approximately $0.35 more housing and capital spending and $0.65 less borrowing per year.

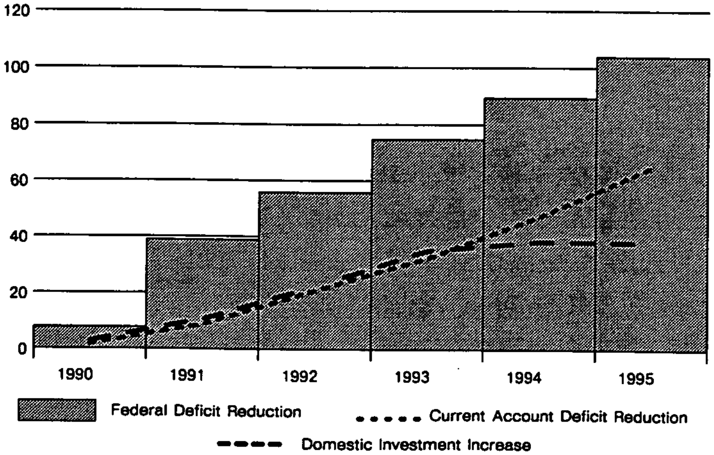
- Significantly lower credit costs—Treasury bill rates averaging 0.5 percentage point lower and Treasury bonds averaging 1.25 percentage points lower—over the next six years.

- Marginally weaker national growth in 1990–91, then stronger in 1992–93, leaving unemployment and inflation basically unchanged.

Table 4
Improving the National Borrowing and Investment Outlook: Key Impacts Of Greater Federal Budget Restraint
(Billions of dollars, calendar years)

	1990	1991	1992	1993	1994	1995
Baseline Deficit	-132	-115	-133	-143	-137	-128
Improved Deficit	-124	-76	-77	-68	-47	-24
How It's Accomplished:						
Changes in Federal Budget						
Program Reductions	-7	-14	-21	-31	-41	-52
Interest Savings	-2	-5	-9	-13	-17	-22
Higher Taxes	-1	20	26	31	31	30
Deficit (Current)	-8	-39	-56	-75	-89	-104
Deficit (Cumulative)	-8	-47	-102	-177	-266	-370
What It Yields:						
Changes in Investment and Foreign Borrowing						
Business Investment	0	2	7	17	20	21
Housing	3	9	15	18	18	17
Foreign Borrowing (Current)	-2	-9	-21	-33	-47	-65
Foreign Borrowing (Cumulative)	-2	-10	-31	-64	-111	-176

Chart 6
Shifts in Investment and Trade in Response to Lower Federal Deficits
(Changes from baseline, billions of dollars)



Representative HAMILTON. Thank you, Mr. Brinner.
Mr. Barbera, please proceed.

STATEMENT OF ROBERT J. BARBERA, CHIEF ECONOMIST, SHEARSON LEHMAN HUTTON

Mr. BARBERA. Thank you very much for the opportunity to discuss the U.S. economic outlook.

It appears to me as well that the U.S. economy is entering a mild recession, or more likely, a multiquarter period of economic stall. I think it's important to remember that that downshift is certainly no accident.

From February 1987 to February 1989, the Fed funds rate rose from 6 percent to a shade under 10 percent. Only when housing activity began to deteriorate and consumer spending stalled did Fed tightening end.

It was a mission there, and the mission was accomplished when housing began to deteriorate.

That Fed tightening effort was clearly part of a global monetary policy strategy. As I see it, the central bank's plan over the last 2 years has been to break demand for goods and services in nations with large trade deficits, thereby dampening global inflation pressures while improving trade imbalances, and also with more limited global recession risk.

The U.S. economic stall then, a part of a global monetary policy strategy, seems to me to be where we are.

I'm not ruling out a mild recession. We've talked a little bit about that. I certainly think that's possible. I think it's important to recognize, though, it's quite unlikely that we're going to have a major U.S. recession soon for a number of reasons.

Most importantly, perhaps inflation pressures are quite limited. Compare them to where we were in either 1973 or 1979, before we went into two major recessions, and you can see that today's are decidedly different kinds of numbers. As a consequence, the excesses that inflation tends to generate aren't there.

If you have a big inflation, you're willing to build inventories in a big way and you build factories because you think it can only get better.

Our assessment of manufacturing sector companies in the United States suggest that that is notably absent.

I think, in addition, a hard landing, a big recession, won't occur because of global monetary policy coordination. We did have a stock market crash which changed the game in terms of monetary policy, I think for the better. Postcrash, what we saw was the United States, the United Kingdom, Australia continue to tighten aggressively, but West Germany, the rest of Europe, much less; in Japan, not at all.

The idea, as I see it, was straightforward. We have a slow global spending, but if we all do it at the same time, we risk recession. So let's let the countries that also need to improve their trade deficits bear the lion's share of the spending squeeze.

Not surprisingly, short rates went up 400 here, 700 in the United Kingdom and they didn't go up a basis point until very recently in Japan.

Last, and perhaps the punch line in terms of why I don't see a big recession, is Fed policy. In the context of 1974, and of 1981–82, consider current Fed policy. The first 6 months of 1982, the average monthly payroll employment report registered a 180,000 job decline; during that period, Fed funds went from 12 to 17 percent.

What we've seen is a slowdown of payroll employment gains in the last 3 months to 200,000 from 300,000 and we've already seen, if you believe the Wall Street Journal this morning, three eases, the most recent occurring yesterday, that have taken the Fed funds rate from 9.80 to 9 percent.

So the Fed tightened, but at the first sign of weakness, we are seeing some ease. I think Mr. Penner put it appropriately:

"If the weakness gets more dramatic, the ease will become more dramatic."

We can have a negative quarter. The third quarter has a decent shot at being negative. But, then you'll see a big ease, and I don't see the economy moving into a big recession.

Let me move from that cyclical picture to some of the more structural concerns. On a positive note, the fact that the U.S. economy is slowing does help somewhat on the global imbalance side.

What we'll get on the squeeze on consumer spending is some freed-up capacity for exports to rise and a slowing of imports.

But, obviously, the economic imbalances that have been a part of the global landscape will remain. We're going to continue to have large, though improving trade deficits while foreign ownership of U.S. assets and the consequent call on future U.S. income will continue to grow.

I think if you look at the debt load in Latin American markets, if you look at the maze-like Japanese markets, it's hard to argue for future substantial gains for U.S. exporters, even with the dollar the current level, a level, I think, by the way, that we're competitive at.

So, by extension, if we talk about governmental efforts to either pare budget deficits, open Japanese markets or reduce Latin American debts, we can say that all of those would help shrink the U.S. trade deficit and give us a more balanced global economic picture.

But—and I do think there's a but—I think the cost of inaction is not going to be calamitous. There has been a conventional wisdom, or at least a school of thought, that suggests that if we don't do something at some point there will be hell to pay, in a palpable sense—that radical surgery on the budget deficit should occur or some dire event will develop.

That has been in many a testimony over the past 8 years, and, of course, we've had the longest peacetime economic expansion. I think it got some new life when we had the 508 point down day for the U.S. stock market; that was no fun, I assure you. I worked at E.F. Hutton. There is no longer an E.F. Hutton.

However, notwithstanding that small cost, if you look past that decline of the stock market, really not much else happened. And, in fact, if you look at the financial market, although it's scared many a client, this has been the decade for stocks and bonds.

We've had a decent economic performance this past year. It was a good performance for stock and bonds. But there was a fair amount of apocalyptic description about the potential future economic performance.

As I see it, that's because we focused a bit too much on the budget deficit, to the exclusion of the progress made on the monetary policy front. We've had steadfast anti-inflation monetary policy in the United States and abroad, and we also have had much better labor management dynamics in the United States.

On the monetary policy side, obviously, big budget deficits force the Fed to do things that they otherwise wouldn't, and that doesn't give us the best growth path. In fact, I think it's quite clear that the long-term growth potential is adversely affected, as Mr. Penner described.

But, in terms of a here and now big crisis, I simply don't think we're going to see it. We'll probably have another large recession at some point in the future, but it will be wrong to hang it on budget deficits. There should be some statute of limitations in terms of how long you can point at an economic statistic and claim it caused an eventual result.

I'm not saying that budget deficits don't matter. What I'm saying, more importantly, is that trying to use Wall Street anxiety or the risk of apocalypse as the glue to pull together something better is wrong headed, because if we don't deliver the apocalypse, perhaps we keep delivering half-hearted fiscal policy adjustments.

For some modest proposals, I would say:

Leave steering the economy to monetary policy. Little time should be spent worrying about the inability to deliver fiscal policy adjustments for cyclical gain.

Second, again, don't look for the economic apocalypse as the glue for radical fiscal adjustments.

If you can accept the widely held notion that U.S. budget deficits as a share of GNP should be pared, it's important to remember that, although we have them, no one claims to have created them. Since they're orphans, I imagine that means nobody justifies them—we can accept the fact that they should be pared and move, much more importantly, to the mix of what needs to be done to reduce those budget deficits.

The microeconomic choices, it seems to me, are the ones that are most egregious right now in terms of what the budget deficit has caused. There are many, from an economist's vantage point, justifiable actions that aren't taken at present because of the limitations that Gramm-Rudman-Hollings puts into place. And it seems to me there are many sensible steps—tobacco subsidies, gasoline taxes, and so forth—that could allow a more rational set of choices on a microeconomic basis.

I'm in a business where it pays to have a macro view. But, in this particular issue, I think the micro questions are more important than what the absolute numbers are.

Thank you.

[The prepared statement of Mr. Barbera follows:]

PREPARED STATEMENT OF ROBERT J. BARBERA

The Emerging U.S. Economic Stall

It appears to me that the U.S. economy is entering either a mild recession, or more likely, a multi-quarter period of economic stall. The much celebrated soft landing is upon us. We can expect to see unemployment rise to about 6.0%. Factory output will decline some this summer, but begin to rise again this fall, albeit at a slower rate. The deterioration we are now seeing in housing will likely continue well into the fall, although interest rate declines we have witnessed already and the declines that lay before us will give some lift to housing early next year. The recent trend of weak U.S. consumer spending will also extend into this year's fourth quarter, although healthy consumer sentiment statistics and limited job loss will prevent any major spending decline. All in all, a picture of subdued economic performance, but an outlook that stops short of full blown recession.

The Stall in U.S. Spending: By Design

The stall that the U.S. economy is now sliding into is no accident. Pre-emptive strikes against inflation have been the hallmark of the Fed's monetary policy in the 1980s, and the current downshift in U.S. economic advance is a direct consequence of the restrictive policy put in place in 1987 and 1988. From February 1987 through February 1989, Fed Funds rose from approximately 6.0% to a shade under 10.0%. That level for short rates has had its intended effect. The end to Fed-engineered increases for short rates this spring reflects the emergence of the U.S. economic weakness. Once housing activity began to deteriorate and consumer spending stalled, Fed tightening ended. The key to arresting inflation pressures is a dash of economic disappointment, and the Fed has served up a dose of sobriety.

A Globally Coordinated Effort

From a global perspective, the developing U.S. economic stall will have some positive repercussions. This too is by design. As I see it, central bankers' plan over the past two years has been to brake demand for goods and services in nations with large trade deficits, thereby dampening global inflation pressures with limited global recession risks. With a U.S. economic slowdown in place, weaker global inflation pressures and more balanced trade numbers are likely to come into focus in the quarters ahead.

The Limited Chance That U.S. Stall Becomes Big Recession

Some contend today, however, that a soft landing globally will involve a hard landing for the U.S. economy. I believe it is quite unlikely that the current economic stall will devolve into a major U.S. economic contraction. One cannot rule out a mild recession in the U.S. in the quarters ahead, but on a number of fronts, one can dismiss the risk of a big U.S. recession. First, inflation pressures in the U.S. are now quite limited. There has been some lift in terms of core wages, from about a 3.0% rate to a 4.5% rate. Consumer inflation stripped of the volatile food and energy components has risen from about 4.0% to a shade under 5.0%. But these inflation moves pale in comparison to the gains inflation registered ahead of both the 1974 and the 1981-1982 recessions. Moderate inflation pressures limit, in turn, factory sector excesses. Aggressive expansion commitments and large inventory building -- the hallmarks of late-cycle manufacturing activity -- are notably absent from the U.S. economic landscape. As a consequence, a dramatic inventory drawdown appears unlikely to be a source of major U.S. economic weakness in the quarters before us.

Secondly, another reason to expect limited downside for the U.S. manufacturing sector is that these companies are just emerging from the dollar-induced recession of 1985 and 1986. Over that two-year period, U.S. manufacturing-based companies eliminated 750,000 jobs in an attempt to survive in the super-competitive global marketplace. Thus, limited inflation pressures and the 1985-1986 factory contraction combine to suggest that U.S. factories will not experience an inventory or capacity expansion glut in the near future.

Thirdly, I would assert that a hard landing is less likely, given the global monetary policy coordination we have seen. The monetary policy squeeze put in place in the U.S., the U.K. and Canada has been matched by accommodative European policies as well as easy money in Japan. In 1987, the U.S., Japan and West Germany were all tightening, each with a narrow focus on its own potential inflation pressures. The global stock market crash was, if nothing else, a warning to monetary policymakers that too much vigor against inflation threatened global recession. The post-crash strategy of tight money in big trade deficit countries, easy money in big surplus countries is now delivering a slower global economy and reduced inflation risks, with a limited threat of global recession.

Lastly, but most importantly, big recession is unlikely given the U.S. Federal Reserve's prospective game plan. Any sign of accelerating weakness in the U.S. economy will clearly be met by more aggressive Fed ease. And such ease will prevent a mushrooming on the downside. It is important to remember that in both the 1974 and 1981-1982 recessions, despite clear signs of widespread economic deterioration, the central bank continued to raise short-term interest rates. In both instances, surging inflation precluded quick Fed reversal. In the current circumstance, with evidence of softening in U.S. economic data, the Federal Reserve has already enacted two small, but measurable eases in its monetary policy. Fed funds are now at 9.25%, down from 9.80%. The Fed is easing early and has said it will ease more if necessary. I think that greatly reduces the likelihood of a full blown U.S. economic downturn.

<u>The Fed's Pre-Emptive Strike: The Right Stuff</u>

One could, of course, object to the previous Fed tightening and the economic weakness coming into focus. From my vantage point, current monetary policy is about right. In 1987 and 1988, the U.S. economy was growing at a 3.5%-4.5% rate, which implied further rapid increases in job growth and capacity utilization. The good news for the 1980s is that wage and price pressures were largely absent until unemployment fell below 6.0%. But in 1987 and 1988, wage gains began to outpace productivity advances in some U.S. markets, which suggested that a sharp further decline in the U.S. unemployment rate threatened inflation acceleration. As a consequence, a temporary braking of U.S. economic growth was the right prescription.

I think it is also important to recognize, however, that it is appropriate for the Fed to ease up now. Greenspan and company could contend that 0% inflation, the ultimate goal of all central bankers, justifies continued tightening despite the obvious signs of economic weakness. In effect, Fed policy could risk a more generalized economic downturn to secure still lower U.S. inflation. That, however, would be quite risky. Debt overhang from the 1970s' inflation and new debt excesses, both public and private, render a major recession an invitation to debt deflation and even more substantial economic distress. A policy of grudging progress in lowering the U.S. core inflation rate, therefore, is much more defensible <u>at present</u> on a risk/reward basis.

Better Budget Policy: No Substitute for Current Economic Stall

Had fiscal policy been more adroit, that is, had bigger reductions in budget deficits been put in place, it would not have precluded the need for the emerging U.S. economic slowdown. Instead, it would have changed the manner in which it was delivered. Higher taxes or bigger cuts in entitlement payments would have taken money out of people's pockets and squeezed economic growth with somewhat less Fed restraint. But to vent inflation pressures, reduced spending, softer economic activity and some rise in unemployment all appear necessary, given the current cyclical character of the U.S. economy. Fiscal policy would have simply changed the mix.

