STATEMENT OF ALICE M. RIVLIN
DIRECTOR, CONGRESSIONAL BUDGET OFFICE

BEFORE THE SUBCOMMITTEE ON ECONOMIC DEVELOPMENT
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION
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Mr. Chairman, as this Committee begins its hearings on the reauthorization of public works programs, I have been asked to present the Congressional Budget Office's views on the outlook for the economy. As you know, economic growth was above trend during 1978, and unemployment declined substantially. Unfortunately, inflation accelerated to very high levels. As a result, the Administration and the Federal Reserve have undertaken an anti-inflationary program of tightened credit, wage-price guidelines, and proposed spending cuts. Their statements and actions have clearly indicated that the primary goal of their economic policies is to reduce inflation.

The economy has recently experienced relatively high rates of resource utilization, and CBO believes that additional stimulus at such rates of utilization could be quite inflationary. In fiscal year 1980, however, when your present decision will be having its effect, we are not very optimistic about the performance of the economy. In an effort to shed what light I can on this topic, I will discuss two issues in my presentation today:

- o CBO's view of the short-run economic outlook; and
- o The relation of the economic outlook to your decision on local public works (LPW) projects.

THE ECONOMIC OUTLOOK

The forecast that I will discuss today is contained in our economic report released last January. This report has been circulated to all Members, and I have additional copies here today. Later in this testimony, I will briefly discuss events that have occurred since that forecast was prepared, but the forecast contained in that report generally still appears to be valid.

When CBO's economic report was prepared, economic growth was especially robust. Gains in retail sales, employment, and production at the end of 1978 exceeded earlier expectations, and many forecasters expect that the momentum of this increased activity will carry over at least through the first half of 1979. At the same time, it appears that high inflation has set the stage for a slowdown in the economy. In response to inflation, as well as to last year's depreciation of the dollar, the Federal Reserve has adopted tight monetary policies, which are expected to affect residential construction and business investment adversely this year. High inflation appears to have taken its toll on consumer and business confidence, which also portends a slowdown in activity.

Although there is quite widespread agreement among forecasters that the pace of economic activity will slow this year, there are differences of opinion concerning the timing and severity of the slowdown. A major factor accounting for differences in the forecasts is the assumed behavior of economic policies, particularly monetary policy.

CBO's January 1979 Forecast

The CBO forecast is based upon two policy assumptions:

- First, the fiscal policy assumption is that the policies contained in the second concurrent resolution for 1979 will be continued, resulting in estimated federal outlays of $494 billion in fiscal year 1979 and $551 billion in fiscal year 1980. The CBO forecast does not assume either the spending cuts proposed by the Administration or its real wage insurance program.

- Second, monetary policy is assumed to remain restrictive, with short-term interest rates rising somewhat above current levels and peaking at the end of the second quarter of this year.

CBO forecasts real output to slow significantly during 1979, growing at a 0 to 2 percent rate, as shown in Table 1. Economic growth is expected to pick up somewhat in 1980, with real growth averaging 3 to 5 percent. As a result of the weaker economic activity, the unemployment rate is projected to rise to a 6.2 to 7.2 percent range by the end of this year and to continue in the same range throughout 1980. Meanwhile, inflation is expected to remain stubbornly high. The increase in the Consumer Price Index (CPI) is forecast to range between 7 and 9 percent this year and between 6.5 and 8.5 percent in 1980.

TABLE 1. SUMMARY OF JANUARY CBO ECONOMIC PROJECTIONS UNDER CURRENT POLICY, CALENDAR YEARS 1979 AND 1980

Economic Variable	1976:4 to 1977:4 (actual)	1977:4 to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 1980:4
GNP (current dollars, percent change)	11.9	13.1	7.0 to 11.1	9.7 to 13.9
GNP (1972 dollars, percent change)	5.5	4.4	0.0 to 2.0	3.0 to 5.0
Consumer Price Index (percent change)	6.6	9.0	7.0 to 9.0	6.5 to 8.5
Unemployment Rate, End of Period (percent)	6.6	5.8	6.2 to 7.2	6.2 to 7.2

The CBO forecast anticipates continued economic growth in the first half of 1979, though at a slower pace than in the second half of last year; but CBO projects a mild downturn during the second half of 1979. The critical element in the expectation of a downturn is the bleak outlook for inflation and the assumed response of monetary policy.