The U.S. Economic Stall Will Help Global Economic Imbalances

The shift in spending and output, here and abroad, will help somewhat unwind global imbalances. A squeeze on U.S. consumption will slow imports and free U.S. capacity for export. Resultant gains in U.S. trade will reduce somewhat our use of additional foreign capital, as it lifts the U.S. personal saving rate. As concerns about a big U.S. downturn recede, companies are likely to be more willing to expand factory capacity in the U.S. -- an activity that has been conspicuous by its absence over the past several years. On the budget deficit side, a soft landing will not help, but it will not hurt much. We do get the benefit of the decline in interest rates, which compensates to a degree for the lost revenues and the increase in counter-cylical spending.

Economic Imbalances Remain and Remain a Challenge

The economic imbalances that have been a part of the global economic landscape will remain, however, and the aforementioned positive adjustments that a soft landing for the U.S. economy will deliver are limited. The U.S. will continue to have large, though improving trade, current account and budget deficits. Foreign ownership of U.S. assets and the consequent call on future U.S. income will continue to grow. Soft U.S. spending, a consequent slowing of import inflows and some freed up product for export will likely drive monthly U.S. trade deficits to $7 billion or so by early next year. But debt-deadened Latin American markets and maze-like Japanese markets make future substantial gains for U.S. exporters problematic, even at today's dollar level, which, I believe, renders most U.S. producers competitive. As a consequence, spectacular U.S. trade improvement is unlikely, and growing foreign ownership of U.S. assets is all but assured.

By extension, then, governmental efforts to reduce the U.S. budget deficit, to further open Japanese markets and to extend progress on Latin American debt reduction would contribute to more significant U.S. trade deficit shrinkage and a more balanced global economic picture. But the cost of inaction on the legislative front is unlikely to be a calamitous end for either U.S. or global growth. Past and prospective U.S. fiscal policy shortcomings cost the U.S., in terms of its long-term growth potential. But the economic apocalypse has been conspicuous by its absence for almost a decade. If budget policy remains half-hearted, with the belief that radical surgery will only follow economic crisis, then we are likely to continue to suffer a slow dimunition of U.S. growth potential, without major economic calamity, but with obvious long-term opportunity costs.

<u>Why the Apocalypse Is a Bad Bet</u>

Conventional economic wisdom since 1982 has been that the U.S. is living on borrowed time and that without radical surgery on budget deficits, bi inflation, big recession or both will be upon us. Notwithstanding thes pronouncements, the U.S. economy has experienced an unbroken string o economic growth since 1982. The financial markets, in addition, have had a excellent decade, even allowing for the October 1987 crash. As I see it, this decent, if unspectacular, economic performance reflects two 1980s developments. First, monetary policy for a wide band of fiscal policy tasks can adjust and steer the U.S. economy clear of major inflation or major recession. And in the 1980s, monetary policy has been skillfully conducted here and abroad. Bad fiscal policy limits U.S. economic opportunities, but if U.S. monetary policy stays the course, it is unlikely to be the cause of a dramatic, negative cyclical development.

Secondly, U.S. labor management dynamics showed a remarkable turnabout in the 1980s, improving the U.S. inflation/unemployment tradeoff. In the 1970s, wages began to run ahead of productivity gains and to push core inflation higher as soon as economic growth resumed in 1975. In the 1980s experience, an eye toward survival in globally competitive markets forced labor and management to work more as a team and less as combatants. Cost/push inflation pressures have been largely absent, only appearing recently in low-end services jobs. The importance of this switch cannot be overemphasized. In Japan, with 2% unemployment, wage pressures are quite limited. In the U.K., when unemployment fell below 10%, wage pressures accelerated appreciably. The good news for the U.S. is that we appear to be operating now in a situation in which unemployment below 6% is possible without upward cost/push pressures.

With the current U.S. economic stall likely to vent any pockets of cost/push pressures, the prospects for resumption of slow, but positive, U.S. economic advance in the early 1990s are good. Thus, waiting for severe economic stress as the catalyst for legislative action to redress global imbalances is, in effect, a prescription for inaction.

But Poor Policy Choices Clearly Have Costs

Again, I believe a big collapse is unlikely. But the long-term growth potential for the U.S. economy is a direct function of how wisely we use our human, financial and physical resources. And it is this realm in which fiscal policy can be taken to task -- not a crisis, but a dimunition of future growth prospects.

The enactment of Gramm-Rudman-Hollings speaks openly to this policy vacuum. Most agree, myself included, that smaller U.S. deficits as a share of GNP would be better. But the mix of changes is as important as the total shifts in taxes and spending. And here is where progress seems so hard to come by. Large tobacco subsidies remain. Gasoline tax levels are one-tenth the level of most of the rest of the developed the world, and many pollution abatement efforts go unfunded. From my vantage point, it is the microeconomic choices in U.S. fiscal policy which appear in disrepair and which play a large role in limiting U.S. growth prospects.

Some Modest Proposals

Given the success that monetary policy has in steering the economy on a cyclical basis, fiscal policy adjustments, both from a macro perspective and a micro perspective, should be focused on long-term economic growth questions. Little time should be spent worrying about the inability to deliver fiscal policy adjustments for cyclical gain. Leave that to monetary policy. Likewise, do not look for an economic apocalypse, as the consensus building glue for radical fiscal adjustment. On a long-term basis, most agree that U.S. budget deficits, as a share of GNP, should be pared. Gramm-Rudman-Hollings targets are reasonable. But recognize that the mix of tax and spending changes made in the next several years are probably as important as coming close to meeting the Gramm-Rudman-Hollings targets. Shocking improvements, from my vantage point, would not be a dramatic slice off of the 1991 deficit, but instead a sensible set of steps that brought us some moderate reduction in the 1991 shortfall.

Representative HAMILTON. Well, OK. Thank you very much for good testimony.

Of course, the thing that stands out to me in the testimony from all three of you is the number of times you use the word "recession" or "growth recession" or "mild recession."

And that seems to me quite different from a lot of the testimony we've heard here.

I guess that reflects a growing view, and I want you to comment on this, among respected professional economists like yourself, that we probably are headed for that.

So the question then is not just your view, but is there a view growing among professional economists that we are headed for, as you all put it, a mild recession or a growth recession?

Mr. BARBERA. Certainly, the Blue Chip economic forecasts have numbers that are decidedly lower than they've been in the past several years. And I think we do suffer from——

Representative HAMILTON. Does that constitute a soft landing?

Mr. BARBERA. Well, soft landing, the way that——

Representative HAMILTON. What is a soft landing anyway?

Mr. BARBERA.The media presentation right now is that soft landing is no recession. So, if you have minus 0.3 percent two quarters in a row, according to the Wall Street Journal we will not have achieved a soft landing.

From the financial markets' perspective, which is where I hail from, if you don't have a substantial decline in corporate profits and you don't have big debt deflation risks, or a big time recession, that meets my definition of a soft landing—a mild recession or stalled economy for two or three quarters.

Mr. BRINNER. I think it's more presentational. A soft landing means there is not fear and panic in Wall Street or in households. A hard landing is a classic recession—everybody thinks they're going to be laid off and their neighbors and others will be laid off soon.

In a soft landing, there's fear of that, but it's not widespread.

Representative HAMILTON. You're all describing a soft landing. Is that right?

Mr. BRINNER. That's correct.

Mr. PENNER. But it's not without pain. I think that's important to note, because what is defined as a soft landing does imply a small rise in the unemployment rate and that's what we used to call a growth recession.

Mr. BRINNER. On the other hand, I would repeat my comment that I don't feel that's really a focal point of debate between us and the administration, to be a basis of budget decisions.

I don't think any of us would argue that the shortfalls we see in GNP compared to the administration are the basis for major fiscal policy adjustments.

We're all more concerned about a structural issue rather than a 1-year cyclical weakness in revenues. And the longer you go out in the administration's forecast, the more unrealistic you get.

Representative HAMILTON. I want to get to that in a few minutes. But, the question Mr. Penner raised in his testimony, is:

The key question is whether the economy can slow down significantly without subsequently sliding into a recession.

You all answered that question yes.

Mr. BRINNER. We at DRI feel that there's one chance in three that we will fall off into a more classic recession.

Representative HAMILTON. You even say one in two, Mr. Penner. You say one in three, Mr. Brinner?

Mr. BRINNER. Yes. There is an important risk that will happen. But nothing that is likely to be done in the matter of current fiscal policy maneuvers will change that for the worse. Indeed, you could change it for the better if you stunned Wall Street by finding some long-term cure for the deficit.

You would see long-term and short-term interest rates move down significantly, putting quite a safety net under the economy.

In fact, in recent months, I have become more optimistic about the odds of avoiding a full recession because bond rates have fallen so far. They've moved down by a full point in spite of the fact that inflation has not really withered away by that much. And that has helped me feel more confident that we won't have an abrupt decline in the economy.

Mr. BARBERA. If you define your terms a little bit more loosely, it becomes a nonissue. I mean, if we ask: Can we have a very mild recession a la 1960, this is a statistical artifact, of course. But if we wanted to look at 1981 to 1982 and 1974, those were big-time recessions. And then you had the 1985 to 1986 slowdown to 1 percent. And you had a mild recession in 1960.

If we split the world into those two categories, I think there's 1 chance in 25 that you're going to end up in a big-time recession. And that's because as the Feds are easing, the markets are easing before we've seen the downturn.

Representative HAMILTON. Now, all of you comment about the optimistic economic assumptions of the administration and of the Congress.

When you object to the administration using economic assumptions that are too optimistic, the administration comes back and says, "Well, we've done better than you have. Our track record is better than the CBO's, for example, and better than the Blue Chip consensus economic forecast, that the economy has grown faster with less inflation, less unemployment than most economists had predicted."

Now, how do you react to that argument? Is that a valid argument or not?

Mr. BRINNER. No, it's not at all a valid argument. I'll give you a couple of——

Representative HAMILTON. But they were right. And the consensus was wrong.

Mr. BRINNER. I totally disagree. [Laughter.]

If you look at the Rand Institute——

Representative HAMILTON. We can't even agree on the figures of the recent past? [Laughter.]

Mr. BRINNER. A completely independent study by the Rand Institute that was announced a little over a year ago compared the administration forecast of the mideighties with bank forecasts and private forecasters like DRI.

The Government forecast came in dead last. They were definitely at the bottom.

Representative HAMILTON. For what years?

Mr. BRINNER. This was for 1984, 1985, 1986, and 1987. Now, I'll give you another point. I made a calculation. I said, let's look at the first economic report that was produced by Mr. Reagan, in 1982. They predicted 3.95 percent real GNP growth for the next 6 years. That was the centerpiece of their forecast for the 1982-88 period.

The same month, with the same data, we predicted 2.8 percent, almost 1.15 percent lower. The actual numbers were 2.7. We were optimistic by one-tenth of a point. The administration was optimistic by a point and a quarter.

Now, where did that point and a quarter show up?

It showed up in exaggerated productivity estimates, because in their forecast, the labor force grows at about the same as ours. So, if you forecast more output growth and about the same unemployment rate and same labor force growth, you must by definition have an unrealistic productivity estimate.

They took that unrealistic productivity estimate, drove it into an unrealistic inflation estimate, used that to motivate an unrealistic interest rates estimate, and used that whole scenario to motivate the notion that you could draw to the deficit.

Representative HAMILTON. Mr. Barbera.

Mr. BARBERA. Yes, I disagree. I think is is absolutely true on the real GNP side, but clearly the focus that I would have is a bit different.

What the financial markets tended to get more right than the conventional forecast was inflation and interest rates, but I think for the wrong reasons. I don't think it was a supply-side miracle. In fact, I think it was monetary policy successes. And the largest critic, ironically, of monetary policy was Don Regan, who hailed from Wall Street. Nevertheless, I think those monetary policy successes did deliver more dramatic declines than the consensus anticipated for either inflation or interest rates over the last 8 years.

Mr. BRINNER. I think you've been reading the OMB press releases. The Rand Institute study covered real GNP.

Mr. BARBERA. No, I've been making money in bonds. [Laughter.]

Mr. BRINNER. Interest rates, deficits, it covered all of those factors that were just covered. We can certainly provide that for you.

Representative HAMILTON. Yes, we would like to have that.

Mr. PENNER. I'm not sure how valuable these comparisons are, to tell you the truth. It's a little bit like comparing the New York Yankees record with the Boston Red Sox from 1920 to 1985. The personalities differ. The styles of play differ. The managers differ, and so on.

You lose a lot of history if you just average forecasts and look at the average error.

Clearly, when the Reagan administration came into office, it made an enormously overoptimistic forecast. When Marty Feldstein took over the Council of Economic Advisers, he was embarrassed by the rosy scenario. He came out with a very pessimistic forecast, much more pessimistic than CBO's.

On average, it looks as though the administration did about as well as CBO over that period, but the average is totally meaningless in hindsight. It hides everything interesting that went on.

But, however you add up the figures for the short run, and it depends on the years you use and all sorts of other things, I do think it's clear that the administration has on average been too optimistic about their longer run projection. And that's very dangerous because, as I said in my testimony, it creates an illusion that the budget problem is not a serious one.

Representative HAMILTON. Let me ask you about that. This really I guess is not an economic question. But, we all understand that the political pressures on an administration are to come in with an optimistic forecast.

Then we don't have to cut the budget as much. And once the administration does it, it's really impossible for the Congress to adopt less optimistic assumptions, and the same political pressures work on the Congress that work on the President to hype the numbers.

And as you just said in your statements, there are serious consequences that flow from that. Maybe the most serious is that we think we're making a lot more progress than we actually are in getting the deficit down. We're doing very well hitting the Gramm-Rudman targets, and we're not doing very well at all in reducing the deficit.

We're getting better and better at our skill in playing the games that you mentioned, Mr. Brinner.

Now, what do you do to get out of that box? I mean, what should we do to make these forecasts more prudent?

Mr. PENNER. Well, first of all, I, frankly, think you should make them less important. I have always been mind blown by the structure of Gramm-Rudman, which gives immense power to the administration to come out with whatever numbers they want.

They control Gramm-Rudman. They have you on a string in terms of how much you have to do to avoid a sequester at any point in time. So, in the midyear forecast, they gave you $5 billion of wiggle room beyond the budget agreement, but they could have made it come out wherever they wanted.

So I've just been amazed that the Congress is willing to convey that much power to the executive branch.

As for how we can do better, that's an issue that I have struggled with for years and years. I don't think I have ever come up with a very good suggestion.

However, I do think that, at the State level in some instances, they do a little better. Many States have panels of experts representing a wide view within the State, who come up with a forecast. And while you always have to leave the final choice of a forecast to the legislative body there's a lot of moral pressure for legislators to use the forecast an independent body comes up with.

I know States make some horrible mistakes as well and, most recently, they have been particularly overoptimistic in their revenue estimate. But I wonder if an independent group might not be worth a try.

You do have a body of very eminent economists serving as an advisory board to the CBO—giving more political weight to the forecast of such a body may act to constrain the Congress.

I think it's a fairly weak idea, but it's about the only one I have.

Mr. BRINNER. On the other hand, if you simply stick to the current Gramm-Rudman-Hollings schedule, that becomes an increasingly pinching jacket.

Creative minds can stretch by about $40 billion and not much more. Sooner or later, that would get the deficit down to $40 billion.

Mr. PENNER. The trouble is, Mr. Brinner, they get more creative. [Laughter.]

Mr. BRINNER. You know, but you amended the original legislation to say asset sales are out. So, in some future bill, you can say, "And you can't change the military pay date, and you can't do lease arrangements for the military."

Eventually, you know, you're going to get it down to a deficit that's $40 billion delivered, with a zero——

Representative HAMILTON. Regardless of your assumptions?

Mr. BRINNER. Regardless of the assumptions.

So I think that you actually may have the answer just in the current legislation with its march down to zero if you get everyone in the administration and Congress convinced, which they are not today, that the targets will not be changed.

I don't think you really need anything other than a conviction that the targets will not be changed.

Now, to deliver that, you probably have to reinforce what Mr. Barbera said; namely, that there is a virtue in achieving budget balance. There is not going to be an apocalypse. I agree with that statement.

Let's think about just what it's costing us not to cure it. If we hold to a deficit of about $125 billion, which is where I think we are headed for the medium term, and we assume borrowing costs at the long end of a little over 8 percent, that means interest costs of $10 billion a year. That's about two-tenths of a percent of GNP.

Now that comes out of the growth rate, not the level, because you keep increasing the debt by $125 billion a year.

So, instead of our standard of living growing by 1.5 percent a year, guess what? It grows by 1.3 percent a year. That's the measure of the loss.

Mr. PENNER. Can I just dissent on Mr. Brinner's first point? He says that the cheating is worth a constant $40 billion a year, and it doesn't matter because you keep lowering the deficit anyway.

I really do think all of the cheating that goes on has some very subtle, nefarious effect. It makes it very hard for anyone to know what's going on. I follow the budget about as closely as anybody on the outside, and I can't keep up with all the smoke and mirrors myself any more. I have to call people at CBO and OMB to find out what's really going on.

And though we all know that the numbers that are being published these days are phony, they still have subtle, psychological effects at the micro level, because the cheating affects some kinds of programs more than others. You get the impression that certain classes of programs are growing more slowly than they really are.

You get a wrong sense of national priorities at the micro level. And it's so easy to slip into swallowing the official figures when you start looking at the more detailed budget functions.

So I really do think that the current situation is outrageous. It's very misleading. If it's misleading to people who think of themselves as budget experts, it's certainly enormously misleading to the press and to the public. Therefore, the Congress should give a high priority to disciplining itself better and getting rid of all of the smoke and mirrors.

Representative HAMILTON. Well, I have a lot of questions. We'll come back.

Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

I know that Gramm-Rudman has been much maligned. On the other hand, I would not want to speculate in terms of where we would be regarding the deficit without it. I think that's the realistic aspect of Gramm-Rudman, frankly. It has forced us to be much more disciplined, even though we have not demonstrated much discipline in the overall process.

I don't think that we would be where we are today, even though it isn't in a great—hasn't produced great results, it has forced the Congress to live within certain boundaries.

Do you think over the long term that deficits matter? I mean, that's obviously a question. I mean, there has been, you know, we're in the 79th month of consecutive growth and that has exceeded everybody's expectations.

Mr. BARBERA. Yes, I certainly do think they matter. But I think the micromix is also where things matter.

How did we get to a point that we actually heard people say all tax cuts are good, and all public spending is bad?

I don't think it is true. But that sort of thinking took over in this town in the early eighties. I think it was a consequence of an inability to judge public spending endeavors in any rational fashion. So you got to the point where you could almost say:

We're doing so many things that make no sense at all with public dollars that you could have a broad sweeping, actually incorrect generalization: All public spending is bad. All tax cuts are good.

We then had extraordinary tax cuts in the early eighties and created a structural deficit that has forced, as I see it, this fixation on the deficit number. The fixation is legit. We have to get the number down. That's a first step.

And that first step, it seems to me, is Gramm-Rudman. But, the second step is the much more difficult step, and that's legitimately looking at the economic implications, and laying it all alongside the political salability, of any micro endeavor.

Tobacco subsidies continue. That's rather an extraordinary notion. We seem to have a lot of environmental investment that goes wanting. I really do think it's the micro side.

What Gramm-Rudman has created, or what the giant tax cuts created, was a need to control the aggregate. Now, the big next step as I see it is not focusing on the aggregate because Gramm-Rudman sort of points you in that direction. It's seeing if you can come to terms with making decent economic choices on the micro side.

Mr. BRINNER. That reinforces what I said earlier in my testimony, that you fundamentally fail if the expenditure cutbacks you make are good public investments. Deficits are bad if they are subsidizing consumption because there's no future payback to them. But they're not any worse than borrowing to finance a new plant if they're used to build infrastructure, education, et cetera.

Senator Packwood, a couple of years ago, when I was testifying, said, "Let me get this straight. If the Government borrows to build a dam, that's bad. If the corporation borrows to build a factory, that's good? Wrong."

He was correct. Those are both good. But the problem is how was our deficit created? What did it buy us? It bought us a private sector consumer binge. It didn't buy us anything for future generations.

Representative SNOWE. Did you want to respond, Mr. Penner?

Mr. PENNER. Yes. I agree with all of the analysis that you heard on the issue. The real danger of the deficit is that the harm it does accrues so slowly that it isn't obviously noticeable to the public.

Just to give you an example, Mr. Brinner said that dollar deficit reduction reduced foreign borrowing by 65 cents, and domestic capital formation by 35 cents. That's a fairly common kind of estimate.

Let's say we're borrowing $130 billion a year from foreigners. Let's be generous and say that the cost of that borrowing is 10 percent a year. That's about $13 billion. That's about a quarter of 1 percent of GNP. Nobody notices that.

But it's one-quarter of a percent layered on a quarter of a percent layered on a quarter of a percent, so that if we continue these policies out into the 21st century, you are then talking about a substantial difference in the standard of living of our children and grandchildren.

Our generation will hardly notice it at all. That's the real tragedy. And in the 21st century, of course, our descendants face an enormous demographic problem of looking after a very rapidly growing elderly population. And I think it's morally incumbent upon us to help them out, and help them support future retirees by increasing their standard of living.

Mr. BARBERA. With the Gramm-Rudman targets, I agree with Mr. Brinner. On the macronumber side, it does appear that the political will is there. Not to generate the extraordinary fix, but with the grudging steps that you would get over the next 6 years if you get anything akin to Gramm-Rudman, it's quite sufficient. I think as important, or if you accept those numbers or something near to those numbers, will be the mix of choices.

Representative SNOWE. As you know, there's been obviously a difference of opinion as to whether or not we should raise taxes in order to reduce the deficit.

What's the impact on the economy over the next 2 years if that were to be a choice? Obviously, we're not going to do it this year.

Mr. BRINNER. The simulation that I presented in the last four exhibits in my prepared statement involved deficit reduction steps beginning with this forthcoming fiscal year and a building through time of a commitment encouraging the Federal Reserve to ease progressively beginning now.

The Federal Reserve needs about a year's leadtime to offset fiscal restraint on the economy. But that's about it. About a year. And the Federal Reserve could seize on a structural commitment and can make that kind of commitment.

Aside from the Fed, the bond markets would reinforce that because, whatever the Fed does, it also matters very much how foreign and domestic long-term lenders feel. If they feel enthused and encouraged, you can see long rates going down. That, as I said earlier, supports investment in the economy and would support the whole economy.

You could have a transformation away from consumer spending toward investments through this. That would mean only a quarter point difference, in my estimate, for 1991 real GNP growth. Inflation would actually be slightly lower.

By 1992, you would have made it up.

So it would be lost in the data revision. This morning, the Commerce Department announced new data for the economy. The changes in real GNP for 1987 and 1988 are larger than the impact of a solid deficit reduction program.

Mr. PENNER. I guess I would argue that the political semantics have gotten out of hand. I mean, there are policies that I really don't care whether you call them a tax increase or a benefit cut, for example; putting transfer benefits into the tax base is one that's hard to define.

In judging policies, I don't think you can generalize that tax cuts are always bad or spending cuts are always good. It obviously depends on what kind. I could think of horribly inefficient tax increases that would be worse than the budget deficit.

At the same time, one can easily think of tax increases that would not do a great deal of harm. Similarly, on the spending side, one could think of spending cuts that would significantly diminish economic efficiency: letting our roads fall apart, for example.

On the other hand, one can think of cuts that would not do a great deal of harm to efficiency——

Representative HAMILTON. Excuse me. Would you yield?

Representative SNOWE. Yes.

Representative HAMILTON. What do you think of the surcharge, surtax proposal?

Mr. PENNER. First of all, I don't think it would do a great deal of harm to the efficiency of the economy. A little, but not significant harm.

I suppose it depends on how idealistic you want me to be. If I lived in a perfect world, I would like to continue the philosophy of tax reform and close those few loopholes that remain rather than to increase marginal tax rates.

But, we know that the tax concessions that withstood the political thrust of tax reform must have some pretty strong political staying power.

So I probably couldn't get very far with my ideal solution to the problem, and in lieu of my ideal solution, I would find Mr. Brinner's perfectly acceptable.

Representative HAMILTON. Thank you.

Representative SNOWE. The Dow Jones level is at the highest point since the crash in October 1987. And some are speculating could go upwards of 2,700 by the end of this summer.

What do you make of it, given all the other speculations about a mild recession?

Mr. BRINNER. The stock market has responded very logically to the change in bond rates. I think of stocks and bonds as being competing investments. When bond yields fall, investors are willing to get a lower yield on their corporate investments.

In 1981, Treasury bonds were 14 percent, and the price earnings ratio was something like 8 percent. By 1986, Treasury bonds were down from 14 to about 8 percent.

And the price earnings ratio was up to 17 percent, a very logical change. The boom we've seen in the stock market this year follows very logically to the move down in bond rates. Earnings are flat at this point. That's not the reason the stock market is booming.

So, I think the stock market right now is pretty fairly priced compared to other investments. I don't think we have a risk like we did in 1987. A substantial correction now might threaten the economic growth later this year, or in 1990.

Representative SNOWE. So we can't draw any conclusions between the stock market's performance and the performance of the economy?

Mr. BRINNER. No. Actually, you can because the bond market performance is a sign of investor confidence in the United States. Investors do believe the Federal Reserve has the right commitment to inflation control. That's why, for example, bond rates did not rise during 1988 as short-term rates moved up.

The bond market said, "We're in there for the long haul and we think the Federal Reserve is, too." So as the Federal Reserve pushed short-term rates up by 3 to 4 percentage points, long rates didn't move up.

This year, they've moved down as short rates moved down because foreign investors have found this quite an attractive place to invest.

So I think that the stock market does reflect a general confidence that we will have only a growth recession, that that will help tame inflation but won't eliminate it.

If they thought inflation were going to be eliminated, the stock market would not do well at all because that would mean that profits would disappear.

Representative SNOWE. Alan Greenspan testified last week and obviously indicated, you know, that he's trying to achieve a soft landing for the economy, and at this point had no intentions of reducing interest rates unless it's clear the economy is heading into a recession.

At what point, what economic indicators does he use to guide him in making those decisions?

Mr. BARBERA. Well, I think the Fed suffers from a problem as all economists do. If you're at the Fed you're driving a car and the windshield is covered with black and you're looking in the rearview mirror. [Laughter.]

You know what just recently happened. In that regard, the employment data get a great deal of attention on Wall Street and at the Fed because they tend to be revised a lot less. You don't find out that what you thought happened 3 months ago didn't in a big way.

And they give you a fairly complete view in a rough sense about three things.

You get the employment data. You can find out how many people have jobs, how long they worked and what they were paid.

That allows you to get a rough estimate of what happened to industrial production, personal income, as well as jobs and wage inflation.

I think that's why we have seen changes in monetary policy following a few days after a "surprising" employment report.

The Fed has eased. It appears once again in the last 2 days, we've had another small ease, subsequent to the testimony, to about 9 percent on Fed funds. I would think that if we want to get into the Fed watching game, if next Friday's employment data are weak, I think the Fed will ease again.

The weakness that you see in coincident economic data, if left to its own devices, I think could put us into a recession and all the dynamics that Rudy Penner talked about.

I think the Fed in that situation, therefore would have to respond rather quickly. We have all indications that, in fact, they will. I would expect Fed funds which are 9 percent now to be 8 percent within 3 to 4 months. And I think that's a fairly routine expectation presently in the market.

Mr. BRINNER. I think that during the mideighties, the Fed shifted to a policy of acting early and moderately as opposed to acting late harshly, which may be a better characterization of the sixties, seventies, and very early eighties.

I think the Fed does look ahead. They don't really believe they have a blackened windshield. They know their actions have an impact on the economy with a considerable life. They must look ahead. And they try to do that. They use current data to help them look ahead.

Mr. PENNER. On the other hand, it has to be noted that, very often, recessions have started quite a bit before anybody noticed, including economists, and sometimes those recessions are very much more severe than anyone could have possibly imagined.

The classic case is 1974. I worked with the Ford administration and I was involved in organizing anti-inflation summits. And unbeknownst to us, the economy was falling out from under our feet.

And, of course, that was the largest peak to trough decline in the postwar period. And we were very, very slow to recognize what was going on.

Representative SNOWE. Is there agreement or disagreement here that Fed policy caused this economic downturn?

Mr. PENNER. Well, it's not a downturn yet. I think that given the risks that they face, they had no alternative but to design policy in a way that created a slightly higher chance of erring on the contractionary side. If, under current circumstances, they had erred on the expansionary side, the pain of eventually curing that mistake would be very severe; whereas, right now, none of us see any downturn as being very severe.

Mr. BRINNER. The last two major data revisions have told us that the Federal Reserve acted very prudently—both last summer and this summer, the national income accounts have been revised to show a much stronger economy in 1987 and 1988. So the Federal

Reserve was, indeed, justified in tightening down credit in both 1987 and 1988 to try and head off a loss of all of the investment in reducing inflation.

Unfortunately, we have an economy which produces inflation the tighter we get—in terms of jobs, labor markets, and goods markets. We can't avoid that.

So, the Federal Reserve is put in the unenviable position of having to tighten credit as we head toward or below 5.5 percent unemployment.

Representative SNOWE. Thank you.

Representative HAMILTON. The administration forecast shows inflation and unemployment falling gradually but steadily between 1990 and 1994. CBO's projections are for 5.6 percent unemployment and 4.4 percent inflation.

Now, my question is: What's the relationship between inflation and unemployment in past business expansions? And do you believe the administration's projections with respect to inflation and unemployment both falling gradually and steadily through this 4- or 5-year period?

Mr. BARBERA. I would point out that I think that is central to where consensus views in the 1980's turned out to be incorrect.

You said, what's the traditional relationship? I think that's the hook.

Representative HAMILTON. Yes.

Mr. BARBERA. In the 1970's, the traditional relationship just was destroyed or obliterated in the first quarter of economic growth. After the big recession of the midseventies, we began to see wage pressures and then inflation acceleration with unemployment at about 9 percent.

That suggested that, with growth only beginning and a great deal of unemployment still in place, we could have cost-push wage pressures.

I think that legacy is why most were worried about inflation accelerating from wage pressures throughout this expansion, since 1983 or 1984. In fact, we did a lot better than that.

If you look at actual performance, we had a steady decline in wage pressures into about mid-1986, late 1986. And the only real pressures we began to see were late 1987 and early 1988.

I think what happened in the seventies, where you had highly unionized manufacturing sector companies and managements who were equally culpable, wage earners demanded wage increases to compensate them. After the oil price increase, managements provided increases because they felt they owned their markets and could pass the price increases through.

So we saw big pressures on the wage side, and on the price side, with high unemployment.

In the eighties, effectively, the globalization of U.S. markets, the intrusion of imports into this marketplace ended that game with a vengeance. If you were to look at what happened to manufacturing sector wages on the high end in the United States in the seventies, they rose well in excess of low-end services.

In the eighties, it was precisely the opposite. I think we've accepted free trade and that's kept a cap on manufacturing sector wages.

Now, that sounds tough, but what it has also meant is that we've had a great deal of economic growth and a big decline in the unemployment rate without much in the way of cost-push wage pressure.

I agree with Mr. Brinner. At about 5.5 percent, it looks like we begin to see those pressures again on the wage front. That doesn't give us much growth, or opportunity for strong growth, from here in terms of lowering unemployment.

But, if you compared the United States to Japan and the United Kingdom, I think there was a great concern that we were like the United Kingdom—get the unemployment rate lower than 10 percent and you have wage pressures and inflation pressures, and you have to contemplate recession.

We've simply done a lot better than that. We're not quite Japan. They say that Japan is the only Communist country that works.

Representative HAMILTON. Is it reasonable to expect a gradual steady decline in both inflation and unemployment from 1990 to 1995?

Mr. BARBERA. No. I think it's reasonable to expect a steady decline in inflation because I think the central banks are going to deliver that. But, from this vantage point, it seems to me that's probably consistent with a steady average unemployment rate of something on the order of 5.5 percent.

Mr. BRINNER. The difference of opinion, I think, is whether you believe that noninflationary unemployment is around 5.25 to 5.5 percent or 4.5 to 4.75 percent. For the administration's inflation forecast to be consistent with their unemployment forecast, the latter would have to be the case because most models say that inflation will decline—core inflation, the basic pressure of the labor costs—will decline by about a half a point per year for every full percentage point that unemployment exceeds some balance point.

Well, the administration's inflation rate erodes by three-tenths of a point per year and that suggests that the unemployment rate is six-tenths of a percent above what they would define as full employment.

So that's how I conclude the administration thinks that full employment is about 4.5 percent, maybe a shade higher; whereas, the consensus is that the balance point is 5.25 to 5.50 percent.

Mr. PENNER. I think the important point is the one Mr. Brinner made earlier. My own judgment, looking at the data, is that the full-employment point is around 5.5 percent. But it might be a great deal lower, and the relationship between inflation and unemployment is a very unstable one that depends on psychology at any particular point.

But the thing that makes the administration forecast for the long run implausible is not the implausibility of any individual assumption. It is that there are a whole array of assumptions, each picked from the extreme optimistic end of the spectrum of what economists would say is reasonable.

Representative HAMILTON. That applies also to their 3 percent figure on growth, real growth?

Mr. PENNER. Yes. I was going to say, the other thing you need aside from the unemployment assumption that Mr. Brinner just described is a return of productivity growth to the average of the postwar period.

Now that is very optimistic, indeed. But, again, we don't fully understand why productivity fell so much in the seventies, so you can't say it's impossible that it will go up.

But I think it's very, very improbable.

Representative HAMILTON. The administration is assuming 1.8 percent growth in nonfarm business productivity.

Mr. BRINNER. I think probably a point and a quarter is more likely. So you have, again, the case where the administration has reached out and assumed that half of the 1970's and 1980's shortfall is recovered from some unspecified reason.

As we tried to model productivity for the economy, we feel we're quite successful by feeding into those forecasts the amount of capital formation in the economy, the type of capital formation, the amount of research and development expenditures that are taking place, and the demographic and educational composition of the labor force.

Representative HAMILTON. Yes.

Mr. BRINNER. You put all those together, add a slight dose of optimism, which we do, and we get to a point and a quarter. I think that 1.8 percent sustained is about a half point too high. So, sustaining 3 percent GNP growth is about a half point too high.

I'm still much more comfortable with a 2.5 percent steady state forecast.

Mr. BARBERA. I would look at it in a little bit more human terms. On the productivity side, it seems that sometimes what we need is duress. The U.S. manufacturing sector in the first half of the 1980's really did an extraordinary job on manufacturing productivity, in part because of the onslaught of import penetration and the United States inability to compete.

So you saw a willingness to do the dirty deed. You know productivity is an interesting word. What you're doing is, obviously, in the short run, eliminating jobs. In the long run, it's very positive, but if you're the individual at the shop, you're taking that other step.

Where productivity has been absent is in the services sector, particularly in the retail sector and in my own area, in financial services.

The pressures in those two areas now are significant. We are I think all in agreement that we're going to see a multiyear period where there's an effort to squeeze consumer spending.

I'm not signing on to a 1.8 percent productivity gain, but I'd point out that if, in the services area, because of the pressure those companies will be under, they begin to have to take difficult steps, we might finally see what we haven't seen in the postwar period: some decent gains on the service-sector side.

But, it's certainly not in the bag.

Representative HAMILTON. The average over the past 40 years has been the 1.8 percent. But, since 1979, it has averaged only 1.2 percent. You're saying it's going to be closer to the average of the last decade rather than over the last 40 or 50 years for productivity increases. Right?

Mr. BRINNER. That's right.

Representative HAMILTON. Now, inflation. I'd like to get your view of what that looks like.

The recent data on wages and labor costs such as the ECI and the collective bargaining settlements data suggest that wages are starting to accelerate.

Why are they accelerating and what's going to be the effect on the inflation outlook?

Mr. BRINNER. Briefly, wages are accelerating not because they're kicking off a cost-push inflation spiral. It's simply that we no longer have the buffer of extra labor supply that we did in 1984, in the earlier part of the 1980's.

Today, employment is approximately full. We have full employment. Therefore, you don't have any pressure that keeps workers from asking for productivity growth plus inflation.

They are today asking for 5.5 percent wage increases. They see inflation at about 4.5 percent. They see productivity growth at a little over a point.

So they say: To keep my share of the economic pie whole, I need 5.5 percent. That's why wage increases have moved up to 5.5 percent from 3.5. At 3.5 percent, they were just matching inflation. They were gaining no benefits from the productivity increases that were ongoing and they had to accept that shrinking share of the pie because the unemployment rate was quite high.

Today, they no longer have to accept the shrinking share. They're not. And so you have seen the move up in pay gains.

With the economy now near a stall, so that unemployment will edge up, even in the administration's forecast, I think you will cap that processs.

I believe it's reasonable to expect that pay gains will level off at about a 5.5-percent pace. That can be offset by a point or a point and a quarter on productivity, and leave inflation at about the 4.5 percent rate.

We are close to a stable equilibrium there.

I might note just a point of irony that struck me last night. I first testified to the Joint Economic Committee in 1971. I presented a paper entitled "The Inflation Process in the United States." It was commissioned by the JEC to explain how life could be so miserable that we suffered 5 percent inflation and 5 percent unemployment simultaneously.

Now, here today, we ask how we could preserve such a marvelous calculation. [Laughter.]

Representative HAMILTON. I know we're very good at redefining the problem. [Laughter.]

You don't see then this having much effect on inflation?

Mr. BRINNER. I think it is a move to a balance point.

Mr. BARBERA. I think the inflation numbers, however, in the near term—and we tend to react to the near term—are going to look a lot better over the next 6 months because the volatile components which made inflation look so bad and gave us the extraordinarily misleading headlines in the earlier part of this year are going decidedly in the other direction.

Representative HAMILTON. So the second half of this year is going to look a lot better?

Mr. BARBERA. Absolutely. I'd say something on the order of 3 percent. And that's simply because unleaded gasoline prices have completely reversed, in wholesale markets, the rise we saw first half. And it's rained more times than not, so we have agricultural prices down about 35 percent.

Representative HAMILTON. Are any of you troubled by the changing structure of corporate financing, with increasing reliance on debt, including so-called junk bonds?

Mr. BRINNER. There are a couple of effects that this greater leverage has produced. First of all, it means that when you tighten economic policy, it is not just the housing sector that's going to reverse course.

We now are likely to see cutbacks in capital spending, and it's possible that we'll see earlier cutbacks in employment.

Now, if the Federal Reserve were ignorant of this greater impact of rising interest rates on the economy, then greater leverage would increase the risk for a recession.

But, the Federal Reserve recognizes that we now have a more highly leveraged economy. Therefore, they have a greater impact in the economy for any percentage point move in interest rates.

With that knowledge, the system risk of a recession has not been changed. We are just spreading the sectors to feel the pain of a credit crunch.

Now, that doesn't seem bad to me. What does seem bad to me is that the creation of junk bonds and the investment in junk bonds by insurance companies and pension funds adds a governmental risk that hasn't been recognized.

You know, we have the savings and loan and thrift crisis because we had put a safety net under some people's investment.

Well, the Pension Benefit Guarantee Corporation puts a safety net under pension funds. The pension funds are allowed to invest in guaranteed insurance contracts and, to a certain extent, junk bonds.

If those perform very poorly, guess who gets to pick up the pieces.

Representative HAMILTON. Yes.

Mr. BRINNER. So I'm not worried about a macroeconomic system risk. I am worried about us having hearings 10 years from now about whether we should have a bailout bill for the PBGC or things like that. You can cope with it now by changing regulations on who can invest in what and under what terms.

It's reasonable to restrict investment by private individuals and private institutions in such instruments, as long as there is already a public role in backing those, such as is provided by the——

Representative HAMILTON. Do you agree with this, Mr. Barbera?

Mr. BARBERA. Actually, I agree with a bit of it, but I was going to comment on how we got there. Extraordinary junk bond performance confuses many. People think it's greed on Wall Street. That can't be true because that's been a constant, right?

So we can't attribute it on a change in the desire to make money on Wall Street. So, at least something has changed about the ability to make money that way.

I talked about the great success in terms of monetary policy in the eighties. The great success in terms of monetary policy is that the Fed has kept inflation low.

The great failure in terms of monetary policy in the eighties, and you can't hang it on the Fed but it's there, is the level of real interest rates that it took to do it. I mean, these have been absolutely off the charts for 10 years now.

You only had 8 years in the 20th century where real rates were above 4 percent, up until 1980, and now we've had a string of years where they've always been above 4 percent.

And when you have a very high real rate, what it does is to cause some people to ignore it. I'll give you my best example, which is Lee Iacocca.

Lee Iacocca in 1984 sold the tank division from Chrysler, and he said, "Well, I have $250 million. I can put it into R&D and get 3 percent, or I can put it into robotics and get 4 percent, or I can buy government bonds and get 13 percent".

He's making a point. But, what did he do? He put it into robotics, because he's in the car business. So you have people in the real economy who still trade assets on the belief that those real yields can't be true.

For example, I buy a forklift for $10,000 because I think it can do some good in my company. But, the minute we put it on a balance sheet, an analyst looks at its value with a 4 percent real interest rate and discounts it, and the value is not $10,000. The value is $7,000.

And what we have now are the bankers, the investment bankers on Wall Street. They say, "You have the market at 2,600 based on discounting the earnings stream of all these companies using a very high real rate, but we can rip the company up and sell the assets. And there are people who will still buy the assets implicitly ignoring that real rate premium."

I mean, think about what would happen if Fed funds were near the inflation rate, where they typically are. What if Fed funds rate instead of 9 percent were 5 percent. The stock market would probably be 3,700 instead of 2,600.

Representative HAMILTON. Did Mr. Iacocca make a bad mistake?

Mr. BARBERA. Did he make a bad mistake?

I don't want to say he made a bad mistake. I'm just saying that if he had bought that 13.5 percent Treasury bond, he could sell it right now. It would be up, I guess, some 50 percent in value and he would have been getting 13 percent per year.

But, the point is that big disparity I think has fueled the move from equity to debt. And I think to look for its end in a simple circumstance, one needs to see that real rate premium come down.

Mr. BRINNER. Let me augment if I could that motivation for junk bonds, because I actually am sympathetic to their development.

The medium of junk bonds is more like an equity investment than a bond investment. It moves the United States back in many respects to a more international mode of financing.

In the United States we do about three-quarters of our financing of corporations on an equity basis, and one-quarter on a debt basis.

They treat their own retained earnings like equity. But, if you add that to the two equity issues, you get three-quarters percent finance equity, one-quarter debt.

In Japan, it's exactly reversed: one-quarter equity, three-quarters debt.

Now, given the tax laws that allow you to deduct interest but not dividends, it certainly makes sense to create an instrument that has the risk of equity but the tax benefits of debt, and that's the junk bond.

Representative HAMILTON. Let me ask you about the trade deficit. If the dollar remains at the present level, do you think that we are in for an extended period of very, very large trade deficits?

Mr. BRINNER. Yes, I do. I think the dollar at the current level will cause the trade deficit to level off about where it is today, perhaps even edge up a bit next year.

And then it will only erode to the extent foreign growth exceeds that in the United States.

Representative HAMILTON. Are all of you pessimistic on the trade deficit level?

Mr. PENNER. There are two elements that are important—the value of the dollar and the state of domestic demand in the United States. I would be optimistic that the trade deficit would respond to a real recession, even at this level of the dollar.

But, with something like the consensus economic forecast for GNP, I would agree that the prospects for further improvement in the trade deficit are very slim.

Representative HAMILTON. You don't think exports are likely to improve very much, you said in your statement.

Mr. PENNER. Net exports are unlikely to improve much.

Mr. BARBERA. I'm somewhat more optimistic.

Representative HAMILTON. What does this mean for the strength of the world economy, the strength of the U.S. economy and the role of the United States in the world economy if we continue these current account deficits and trade deficits at these very high levels? What's the impact of that?

Mr. PENNER. Well, I think it's more that the trade deficit is the symptom of what else we're doing wrong. The trade deficit is basically a symptom of the fact that we have very low domestic saving and that that makes us a very attractive place to invest for foreigners. And as the money flows in, it has to be balanced by a trade deficit on the other side.

Given that we want to be a high-consumption economy, the trade deficit has actually been a great benefit to us. It has allowed us to sustain a fairly high level of total investment in this country while still consuming at a high level.

So I just see the trade deficit as a symptom of a more fundamental weakness in our policy, and that's the budget deficit that we've been discussing.

Mr. BARBERA. I would disagree a bit. I think we suffer as well because of how we're perceived around the world. We had an extraordinary trade deficit and it was growing, and then there was a concerted policy effort along with some market participation and we had a giant dollar devaluation.

But we did two things when we took the dollar down by 50 percent. We cut the price of our goods and services, and we've seen moderate trade improvement.

But we also cut the price of our assets roughly in half. And one of our problems is that our assets are being sold at a low price. And despite continual discussions about the risk of dollar crisis and big dollar selloff, the problem for the central banks since we devalued the dollar is keeping the dollar down, not keeping the dollar up.

I think that's because U.S. assets are cheap at this dollar level and we face a mismatch in terms of the desire of foreigners to buy U.S. assets and our desire to keep the dollar low and have trade improvement.

Mr. PENNER. But the cheapness of the assets is just another symptom of what I was sayng.

Mr. BRINNER. I think that Mr. Penner has painted a much too benign picture of the trade deficit as the factor that allowed us to go forth with investment. We went forth with investment but we didn't own it.

I'm not that interested in investment, but we went forward with it. That's like me saying that my twin brother got to buy his stock, it appreciated and he's going to get a nice gain from it. It doesn't do me much good other than since he's my brother, I enjoy seeing him doing well.

But, me seeing Japan do well because they were able to buy an asset here? I get no joy from that.

Mr. BARBERA. The production, the employment, and the personal income all reside here. I mean, if you put up that plant in the middle of Tennessee, we get about 85 percent of that activity and the profits accrue abroad.

Mr. BRINNER. Think about what was accomplished during the eighties. We are at 5.25 percent unemployment today. The Federal Reserve manuevered us through a recession to bring inflation down. But we're back at about 5.25 percent unemployment.

What is the composition of our consumption and investment and the ownership of that investment?

We have about the same investment that we would have had, but we don't own it. So we didn't get any extra investment out of foreign lending to us. They own the assets. This was not an increment to domestic investment.

Mr. PENNER. I guess it depends on what you're comparing it to.

Mr. BRINNER. I'm comparing it to a case where we didn't have Federal deficits that forced the borrowing in the first place.

Mr. PENNER. And I'm comparing it to a case where we had the Federal deficit but we didn't have the foreign lending, in which case, the total American capital stock would have been lower. American productivity would have been lower.

True, the foreigners own the wealth, but foreign investment does improve our standard of living by increasing worker productivity.

Mr. BARBERA. Can I intrude a little bit and make it a little worse? [Laughter.]

Korea, Taiwan, Hong Kong, Singapore, and Malaysia were exploding in productive capability and we were coming out of a very,

very big recession. We were going to buy those products even if we had had more appropriate fiscal policy.

And because we bought those products in a big way, we also saw a big decline in the personal savings rate.

If you look at the declines in saving, personal savings went down a lot. One can account for a fair amount of the rise in the trade deficit on the personal saving side.

Now, if we're about to enter a period of muted consumer spending and somewhat better growth abroad, one could expect improving trade deficits and head-scratching improvement in the personal saving rate, because now I'm spending a dollar that someone else is spending as well, providing income beyond our spending.

Representative HAMILTON. I think, if I know the situation on the floor, I think we may have a series of votes, and if we do, we'll conclude the hearing.

I would like you to comment on the testimony we had before the committee the other day on the relationship between investment and infrastructure and productivity and economic growth.

You probably saw that we had a letter signed by 327 economists calling for more public investment in human and public infrastructure.

Do you agree basically with that?

I gather you do, Mr. Brinner.

Mr. BRINNER. I didn't see the letter.

I'm suspicious though that the following scenario might develop. You say: All right, I've heard from this group of 300 economists and I also got independent testimony from Roger Brinner. It says protect investment. Let's create separate national budget accounts for capital expenditures investment and for consumption——

Representative HAMILTON. Do you like that idea?

Mr. BRINNER. I hate it, because there's so much creativity that could be used——

Representative HAMILTON. Mr. Penner, do you like that idea of a capital budget?

Mr. PENNER. No, I'm against it.

Representative HAMILTON. You're against it, too?

Mr. PENNER. Yes.

Representative HAMILTON. Do you agree?

Mr. BRINNER. There are just too many games that could be played. I can imagine a Gramm-Rudman target that's separate for capital and consumers ventures by the Government.

And, guess what? Every defense program would be defined as a capital program.

Representative HAMILTON. Now, do you all agree that we've neglected our infrastructure investment?

Mr. PENNER. Well, we have neglected some of it. But, on the other hand, some of the cuts in public investment have been very good. We no longer invest in these very low benefit-cost ratio water projects in the west to the same extent. I don't think we'll have a Tom Bigbee again.

So, you have to really be very careful when it comes to public investment that it doesn't become a pork barrel.

Representative HAMILTON. Do you see a clear relationship between infrastructure investment and productivity?

Mr. PENNER. If it's the right kind of investment, sure.

Representative HAMILTON. Is that an established relationship? I mean, would all economists agree that investment in physical infrastructure, let's say human infrastructure—the right kind—would increase productivity?

Mr. BRINNER. If you do cost-benefit analysis, that's the heart of the issue, yes.

Mr. BARBERA. But I think we got here discussing this because cost-benefit analysis failed, because the method of cost-benefit analysis doesn't provide any real means by which to change the political decisionmaking.

I mean, there are 10,000 water projects that you can do cost-benefit analysis on if you're in the private sector which would suggest they were notoriously unproductive, and yet they were all built because you can do cost benefit any way you want.

Mr. PENNER. But the past tense is important here. I think we've gotten better. I mean, we've stopped doing that sort of thing——

Mr. BARBERA. But I think it's the top/down. It's because you have the big budget deficit. The discipline didn't come from economists.

Representative HAMILTON. Well, gentlemen, we have three votes in a row so we won't hold you here and I'll conclude the hearing.

Thank you very, very much for your testimony. We appreciate it.

The committee stands adjourned.

[Whereupon, at 11:10 a.m., the committee adjourned, subject to the call of the Chair.]

THE ECONOMIC OUTLOOK AT MIDYEAR

TUESDAY, AUGUST 1, 1989

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

The committee met, pursuant to notice, at 2 p.m., in room 2359, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the committee) presiding.

Present: Representatives Hamilton, Snowe, and Upton.

Also present: William Buechner and Chad Stone, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative HAMILTON. The meeting of the Joint Economic Committee will come to order. This afternoon, we are pleased to welcome Mr. Robert Reischauer, the Director of the Congressional Budget Office, who is here to testify today.

In his appearance before the Joint Economic Committee on July 20, Chairman Michael Boskin of the Council of Economic Advisers projected growth of 3 percent per year through 1994.

Interest rates are expected to decline from 8 percent in 1989 to 4.5 percent in 1994. And inflation is expected to decline by 5 percent to less than 3 percent.

Now, based on this forecast, the administration predicts a decline in the budget deficit from $148 billion this year, to just under $100 billion for fiscal year 1990, and then to $25 billion by 1994.

The purpose of today's hearing is to evaluate this economic and budget forecast, as well as the administration's current economic policies.

Our witness today is eminently qualified to do that. The committee will now turn to Mr. Reischauer for his testimony and the CBO's analysis of the President's midyear review.

We are pleased to have you, and you may proceed, sir.

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. REISCHAUER. With your permission, I will submit my prepared statement for the record, and I will confine my remarks here today to a summary of three things: First, the Congressional Budget Office's (CBO's) updated economic forecast; second, the comparison of that forecast with the Blue Chip consensus forecast, the forecast contained in the administration's midsession review, and the forecast described by Mr. Greenspan last week; and, third, I will devote a few minutes to describing the budget outlook for the next several years.

Recent data clearly indicate that the economic expansion slowed sharply during the first half of 1989, and CBO projects that the economy will continue growing at a relatively slow pace during the rest of 1989 and into 1990. On a fourth-quarter-to-fourth-quarter basis, we expect real gross national product (GNP) to grow by 2.4 percent in 1989, and by 2 percent in 1990.

Even though recent retail sales have been disappointing, durable goods orders have been weak, and the index of leading indicators has fallen in 3 of the last 4 months, CBO does not foresee a recession. Our judgment is buttressed by other indicators that present a more sanguine view of the likelihood of recession. For example, the stock market, which has fallen before all but one of the previous recessions, continues to be strong; personal income continues to grow, albeit slowly; and the recent declines in interest rates should help the housing and durable goods sectors in the months ahead.

Rules of thumb and economic models that generate direct estimates of the probability of recession suggest that there is between a 15 percent and 40 percent probability of a recession occurring during the next 9 months.

With respect to inflation, CBO projects that consumer price increases will average 4.6 percent over the next year and a half. This rate is up from the 4.3 percent rate of 1988—on a fourth-quarter-to-fourth-quarter basis—but below the rate of the first half of this year, which exhibited a surge in food and energy prices that we expect to subside.

CBO forecasts that short-term interest rates will continue declining, although gradually. The 3-month Treasury bill rate, which rose from 5.7 percent in February 1988 to a peak of 8.8 percent in March 1989, has fallen to below 8 percent in recent weeks. Our forecast entails a moderate continued decline, with an average Treasury bill rate of 8.2 percent for 1989 as a whole, and 7.2 percent for 1990.

Long-term interest rates increased less than short rates during 1988 and the first half of 1989 but have fallen faster than short rates since March. Over the March 1988 to March 1989 period, the 10-year Treasury bond rate increased by only 1 percentage point, from 8.4 percent to 9.4 percent and has since fallen to a bit under 8 percent. CBO forecasts that longer term interest rates will change little from their present levels.

CBO's current forecast is quite close to the consensus of the 52 private forecasters that make up the Blue Chip survey, while the administration's midsession projections were somewhat more optimistic. The administration's forecast entails real GNP growth of 2.7 percent in 1989 and 2.6 percent in 1990—rates that are higher than both CBO's rates and the Blue Chip figures in both years. Only 10 of the Blue Chip's 52 respondents are as optimistic as the administration about real GNP growth in 1990.

For consumer price inflation, the administration's forecast is for rates of 4.9 percent in 1989 and 4.1 percent in 1990. The 1990 figure is about one-half of a percentage point below those of either CBO or the Blue Chip consensus; and only 10 of the 52 Blue Chip forecasters are as optimistic as the administration is with respect to inflation in 1990.

For the Treasury bill rate, the administration projects a level of 8 percent in 1989 and 6.7 percent in 1990. The 1990 figure is about one-half of a percentage point below the CBO and Blue Chip figures. Thirteen of the 52 Blue Chip respondents are as sanguine as the administration about interest rates.

The CBO forecast for real growth and inflation falls within the bands that were laid out in the recent forecast of the Federal Reserve. The Fed's forecast projects real growth to be in the range of 2 percent to 2½ percent in 1989 and 1½ percent to 2 percent in 1990. It expects inflation to be in the range of 5 percent to 5½ percent this year and 4½ percent to 5 percent next year. The administration's latest forecast is above the Fed's growth band and below the Fed's inflation band.

Let me now say a few words about the budget outlook. Though CBO has not yet completed reestimating the budget using our new economic assumptions, we do not expect that the new forecast or the technical estimating revisions that we will make will cause a substantial change in our view of the budget outlook.

With the current fiscal year more than three-quarters over, we estimate that the 1989 deficit is likely to be around $150 billion. This compares with our February estimate for the deficit of $159 billion. The lower 1989 deficit comes largely from higher revenues, with total outlays remaining basically unchanged.

The budget framework for 1990 was established by the bipartisan budget agreement, which was incorporated into the 1990 budget resolution. Based on CBO's winter economic and technical assumptions, a 1990 deficit of $120 billion—almost $28 billion below the budget resolution baseline of $147 billion—would result if the budget resolution were fully implemented.

Of course, the 1989 and 1990 deficit projections will be affected by the pending savings and loan legislation. The conference agreement created a new on-budget entity, the Resolution Financing Corporation (REFCORP), which will borrow money from the Treasury to help resolve insolvent thrift institutions. The spending of the borrowed funds, however, would be excluded from the budget totals used for the Balanced Budget Act. While CBO has not finished pricing out the conference agreement, its budgetary impact should be similar to that of the House-passed bill, which would have added about $20 billion to the 1990 deficit. An estimated $23 billion in REFCORP outlays, however, would not be counted for the purposes of the Balanced Budget Act, meaning that the effect of this bill on the deficit would actually be a decrease of about $3 billion.

CBO projects that substantial deficit reduction will be required for fiscal year 1991, even after the 1990 budget resolution is fully implemented. The 1991 deficit calculated for purposes of the Balanced Budget Act would be about $138 billion. This amount is $74 billion over the Gramm-Rudman target, and $64 billion above the level required to avoid sequestration.

Deficit reduction of $64 billion would represent more than twice the amount of permanent deficit reduction achieved in any recent year. Such a large dose of fiscal restraint in 1 year would require aggressive actions by the Federal Reserve in order to prevent short-run reductions in real GNP and employment.

Although no immediate catastrophes are likely to follow from failing to act decisively on the deficit, continued large budget deficits exacerbate the Nation's major economic problems and impair our longer term prospects. The Congress has made some progress in reducing the budget deficit, but further cuts would have to ensure that American living standards grow adequately in the long run. CBO looks forward to assisting Congress and this committee as they work on the important tasks dealing with the economy and the budget deficit.

Thank you.

Representative HAMILTON. Thank you very much, Mr. Reischauer.

[The prepared statement of Mr. Reischauer follows:]

PREPARED STATEMENT OF ROBERT D. REISCHAUER

Mr. Chairman and Members of the Committee, it is a pleasure to be here this morning to discuss the Congressional Budget Office's (CBO's) updated economic projections and the budget outlook. My testimony today will concentrate on the economic outlook, reflected in the July CBO forecast, which we released last week, as well as in the Administration's Midsession Review, the forecasts of the Federal Reserve, and the consensus of private forecasters. In addition, my statement will touch on two related issues: the effects of the dollar's recent rise and the probability of a recession.

Finally, I will discuss the budget outlook. Because CBO's revised baseline budget projections are not yet complete, however, my discussion of that outlook will be based largely on our figures from last winter. Our revised budget projections are scheduled to be released on August 17. In the past, changes in the economic assumptions have been one of the main sources of revisions to the budget outlook. This summer, however, changes in the forecast and technical estimating revisions are unlikely to cause a significant change in the budget numbers.

THE JULY CBO FORECAST

The pace of economic expansion slowed sharply during the first half of 1989, and CBO, like many other forecasters, projects that the economy will continue to grow during the rest of 1989 and 1990 at the slower pace of recent months. As a result, CBO projects a slight increase in unemployment, a gradual decline in short-term interest rates, and an easing of inflation from the pace set in the first half of this year. Compared with CBO's winter 1989 forecast, this projection entails a marginally higher level of nominal gross national product (GNP) in 1990, with lower interest rates and slightly higher inflation rates.

Neither CBO's July forecast nor other forecasts discussed here reflects last week's revisions in the GNP data. The revisions will not, however, significantly affect the CBO forecast.

CBO's July forecast reflects the strong consensus among forecasters that the recent slowing in economic growth will not go so far as to turn into a recession during the next several months. After adjusting for inflation, CBO projects that GNP will grow by 2.4 percent in 1989 on a fourth-quarter-to-fourth-quarter basis, and by 2.0 percent in 1990 (see Table 1). CBO's July forecast is slightly less optimistic than last winter's, which envisioned GNP growth rates of 2.9 percent in 1989 and 2.2 percent in 1990. Together with the forecast of the implicit GNP deflator that I will describe below, the forecast implies nominal GNP growth rates of 6.8 percent in 1989 and 6.4 percent in 1990, both of which are quite close to CBO's projections of last winter.

The unemployment rate rises slowly over the next year and a half in CBO's forecast as a result of the slow economic growth that we foresee. While we expect the average unemployment rate for 1989 as a whole to be close to the present level of 5.3 percent, the projection for 1990 is a slightly higher rate of 5.5 percent.

TABLE 1. THE CBO FORECAST FOR 1989 AND 1990

	Actual	Forecast	
	1988	1989	1990
Fourth Quarter to Fourth Quarter (Percent change)			
Nominal GNP	7.2	6.8	6.4
Real GNP	2.8	2.4	2.0
Real Nonfarm GNP	3.6	1.8	2.0
Implicit GNP Deflator	4.3	4.2	4.4
CPI-W[a]	4.3	5.2	4.7
Calendar-Year Averages (Percent)			
Civilian Unemployment Rate	5.5	5.3	5.5
Three-Month Treasury Bill Rate	6.7	8.2	7.2
Ten-Year Government Bond Rate	8.8	8.6	8.2

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

a. Consumer Price Index for urban wage earners and clerical workers.

NOTE: This table does not reflect the July 27, 1989 revisions in the GNP data.

CBO's projection of a sustained slowing in economic growth reflects the effects of Federal Reserve restraint, which came in reaction to signs that strong economic growth had brought the economy into an inflationary danger zone. In explaining its policy, the central bank has argued that strong economic growth in 1987 and 1988 absorbed virtually all the economy's spare production capacity. The unemployment rate, for example, fell steadily throughout that period, finally reaching a 14-year low of 5.0 percent in March of this year, while capacity utilization in manufacturing rose as high as 84.7 percent in January. Both of these levels are in the range that in the past has been associated with an acceleration of inflation. Preliminary signs of increasing inflation emerged last winter as hourly labor costs accelerated, and they became clearer with strong increases in producer and consumer prices during the spring.

The restrictive monetary policy caused GNP growth to slow, particularly in interest-sensitive sectors of the economy. Having averaged 3.6 percent during 1988, nonfarm real GNP growth slowed to 2.1 percent in the first quarter of 1989. Preliminary evidence suggests that second-quarter growth will be similarly low. Housing and business construction slowed, and demand for autos and other consumer durables was reduced. Business investment in producers' durable equipment has slackened as well.

The Outlook for Inflation

CBO projects that inflation in consumer prices will be higher for 1989 and 1990 than in recent years. Part of the increase, however, reflects a surge in the first half of this year that is expected to ease. Our forecast for the increase in the Consumer Price Index averages 4.6 percent for the next year and a half. This rate is up from the 4.3 percent rate of 1988 (on a fourth-quarter-to-fourth-quarter basis), but below the rate of the first half of this year. The slowing in the next few months comes about because food and energy prices are expected to slow from their unusually high growth rates of the first half of the year. For the GNP deflator, we currently project growth on a fourth-quarter-to-fourth-quarter basis of 4.2 percent in 1989 and 4.4 percent in 1990. Our current forecast of inflation in consumer prices is close to our winter figures, while our projection of changes in the GNP deflator is somewhat higher than we expected last winter.

Interest Rates

Federal Reserve tightening resulted both in increases in short-term interest rates and a slowing in the growth rates of the monetary aggregates. Largely as a result of this policy, the three-month Treasury bill rate rose by over three percentage points--from 5.7 percent in February 1988 to 8.8 percent at its peak in March 1989. At the same time, M2, one of the most carefully watched monetary aggregates, slowed to an average annual growth rate of 3.7 percent between March 1988 and March 1989. This growth put M2 below the bottom of the Federal Reserve's target ranges in both 1988 and the first half of 1989.

CBO forecasts that short-term rates will continue declining gradually. The three-month Treasury bill rate has fallen by about one percentage point since its peak in March, from 8.8 percent to below 8.0 percent in mid-July. The forecast entails moderate continued declines, reflected in an average Treasury bill rate of 8.2 percent for 1989 as a whole and 7.2 percent for 1990. These figures are close to the levels that we projected last winter.

Long-term interest rates increased less than short-term rates during 1988 and the first half of 1989, and have since fallen faster than short-term rates. This pattern has been attributed to a combination of expectations of slower economic growth and inflows of investment funds from abroad. From March 1988 to March 1989, the 10-year Treasury bond rate increased by only one percentage point, from 8.4 percent to 9.4 percent, and has since fallen to about 8 percent. Longer-term rates are influenced by expectations of future short-term rates, which will fall if growth slows substantially. Hence, the slow growth expected by many forecasters for the next year may have helped to reduce long-term rates. In addition, analysts cite an apparent increase in foreign demand for U.S. bonds among reasons for their reduced yields.

CBO forecasts that longer-term interest rates will decline little from present levels. This outlook is reflected in projected levels for the 10-year Treasury bond rate of 8.6 percent for 1989 and 8.2 percent for 1990. These levels are well below our winter forecast, which put this rate at or above 9.0 percent in both years.

The Effects of the Dollar's Recent Rise

The strong appreciation of the dollar since the beginning of the year has contributed to CBO's forecast of a slowing in the economy by reducing its projection of net exports. The net export deficit improved by $21 billion in 1982 dollars during 1988 and probably at a similar rate in the first half of this year. These increases have thus far been helping to sustain the economic expansion. In the next 18 months, however, net exports are expected to improve by only about $6 billion. A rising dollar makes U.S. exports more expensive and slows the growth of demand for these American products. At the same time, it also makes imports cheaper and more likely to be substituted for U.S.-produced goods.

Recent monetary policy actions and several unexpected political developments apparently brought about the rise in the dollar. Rises in interest rates in the United States during the winter may have contributed, since they increased the attractiveness of financial assets in this country and thereby increased the demand for dollars. Analysts also believe that some weakening of the governments of Japan and West Germany and this spring's events in China may have contributed to the strength of the dollar by heightening perceptions of the United States as a safe haven.

The Probability of Recession

Recent developments, especially those encompassed in the index of leading economic indicators, suggest that the current slowing of economic growth could turn into a recession in the next nine months. Retail sales have been disappointing in recent months, and the index of leading indicators has fallen in three of the last four months. The latest decline in the index was relatively large, and it involved many of the constituent parts of the index, which is also a bad sign.

Other indicators, however, present a more sanguine view of the likelihood of recession. The stock market, which has almost always fallen before previous recessions, continues to rise. Moreover, the index of leading indicators has not yet fallen for three consecutive months, the rule of thumb that is accepted by many economists as indicating a recession. The weakness of retail sales is at least partly offset by the continued growth in personal income, and the recent decline in interest rates is likely eventually to help housing and spending on durable goods.

Direct estimates of the probability of recession during the next nine months place the figure in the 15 percent to 40 percent range. The higher figure of 40 percent stems from calculations using the index of leading economic indicators, while the lower estimate of 15 percent is based on alternative methods of analyzing indicators.

Comparison with Other Forecasts

This summer, as in many previous cases, CBO's July forecast is quite close to the consensus of 52 private forecasters reflected in the *Blue Chip* survey, while the Administration's recent projections are somewhat more optimistic. The Administration's forecast, shown in Table 2, entails real GNP growth of 2.7 percent in 1989 and 2.6 percent in 1990--rates that are higher than both the CBO and *Blue Chip* figures in both years. For consumer price inflation, the Administration's forecast is for rates of 4.9 percent in 1989 and 4.1 percent in 1990. The 1990 figure is one-half a percentage point below those of CBO and the *Blue Chip*. Finally, for the Treasury bill rate, the Administration projects a level of 8.0 percent in 1989 and 6.7 percent in 1990. The 1990 figure is about one-half a percentage point below the CBO and *Blue Chip* figures.

TABLE 2. THE CBO FORECAST FOR 1989 AND 1990, IN COMPARISON WITH LAST WINTER'S FORECAST AND RECENT FORECASTS BY ADMINISTRATION AND *BLUE CHIP*

	Actual 1988	Forecast 1989	Forecast 1990
Fourth Quarter to Fourth Quarter (Percent Change)			
Nominal GNP			
CBO Summer	7.2	6.8	6.4
CBO Winter	6.7	6.9	6.6
Administration	7.2	7.1	6.8
Blue Chip	7.2	6.8	6.2
Real GNP			
CBO Summer	2.8	2.4	2.0
CBO Winter	2.6	2.9	2.2
Administration	2.8	2.7	2.6
Blue Chip	2.8	2.2	1.7
Implicit GNP Deflator			
CBO Summer	4.3	4.2	4.4
CBO Winter	4.0	3.9	4.4
Administration	4.3	4.2	4.1
Blue Chip	4.3	4.4	4.4
CPI-W[a]			
CBO Summer	4.3	5.2	4.7
CBO Winter	4.3	5.0	4.8
Administration	4.2	4.9	4.1
Blue Chip	4.3	5.3	4.6
Calendar-Year Averages (Percent)			
Civilian Unemployment Rate			
CBO Summer	5.5	5.3	5.5
CBO Winter	5.5	5.5	5.5
Administration	5.4	5.2	5.4
Blue Chip	5.5	5.3	5.7
Three-Month Treasury Bill Rate			
CBO Summer	6.7	8.2	7.2
CBO Winter	6.7	7.9	7.1
Administration	6.7	8.0	6.7
Blue Chip	6.7	8.2	7.4
Ten-Year Government Bond Rate			
CBO Summer	8.8	8.6	8.2
CBO Winter	8.9	9.3	9.0
Administration	8.8	8.5	7.7
Blue Chip[b]	8.9	8.5	8.1

SOURCES: Congessional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators*, July 10, 1989; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

a. The *Blue Chip* projection is for the CPI-U.

b. *Blue Chip* does not provide a 10-year note rate. The values here are based on the *Blue Chip* projection of the AAA bond rate adjusted by CBO to reflect the estimated spread between AAA bonds and 10-year government notes.

NOTE: This table does not reflect the July 27, 1989 revisions in the GNP data.

Only 10 of the 52 *Blue Chip* respondents are as optimistic as the Administration for real GNP growth in 1990, whereas 26 are at least as optimistic as CBO is. Similarly, only 10 out of 52 are as optimistic as the Administration on inflation in 1990, and 13 out of 52 are as sanguine on interest rates.

TABLE 3. CBO AND ADMINISTRATION MEDIUM-TERM PROJECTIONS (Annual averages in percentages)

	Forecast		Projected			
	1989	1990	1991	1992	1993	1994
Nominal GNP						
CBO	7.4	6.2	6.7	6.9	6.9	6.8
Administration	7.5	6.6	7.2	7.0	6.6	6.1
Real GNP						
CBO	2.8	1.7	2.3	2.5	2.5	2.5
Administration	2.9	2.3	3.1	3.2	3.1	3.0
CPI-W						
CBO	5.1	4.7	4.6	4.6	4.6	4.6
Administration	5.0	4.2	3.9	3.6	3.3	3.0
Three-Month Treasury Bill Rate						
CBO	8.2	7.2	6.8	6.5	6.3	6.1
Administration	8.0	6.7	5.3	5.0	4.7	4.4
Ten-Year Government Bond Rate						
CBO	8.6	8.2	8.1	7.9	7.7	7.6
Administration	8.5	7.7	6.8	6.0	5.7	5.4

SOURCES: Congressional Budget Office; Office of Management and Budget.

The current forecasts by members of the Board of Governors of the Federal Reserve and presidents of regional Federal Reserve banks are closer to CBO's forecast than to the Administration's. The so-called "central tendency" of the Federal Reserve forecasts of real growth was 2 percent to 2-1/2 percent in 1989 and 1-1/2 percent to 2 percent in 1990. For inflation, it was 5 percent to 5-1/2 percent in 1989 and 4-1/2 percent to 5 percent in 1990. CBO's forecasts for both real growth and inflation fall within these bands, while the Administration's forecast is above the band for real growth and below it on inflation.

Medium-Term Projections

Unlike CBO's economic forecast for 1989 and 1990, its economic projections for 1991 through 1994 are largely mechanical calculations based on historical patterns for different economic variables. The projections show real growth at roughly the estimated growth rate of potential GNP, about 2-1/2 percent, while inflation remains near the rate that we forecast for 1990, and interest rates decline gradually (see Table 3).

The Administration's medium-term projections for economic growth and inflation are somewhat more optimistic than CBO's, presumably because of different views of the outlook for growth in productivity. CBO's projections for productivity are based on the relatively weak average growth in productivity during the 1980s. The Administration's projections, by contrast, have usually been based on the higher average rates of productivity growth over the entire postwar period.

The Administration's interest-rate projections decline more sharply than CBO's, but the difference stems entirely from different projections of inflation: the inflation-adjusted, or "real," interest rates of both groups are nearly the same. CBO projects that three-month Treasury bill rates will fall to about 6.0 percent by 1994, while the Administration assumes a decline to about 4-1/2 percent. Both projections assume that real interest rates will return to historical average levels of about 1.5 percent in 1994 from their much higher levels of the 1980s. Such a decline is likely to be realized only if there is significant progress in reducing the federal deficit.

THE BUDGET OUTLOOK

CBO has only recently completed its economic forecast, and has not yet incorporated it into its budget projections. The new forecast and any technical estimating revisions, however, are unlikely to cause a substantial change in our view of the budget outlook. Since the current fiscal year is more than three-quarters over, we can update our estimate of the 1989 deficit. My discussion of the budget for 1990 and later, however, is based on CBO's winter economic and technical estimating assumptions.

Fiscal Year 1989

We now estimate that the 1989 deficit will be around $150 billion, as compared with our February estimate of $159 billion. While the outlook has improved slightly since the winter, the improvement appears to be considerably less than a number of press reports would indicate. Although the 1989 deficit is almost certain to exceed the Balanced Budget Act target of $136 billion, it may not exceed the target by much more than the $10 billion allowed in the law.

The lower 1989 deficit comes largely from higher revenues. Although projected outlays are lower in certain areas, there are offsetting increases elsewhere. For example, the Administration has taken actions to speed up spending by making 50 percent advance deficiency payments on 1989 crops and by advancing the October 1 payday for military personnel to September 29. Uncertainty remains over the cost of deposit insurance during the next few months.

Fiscal Year 1990

The budgetary framework for 1990 was established by the bipartisan budget agreement of April 14 and has been incorporated in the 1990 budget resolution. Table 4 provides CBO's estimates of the effects of the policies assumed in the budget resolution.

Using CBO's winter assumptions, fully carrying out the budget resolution would produce a 1990 deficit of $120 billion–almost $28 billion below the budget resolution baseline of $147 billion. Permanent spending cuts and tax increases would account for about $17 billion of the reductions. Over one-third of the reductions, however, would consist of accounting changes, one-time savings, and asset sales, which would not reduce the deficit in the long run.

The deficit projections would also be affected by enactment of the savings and loan bill. The conference agreement creates a new on-budget entity, the Resolution Financing Corporation (REFCORP), which will borrow money from the Treasury to help resolve insolvent thrift institutions. The spending of the borrowed funds, however, would be excluded from the budget totals used for the Balanced Budget Act. While CBO has not finished pricing the conference agreement, its budgetary impact should be similar to that of the House-passed bill, which would have added about $20 billion to the 1990 deficit. An estimated $23 billion in REFCORP outlays, however, would not be counted for purposes of the Balanced Budget Act.

TABLE 4. CBO ESTIMATES OF FISCAL YEAR 1990 BUDGET RESOLUTION (By fiscal year, in billions of dollars)

	1990	1991	1992
BUDGET RESOLUTION BASELINE DEFICIT	147.3	148.0	143.7
Permanent Deficit Reduction			
Tax revenues	-5.3	-5.3	-5.3
Tax compliance	-0.5	-0.9	-1.0
User fees (offsetting receipts)	-2.5	-3.3	-2.5
Defense	-4.2	-4.2	-3.9
Nondefense discretionary	-0.4	3.3	3.9
Medicare	-2.3	-2.3	-2.3
Agriculture	-0.6	-0.6	-0.6
Postal benefits	-0.5	-0.5	-0.5
Other	0.1	-0.2	-0.2
Debt service	-1.1	-1.9	-1.9
Subtotal	-17.2	-15.9	-14.3
Accounting Changes, One-Time Savings, and Asset Sales			
Postal Service off-budget	-1.8	0.6	-0.8
Farm credit assistance off-budget	-0.4	-0.5	-0.4
Veterans loan assets	-0.5	-0.6	-0.6
Food Stamp write-off	-0.5	0	0
Lump-sum pension payments	-0.6	0	0
Advance farm deficiency payments	-0.9	0	0
Asset sales	-5.7	0.6	0.6
Subtotal	-10.3	0.1	-1.2
Total Changes	-27.5	-15.8	-15.5
BUDGET RESOLUTION DEFICIT	119.8	132.2	128.2
BALANCED BUDGET ACT TARGETS	100.0	64.0	28.0

SOURCES: Congressional Budget Office, based on its economic and technical estimating assumptions of February 1989.

Fiscal Year 1991

While carrying out the budget resolution would come close to meeting the Balanced Budget Act's requirements for 1990, CBO projects that it will leave much more deficit reduction to be accomplished in fiscal year 1991. If the budget resolution is fully implemented, the 1991 deficit would be $132 billion. Enactment of the savings and loan bill would add upto $20 billion, of which about $14 billion would not be counted for the Balanced Budget Act. The resulting deficit of $138 billion would exceed the target by about $74 billion and would surpass the sequestration threshold by $64 billion.

Deficit reduction of $64 billion would represent more than twice the amount of permanent deficit reduction achieved in any recent year. To get a sense of how big this reduction would be, consider the hypothetical example of achieving it buy imposing an across-the-board cut in spending. Such an approach would require a cut in spending of more than 10 percent, excluding only Social Security benefits, net interest, and outlays from prior-year appropriations.

Such a large deficit reduction in one year would require strong actions by the Federal Reserve in order to prevent short-run reductions in the growth of real GNP and employment. The central bank would have to permit faster money growth and a substantial decline in interest rates in order to stimulate interest-sensitive spending enough to offset the direct depressing effect of deficit reductions this big.

One way to ease the deficit reduction task in 1991 is to press forward on carrying out the 1990 budget agreement and resolution. Because of identifiable one-time savings, the budget resolution is estimated to save only $16 billion in 1991, as compared with $28 billion in 1990. If some of the as yet unspecified 1990 savings are also achieved through accounting changes or timing shifts, or if some of the savings are not accomplished at all, the amount of permanent deficit reduction could be even less, and the further cuts needed in 1991 would be that much greater.

As CBO has stated many times before, large budget deficits exacerbate several major problems of the economy--a low saving rate, a large trade deficit, and mounting foreign debt--all of which impair economic growth. The Congress has made some progress in reducing the budget deficit, but further cuts could help our economy grow more rapidly in the long run. CBO looks forward to assisting the Congress as it continues the important task of reducing the deficit.

Representative HAMILTON. Let's begin with some of the previous testimony that we have had before the Joint Economic Committee.

From the private economists, and I think now from you as well, the testimony is that the administration's medium-term economic projections are more optimistic, perhaps it is fair to say far more optimistic, compared to other forecasts than the short-term forecasts.

And as a result of that optimistic forecast, the administration projects a decline in the budget deficit to under $25 billion in 1994, with no other action required than enactment of the April budget agreement.

By contrast, your estimate of the 1994 deficit is closer, I think, to $100 billion, if not higher.

So, the question is obviously a difference in the forecast. What is your estimate of the probability that the economy will perform as well as the administration is saying that it will perform over this period of time?

Mr. REISCHAUER. I certainly do not have a point estimate of that probability, but I would just note that under the administration's forecast and its projections out to 1994, the economy is growing pretty much along the administration's assumed path of full capacity. And that path is modestly higher than the path seen by the Congressional Budget Office and many private forecasters. The administration feels that the economy can grow roughly 3 percent a year in real terms without creating inflationary pressures. The Congressional Budget Office's view is that the potential for the economy will increase around 2.5 percent over this period.

Representative HAMILTON. If you were just characterizing, not trying to get into quantities at all, but if you just were characterizing the administration budget projections, would you say that the economy will perform as well as they are projecting or that it is unlikely that it will perform as well as they are projecting?

Mr. REISCHAUER. It is unlikely.

Representative HAMILTON. It is unlikely in your view. And, thus, the forecast in your view is not the most appropriate forecast to use in developing budget and deficit projections for fiscal year 1990 and beyond?

Mr. REISCHAUER. Well, I think that when you are dealing with the budget projections for the future, it is always wise to be prudent. It is better to be wrong in one direction, as you know, than in the other.

If you found that you had, in fact, a stronger economy and that as a result, the deficit was coming down even faster than you expected, it certainly would not do anything except strengthen the longrun position of the American economy in the world.

Representative HAMILTON. And, yet, we proceed in exactly the opposite way, do we not?

Mr. REISCHAUER. I wouldn't characterize your behavior. [Laughter.] Yes. Yes.

Representative HAMILTON. No, what I'm talking about the Congress, the President——

Mr. REISCHAUER. You are in a difficult situation. The administration is forecasting an optimistic or rosy picture. And for you to adopt a more pessimistic outlook puts you in the position of having to engage in more deficit reduction under the Gramm-Rudman procedures than would be the case if you accepted the administration's outlook.

Representative HAMILTON. Do you think that the excessively optimistic economic assumptions then have contributed to our failure to make substantial progress in reducing the budget deficit?

Mr. REISCHAUER. Probably. I am not trying to be cute, but it is difficult to answer the question: If Congress had even a higher hurdle to leap over to reach the Gramm-Rudman targets, would it leap over that hurdle, or would it change the hurdle, or obfuscate?

Representative HAMILTON. You and I, we all understand the political pressures that operate on any President and any Congress, almost forcing them to adopt unusually optimistic assumptions. It makes our life a lot easier up here because we don't have to cut spending as much. That is what it comes down to.

And whether or not it is the wise and the prudent thing for the Nation to plan its economic future on the basis of excessive spending is another question.

How do we get ourselves out of this box?

Have you given any thought to how you get out of this box? Is there some kind of procedure we can follow that would put us on a more realistic or more probable path for the economy and thereby our estimates will be better?

I know that is not an economic question dead center, but, nonetheless, it is one that you must have thought about and wrestled with.

Mr. REISCHAUER. Well, I do not believe that procedure will drive the process, but we clearly have made certain strides with respect to the deficit when we adopted the Gramm-Rudman rules—and again when they were revised again in 1987. But just as quickly as the rules are tightened and changed, new methods of evading them are discovered.

What seems to be lacking is the will to face this problem directly. It is a very hard thing to generate political support and will for what is inevitably a painful process when there seems to be no compelling reasons to the average American to engage in significant deficit reduction. The economy is relatively strong. The inflation rate seems to be under control. Interest rates are coming down. Why worry?

Representative HAMILTON. Do you think we should worry?

Mr. REISCHAUER. Oh, I think we should, very definitely. But, all of the economists in the world lined up end to end saying you should worry has never convinced the American public that action should be taken.

Representative HAMILTON. Or the Congress.

Mr. REISCHAUER. You said that. I didn't. [Laughter.]

We are still hoping. [Laughter.]

I am lining them up down at the office.

Representative HAMILTON. Just one other question, and then I will turn to Congressman Upton.

When Mr. Boskin was here, of course he declined to say that your projections were excessively optimistic but he did say that it might be helpful if the Congress and the administration would look at the effect of the budget with alternative paths for the economy.

Would that be a feasible exercise, for example, for CBO? Would it be helpful to the budget process, do you think, if we did that?

Mr. REISCHAUER. Well, it certainly is feasible. And we do this in a partial way in our annual volumes, as does the administration in its budget, by making an estimate of what the impact would be on the deficit if growth were higher, if inflation were higher, if interest rates were higher, and if unemployment were higher.

Representative HAMILTON. But you basically give us, and the administration gives us, one set of figures.

Mr. REISCHAUER. One set of figures. And we show you the sensitivity of those figures to a change in a single economic variable.

We certainly could provide an alternative estimate. And, in a sense, one can get this out of our reestimate of the President's budget proposal, for example, because we show how much of the gap between our estimate of the President's proposal versus his own estimate of his proposal is attributable to differences in economic assumptions. And with respect to the Bush budget for fiscal year 1990, I believe the figure was something on the order of $9 billion to $10 billion.

Representative HAMILTON. What I thought he was suggesting to us was that you could actually work out, say, three alternative paths for the economy for simplicity's sake, say optimistic, moderate, and pessimistic.

Mr. REISCHAUER. There was a time when the Congressional Budget Office did provide several different economic forecasts to the Congress, and the budget numbers associated with those forecasts. We had the feeling that the proliferation of numbers was more confusing than enlightening. And there is always a danger that, if you have out on the table a series of alternatives, people will gravitate toward the one that is easiest to accept.

Representative HAMILTON. For whatever it is worth, it is my sense that in using optimistic economic assumptions for reasons that we all understand, we end up fooling ourselves. And we believe that we are making more progress than we are actually making in reducing the deficit.

And the net result of that is that this approach is eroding the long-term economic strength of the country.

So I think, when you are talking about optimistic economic assumptions, you are talking about something that is really very important because the assumptions that you adopt dictate the results that you get.

And I am worried that the process is driven now by these optimistic economic assumptions which I think lead us not to a prudent result, but a result if the economy performs at the proper level of the projections.

And I don't know how you get out of that box. Mr. Boskin has suggested one way, and that might be the best way. And I am open to further conversation with you and others about how that could best be done.

Shall we take a break and then come back, and we will begin with Congressman Upton?

Mr. REISCHAUER. Just one comment on your statement, which I agree with completely. And that is that, when we are talking about the budget outlook for the coming year—the budget year, 1990—

there really is a limit to how much finagling one can do by using unrealistically optimistic economic assumptions.

Representative HAMILTON. We have pretty well reached our limit, haven't we? [Laughter.]

Let's stand in recess.

[A recess was taken at this point.]

Representative HAMILTON. The committee will come to order.

Congressman Upton.

Representative UPTON. Thank you.

I wanted to follow up a little bit with the chairman's questions at the end with regard to the various budget deficit paths that you can look at, particularly when you discuss and look at different economic statistics.

What is the path that you see if the real GNP growth is 1 percent above what you predicted and/or 1 percent below?

Where do you see the deficit path coming out? It is probably not much of an impact with the balance of this fiscal year 1989, which only has a couple of more months to go, but what is your outlook as we look toward 1990 and 1991?

Mr. REISCHAUER. We are in the process of revising our February baseline.

Representative UPTON. Officially, it comes out the 17th of August?

Mr. REISCHAUER. The 17th of August. And that baseline will have a new set of numbers in it that will take into account all of the legislative changes that have occurred plus a number of technical changes that have generated increased revenues, and our new estimates of the catastrophic health insurance plan.

But, if real growth were lower by 1 percentage point beginning in January and if that rate persisted throughout a 5-year period, the 1990 deficit would be $24 billion above where we originally predicted it would be. And by 1994, the deficit would be $134 billion higher. In other words, that drop of 1 percentage point would cause a doubling of the deficit over that 5-year period. Keep in mind that is a persistent growth rate that is 1 percentage point below the growth rate that we had forecast, which was around 2.5 percent. So we would be talking about growth of 1.5 percent over a 5-year period. You would have rising unemployment over the entire period and a much, much weaker economy.

Representative UPTON. So it is about $24 billion per percentage point? Is that the rule of thumb?

Mr. REISCHAUER. It is a little hard to describe because there is a time path involved here. And for fiscal year 1989, if conditions changed starting in January and the growth rate were consequently slower, we would still have three-quarters of fiscal year 1989 left to go, and the deficit impact would only be $7 billion for that fiscal year.

So these effects accumulate—$24 billion in 1990, $48 billion in 1991, and so on.

Representative UPTON. You indicated in your testimony that you had revised your budget deficit figure from $159 billion, I think that is the figure that you cited in February, to approximately $150 billion for 1989.

And you indicated that it was because of the higher revenues that had come into the Treasury. And we on the committee have been watching this budget, I guess you could say, of the expected revenue that has come in.

What is your view in terms of how much longer is this bulge going to last? Do you see some semblance of the continuing bulge in new revenues? In higher revenues?

Mr. REISCHAUER. Once again, it is a bulge compared to what? The administration saw a very large bulge, but its revenue projections were below CBO's. We had expectations for fiscal year 1989 that were higher than the administration's; and for 1990, the administration has now revised its revenue number upward by something on the order of $14 billion.

Representative UPTON. Doggone it.

Mr. REISCHAUER. We were $4 billion above the administration for 1989, as it was. We have now raised our 1989 estimate by $8 billion. For fiscal year 1990, we will revise our number upward by $3 billion. So, obviously, we are not expecting the upward shift to be as large as the administration expects.

Representative UPTON. Let me just ask one more question, and then I will pass to Olympia Snowe.

Mr. Boskin was here, I guess a week or two ago. I'm going to cite from his testimony, in which he was comparing their growth figures with the Blue Chip forecast, and he said, quote:

"For example, 2.6 percent is the average of the highest 10 Blue Chip forecasters for 1990 real GNP growth on a year-over-year basis," which compared to the administration's forecast of 2.3.

In other words, instead of taking the 50 Blue Chippers, he was taking the top 10, trying to show us that, in fact, their amount was actually less.

Now, what do you think of that type of analysis? What is your reaction to looking at a certain window within the Blue Chippers and comparing it in this case favorably with the administration's forecast?

Mr. REISCHAUER. Well, I do not want to be too critical of that technique because, just 10 minutes ago, I told you that we were smack in the middle of the Blue Chip. And that was supposed to make you think that CBO was reasonable.

To say something in favor of the administration, the administration's forecast has become less optimistic. Now it is within the range of the Blue Chip. Many of the forecasts that were issued by the previous administration were more optimistic than all 52 of the Blue Chip forecasters. I think that Mr. Boskin and Mr. Darman are correct when they say that their path is optimistic but it is possible. It could come out that way.

I think that when you are trying to gain credibility, however, the right thing to do is to look at the entire spectrum, not just at the most optimistic 20 percent of the forecasters. And that is what I tried to do in my testimony—to show you when you array a wide range of economists, how that pattern looks and where CBO falls and where the administration falls. The administration falls in the top group, and we fall smack dab in the middle.

Representative UPTON. Thank you.

Representative HAMILTON. Congresswoman Snowe.

Representative SNOWE. Thank you.

Besides economic assumptions, what else impacts our deficit projections? For example, policy assumptions. Wouldn't it be true that, say, in the last 8 or 9 years that we have been off our deficit, the deficit projections maybe on the order of $20 to $30 billion, because we have made incorrect policy assumptions?

Mr. REISCHAUER. Certainly, that is true. Both the administration and the Congressional Budget Office are forecasting a budget picture based on an assumed set of public policies. And sometimes those policies do not come out the way we think they will. Excuse me—the way we think they will come out. We have some numbers, which I can provide for you, that try and strip out those policy differences—numbers that say, well, what if both CBO and the administration were forecasting the same policy package? Such a comparison would not distort the relative accuracy of the two budget forecasts.

Representative SNOWE. What about CBO's projection of catastrophic legislation? That is a good example, isn't it?

Mr. REISCHAUER. It depends on which side of the table you are sitting on.

Representative SNOWE. What do we calculate? What did CBO calculate for the last year when we passed the legislation?

Mr. REISCHAUER. The cost of the catastrophic health bill, when it was passed last summer, was surrounded by a good deal of uncertainty about what its ultimate costs would be, particularly the drug portion of that bill.

Representative SNOWE. Right.

Mr. REISCHAUER. We had very little data to go on, and we expected the drug portion to be considerably less expensive than the administration did at that time. Since last summer, new information has become available. When we redid our estimate, in fact, it turned out that the administration's number was much closer to where we think the final costs of this bill will be. The differences with respect to fiscal year 1990 are fairly small because, as you know, the drug benefit does not really begin until 1991. But we are talking about billions of dollars by 1993.

Representative SNOWE. And on the prescription drug.

Mr. REISCHAUER. On the prescription drugs alone.

Representative SNOWE. That was a business calculation. That was an example of the administration projecting more accurately than the Congress did in terms of the cost of that legislation; that obviously scared our deficit projections.

Mr. REISCHAUER. Correct.

Representative SNOWE. OK. You mentioned in your testimony the direct estimates of "The probability of recession during the next 9 months place the figure in the 15 percent to 40 percent range."

Now, I was wondering whether you think it is closer to 15 percent or 40 percent given the fact that that is quite a wide-ranging percentage.

Mr. REISCHAUER. Let me explain that a little. The 40 percent figure comes from rules of thumb that economists use when looking at the index of leading indicators and at the pattern that it has exhibited—for example, several months of decline, or declines of a certain size. The economist looks at these patterns and asks: When we have experienced these patterns, how frequently have recessions followed? That is a pretty crude measure, and so I would not put a lot of weight on the 40 percent.

Other economists, however, have put together econometric models that try to develop direct estimates of the probability of recession given the current types of conditions that we are having. These are statistical models. And when you look at the ones that are available, they suggest probability of a recession in the next 9 months of somewhere between 15 percent and 25 percent.

So, if I were asked to put a bet on this, I would be down in the 15 percent to 25 percent range, not up near 40 percent. But I wanted to give you the full flavor of the uncertainty that surrounds such estimates.

Representative SNOWE. OK, thank you.

Representative HAMILTON. Mr. Reischauer, I would like to ask a few additional questions, so we will take another recess for a vote.

[A recess was taken at this point.]

Representative HAMILTON. The committee will resume its sitting. We are sorry for all of the interruptions. I think maybe that is the end of them, I hope it is, for the day.

You know that the budget resolution has been heavily criticized for the smoke and mirrors in it. The military pay day, the Post Office moved off budget, the advanced agricultural support payments, the FSLIC rescue funds counted as revenues, and a number of other items.

Now, as a careful and a reputable professional economist, those kinds of moves must give you some concern, don't they?

Mr. REISCHAUER. Yes.

Representative HAMILTON. How do you eliminate that kind of thing?

Mr. REISCHAUER. Well, we can try the route of legislation. We tried that in 1987 and, in fact, a number of changes were made in the Gramm-Rudman-Hollings Act that made it much more difficult to engage in this kind of smoke and mirrors. I think that the steps that were taken in 1987 were good. Further revisions of the Gramm-Rudman law could, I think, improve the situation somewhat.

But, as long as there is a will, there will be a way. And some of these proscriptions that have been made can be rendered ineffective—such as "Thou cannot shift payments from the budget year to an adjacent fiscal year without saying you are doing it"—well, some of the things we are doing are going right along with the new law. We are shifting payments and saying that we are shifting the payments.

So, no amount of rules or regulations can stop that kind of action. I think what is needed is a considerable amount of leadership both in the White House and in the Congress to come to grips with the budget deficit. And as long as we think that this is a sometime effort or it is a 1-year-at-a-time battle, we are not going to make substantial progress.

Representative HAMILTON. Are there legislative steps that can be taken to eliminate or sharply reduce smoke and mirrors if we passed a law saying that, "Thou shalt not have smoke and mirrors"?

Can we do something like that?

Mr. REISCHAUER. That basically is what was done in 1987.

Representative HAMILTON. Did it help?

Mr. REISCHAUER. It helped, but it did not solve the problem completely.

Representative HAMILTON. Is there any thinking being done now in the CBO, for example, as to how you reduce smoke and mirrors?

Mr. REISCHAUER. The Budget Committees have been keeping track of the various devices that have been used to evade real deficit reduction. Should Gramm-Rudman be revised again, I think that changes will be made to preclude a large number of activities that have been engaged in over the last year. But remember, some of these things that you have characterized as gimmicks and smoke and mirrors are really quite acceptable and legal under our current sets of rules and regulations—like the shifting of advance deficiency payments. The Secretary of Agriculture has the authority to make advance deficiency payments within a certain band by advancing 40 percent to 50 percent of expected total payments around the time of planting.

And he has just taken advantage of that authority.

Representative HAMILTON. I am not suggesting that those steps are illegal. I understand that.

Mr. REISCHAUER. They are not even proscribed by the Balanced Budget Act.

Representative HAMILTON. Now, on the probability or possibility of a recession, I guess your testimony amounts to a prediction that we're going to have a soft landing.

Mr. REISCHAUER. Yes.

Representative HAMILTON. And you say that in the next 9 months, you place the probability of a recession in the 15- to 40-percent range.

Does that statement mean, for example, that 40 percent of the time in the past when we have observed similar economic conditions a recession has followed?

Mr. REISCHAUER. There is a great deal of uncertainty around that estimate, as you can tell by the range of 15 percent to 40 percent. As I explained to Representative Snowe, the 40 percent figure comes from rules of thumb that economists have developed by looking at the index of leading indicators and saying that when it has behaved as it has behaved during the last few months—namely, 2 months of decline or decline of a certain magnitude—then 40 percent of the time that we have experienced those conditions, we have experienced a recession.

That is a pretty crude measure. The 15 percent number comes from econometric models developed by several economists who have tried to stochastically estimate the probability of recessions. Those models come up with numbers closer to the 15 percent to 25 percent range.

And if I had to——

Representative HAMILTON. I remember your testimony.

We had testimony from Mr. Penner the other day, and he said that every period of 2 percent growth or lower in the postwar period has ended in a recession.

Now, the general consensus projects less than 2 percent growth to the end of 1990.

Do you think that if real growth slows to less than 2 percent, we would inevitably have a recession?

Mr. REISCHAUER. No, I do not. Remember, we are seeing the easing of monetary policy right now.

Representative HAMILTON. What are the major sources of strength in the economy right now?

Mr. REISCHAUER. I think the major source of strength that we would see in our forecast is continued strong net exports. But that requires that the recent strength of the dollar not continue, that we have some gradual weakening of the dollar over the next year.

Representative HAMILTON. What kinds of things can cause a recession?

Mr. REISCHAUER. I think the major danger that we face is the possibility that monetary policy has been too tight too long, and that the restraint brought on by the monetary policy of the last year and a quarter leads to not just a slowdown but, in fact, a recession and further weakness.

Representative HAMILTON. What are your views on the recent conduct of monetary policy?

Mr. REISCHAUER. I think, overall, it has been quite prudent.

Representative HAMILTON. Has it loosened too much or not enough in recent months?

Mr. REISCHAUER. I would not want to second-guess Mr. Greenspan at this point. I think, so far, all of the signals are that the economy is moving along a path that most economists would approve of. We were growing faster than capacity. We were bumping up against capacity constraints in our economy and we have slowed that growth down now so that we are perking along at less than the growth of our potential GNP.

Representative HAMILTON. With the slowdown in the economy, and the use by economists more frequently of the word "recession," is the Federal budget deficit now viewed as benign?

Mr. REISCHAUER. Do you mean the fiscal year we are in right now? There was not a lot of fiscal restraint applied by the Federal budget. Should the budget resolution be implemented in full, even with the smoke and mirrors that we were talking about, there would be moderate further restraint in fiscal year 1990——

Representative HAMILTON. Do you think we ought to continue to reduce the deficit?

Mr. REISCHAUER. Very definitely.

Representative HAMILTON. On the path of what? Forty or fifty billion dollars a year reduction?

Mr. REISCHAUER. I think that could be sustained if appropriate accommodative monetary policy were implemented.

Representative HAMILTON. And if you fell into recession, would you have the same deal?

Mr. REISCHAUER. If we were slipping into what appeared to be a serious recession, I certainly would not be advocating a $50 billion reduction in the structural deficit.

Representative HAMILTON. Do you think that there is a tendency now in this town to more and more view the budget deficit as benign?

Mr. REISCHAUER. Unfortunately, I think the answer to that is yes.

Representative HAMILTON. Now, the administration forecast shows both inflation and unemployment falling gradually but steadily between 1990 and 1994, to 5 percent unemployment in 1994 and to 3 percent inflation.

Your projection is that inflation will stay level at 4.6 percent through 1994. But I don't think you give long-term unemployment projections.

Is there any precedent in our postwar history that would justify the administration predicting a gradual, steady decline in both inflation and unemployment after 1990?

Mr. REISCHAUER. I am not sure about past history and whether we have ever experienced a 5-year period of gradually declining unemployment and inflation. I would doubt that that would be the case.

Representative HAMILTON. Is that one place where you might be skeptical of the administration's forecast?

Mr. REISCHAUER. Very definitely. There is a question on where inflation will pick up as the unemployment rate drops. There is a slight difference of emphasis on this between the administration and CBO. We predict or we estimate the threshold unemployment rate to be in the range between 5 percent and 5.3 percent. The administration is saying that there appears to be no danger of accelerating inflation even when one has a 5-percent rate of unemployment.

Representative HAMILTON. Or lower?

Mr. REISCHAUER. Well, one would expect that—Michael Boskin went into that in the affirmative—given that their inflation rate is falling, although they have a steady 5-percent unemployment rate.

Representative HAMILTON. Would they go down as low as 4.5 percent? Do you know?

Mr. REISCHAUER. I do not know.

Representative HAMILTON. The administration forecasts that the budget deficit will decline to $30 billion in 1993, $25 billion in 1994, with no further deficit reduction except enactment of the current budget resolution.

Do you believe that the United States can grow its way out of the budget deficit with no further spending cuts or tax increases?

Mr. REISCHAUER. No.

Representative HAMILTON. Under your economic and technical assumptions, we will need to produce additional deficit reduction accounting to at least $100 billion by 1994.

Mr. REISCHAUER. Correct.

Representative HAMILTON. Where can such an amount be found?

Mr. REISCHAUER. I am not sure I have the answer any more than the Congress does. I think it is going to involve widespread reduction in spending or significant increases in taxes. And I do not think we should look at this as a search for a pocket of waste here or a bit of excess there, or a tax that is too low some where else.

When we are talking about $100 billion, we are talking about big numbers, and the pain of higher taxes and lower spending is going to have to be shared broadly across all sectors of the budget.

Representative HAMILTON. You are looking, I guess, at CBO, at the various revenue options, aren't you? Could you make those available to us?

Mr. REISCHAUER. Yes.

Representative HAMILTON. And likewise the spending reduction options. Those publications that I think you put out, I guess they come out once a year, I think they are exceedingly well done, I might say to you, and very helpful to Members of Congress.

On the various revenue projections that you make, do you have information concerning the relative effect of different kinds of taxes on the efficiency of the economy? Or do you analyze it in those terms?

Mr. REISCHAUER. I do not think that we have analyzed it in those terms.

Representative HAMILTON. What you do really is just identify the option.

Mr. REISCHAUER. The options and the amount of revenue produced.

Representative HAMILTON. The amount of revenue that can be produced.

Mr. REISCHAUER. Right.

Representative HAMILTON. On the administration forecast, they were very optimistic with regard to corporate tax receipts, or I guess another way to put it, they were very optimistic with respect to corporate profits. Corporate profits were 6.3 percent of GNP in 1988, and the administration is projecting them to rise to 7.8 percent of GNP by 1994.

How does that compare, if you know, to your projections on corporate profits? Have you focused on that at all?

Mr. REISCHAUER. It is part of our forecast. I just was not sure where on this table it is. We have profits as a share of national income falling from 6.8 percent in 1988 to 5.9 percent in 1989, to 5.6 percent in 1990. So we are considerably less optimistic than the administration.

I also would note that when we come out with our new baseline budget forecast in the middle of August, we will be revising downward our corporate income tax revenues from where they were in February, because we see corporate profits as weaker than we saw them 6 months ago.

Representative HAMILTON. Now, why does that happen? Why is it that the administration is so much more optimistic than you are on corporate profits?

Mr. REISCHAUER. It has more rapid growth.

Representative HAMILTON. Does that explain it completely?

Mr. REISCHAUER. I expect that that would explain a large portion of it.

Representative HAMILTON. It goes back to the economic assumptions.

Mr. REISCHAUER. Right.

Representative HAMILTON. What is your impression of the trade deficit if the dollar remains at the present level? What do you believe is going to happen on the U.S. trade and current account deficit balances?

Mr. REISCHAUER. In nominal terms, we do not have the current account situation changing much over the projection period. In other words, we have it ranging between $120 billion and $130 billion over the 1989–94 period.

In other words——

Representative HAMILTON. You are not optimistic that we are making much progress on the current account deficits then?

Mr. REISCHAUER. No. Well, we are making some progress relative to the size of the economy.

Representative HAMILTON. If you keep it at the same level.

Mr. REISCHAUER. In nominal terms, we do not see much improvement.

Representative HAMILTON. If we make progress in reducing the Federal deficit, will that result in an improvement in our trade balance?

Mr. REISCHAUER. If we were to achieve the Gramm-Rudman targets prescribed by the law, that would make a considerable difference and it would allow for an easier monetary policy in this country.

Representative HAMILTON. So reducing the Federal deficit would improve our trade balance?

Mr. REISCHAUER. Yes.

Representative HAMILTON. And it would be one of the most significant actions we can take to do that, I presume?

Mr. REISCHAUER. I think you could even be stronger. I think it would be the most.

Representative HAMILTON. The most.

Mr. REISCHAUER. The most significant single step we can take.

Representative HAMILTON. Can you spell out for me why that is the case?

Mr. REISCHAUER. Well, to the extent that the deficit fell, the Nation would ease its monetary policy. We would not need to borrow from abroad. With less need to borrow from abroad, the value of the dollar could decline. As the value of the dollar declined, the export position of the United States would be strengthened.

Representative HAMILTON. We have had quite a bit of testimony in this committee with respect to the relationship between public investment in human and physical infrastructure and economic growth.

Are you under the general impression that we have been underinvesting in both physical and human infrastructure in this country?

Mr. REISCHAUER. I think one can make a case that the United States is underinvesting in public and private capital. The public capital generally involves infrastructure and human resource investments—education, health, and so on. This is part and parcel of the fact that we as a nation have been overconsuming and living for today rather than investing for the future.

Representative HAMILTON. Do you agree with that?

Mr. REISCHAUER. Yes, I do.

Representative HAMILTON. And when you talk about investing for the future, what are you talking about, basically? Investing in what?

Mr. REISCHAUER. I am talking about investing in plant and equipment. I am talking about investing in human resources; in other words, in the education and health of tomorrow's work force. I am talking about investing in the public capital that increases our productivity—roads, transportation of various sorts. This gets very tricky, as you know, measuring the appropriate areas where further investment really will produce a significant rate of return. Public spending on some public projects that are labeled "investments" is more pork than investment, as you know.

Representative HAMILTON. But, in general, you subscribe to the view that there is a relationship, favorable relationship, between investments, say, in infrastructure and in productivity and economic growth?

Mr. REISCHAUER. Yes.

Representative HAMILTON. We have had witnesses testify that we ought to take the surplus from the Social Security trust fund and use that to fund public sector investments.

Have you made any judgment about that?

Have you looked into that from the CBO standpoint?

Mr. REISCHAUER. No, we have not. I think the real issue is the rate of national saving. And that, of course, is the function of both private saving and public dissaving. And one should not take one segment of the Federal budget, or Social Security, which is off budget, and say that this is an appropriate chunk of resources to devote to a particular form of investment without looking at the much larger picture.

Representative HAMILTON. And then how do you feel about a capital budget in the U.S. Government?

Mr. REISCHAUER. CBO is not an advocate of a capital budget.

Representative HAMILTON. And why are you not?

Mr. REISCHAUER. We think it would skew certain kinds of decisions that are made between operating and capital with respect to government allocation decisions. And it would obscure the role that the current budget plays in determining the impact that Federal spending has on the macroecoomic situation.

Representative HAMILTON. You think that that is the weight of authority among the economists?

Mr. REISCHAUER. I think that it probably is. However, I do not think that there is a strong consensus. In other words, I do not think that it is a 90-10 call, the way it might have been back in 1967 when the President's Commission on Budget Concepts reported on this issue.

Representative HAMILTON. Is the CBO analyzing that issue at all now, making any studies on it?

Mr. REISCHAUER. We have done some in the past, and I would be glad to——

Representative HAMILTON. I'm not asking you to. I'm just curious as to whether it is under active consideration now at the Budget Committees.

Mrs. REISCHAUER. The Budget Committees and the budget resolution this year asked for further information on capital accounts, and asked CBO to prepare certain tabulations wth respect to capital spending—government capital spending—as part of the material that we provide for the budget resolution debate. And we intend to do that in the next budget cycle.

Representative HAMILTON. OK, Mr. Reischauer, thank you very much. We appreciate your appearance this afternoon.

The committee stands adjourned.

[Whereupon, at 3:45 p.m., the committee adjourned, subject to the call of the Chair.]

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