Inflationary pressures are expected to be quite intense during the first half of 1979. Import prices are projected to rise, in reaction to the earlier depreciation of the dollar. Increases in social security taxes and minimum wages, which became effective in January, will boost compensation and prices. Adding to this is an assumed rapid increase in farm and energy prices. The acceleration in inflation over the past 12 months is also expected to increase pressures for large wage gains.

Given the outlook for prices, CBO believes that it is unlikely that the Federal Reserve will quickly reverse the more restrictive policies adopted last fall. These policies are intended to reduce the growth of credit, thereby slowing final demands and inflationary pressures. An easing of monetary policy might be viewed as contradictory to the announced anti-inflation goals of the Federal Reserve. In addition, there still are fears that an easing of monetary policy would increase pressures for further depreciation of the dollar, a development that the Administration and the Federal Reserve clearly want to avoid. Thus, CBO assumes that monetary policy will remain tight until there are clear signs of a slowing of the economy.

Residential construction and business investment are expected to be most severely affected by tight credit conditions. Surveys of business spending intentions provide confirmation of the impending weakness of investment. A decline in consumer confidence also suggests consumption will weaken in 1979. A buy-in-advance consumer psychology, fed by inflation, seems to have boosted sales toward the end of 1978, at the expense of later consumption.

The downturn in economic activity forecast by CBO is not expected to be deep or prolonged for several reasons:

- o Business inventories are relatively lean, indicating that any inventory adjustment would likely be mild;
- o Net exports are projected to be a source of strength as a result of an expected improvement in the economic growth of U.S. trading partners and because of the depreciation of the dollar last year;
- o The cut in personal income taxes provides stimulus in 1979, and overall federal fiscal policy is not expected to be a significant drag on the economy until 1980; and
- o Large order backlogs at capital goods industries are expected to provide support to total spending during the slowdown.

The outlook I have just described is CBO's best guess. But there are a number of major uncertainties in the outlook, including the following:

- o The effect on oil supplies and on the size of the increase in oil prices arising from the recent situation in Iran;
- o The behavior of prices generally and the degree of compliance with the Administration's wage-price standards;
- o The response of monetary policy to continued inflation;
- o The difficulty of estimating the economic impact of restrictive monetary policies, given recent changes in financial institutions; and
- o The possibility of prolonged strikes as a result of attempts by business firms to abide by the Administration's wage standards.

Recent Economic Developments

Information that has become available since CBO prepared its economic report has not reduced the considerable degree of uncertainty in the economic outlook. New estimates of federal budget

outlays in fiscal year 1980 suggest that the current policy budget may be slightly more restrictive than thought earlier. Moreover, if the Congress adopts the spending cuts for fiscal year 1980 recommended by the Administration, the budget would exert more restraint on the economy than under CBO's current policy assumptions. Incoming economic data have given mixed signals:

- There was a widespread acceleration in prices in the first two months of this year, partly related to food and fuel and the increase in minimum wages. Although the most recent data indicate a surge in prices, CBO does not at this time feel there is sufficient basis for revising upward its price forecast.

- Short-term interest rates controlled by the Federal Reserve have not yet increased since the end of the year, but the growth of money aggregates, another indicator of Federal Reserve policy, has been much slower than expected.

- Household demands appear to have weakened significantly. Housing starts dropped sharply in the first two months of the year, though some part of the decline is related to adverse weather conditions. Retail sales appear to have declined in real terms in the January-February period, following exceptional growth in the last quarter of 1978.

- Business demands, as reflected in new orders, appear to have strengthened, with perhaps some speculative buying contributing to the acceleration in inflation. Corporate profits appear to have grown very rapidly in the last six months, thereby providing the financial basis for further expansion. At the same time, however, a new survey of business capital spending plans confirms the earlier finding that capital spending will be substantially weaker in 1979 than last year.

- Increases in industrial production were small in the January-February period, but employment gains were quite large and unemployment edged down to 5.7 percent.

- Trade data, for one month only, suggest weaker net exports than expected.

- While inventory stocks remain lean relative to sales, their growth appears to have been rapid in January, possibly signaling the beginning of a build-up or just a rebuilding from the low levels at the end of last year.

Adverse weather conditions make it difficult to determine the underlying trends, but data for January and February indicate that the first quarter of 1979 is likely to show less real growth and more inflation than many forecasters expected. However, if retail sales figures are revised upward and housing starts bounce back strongly in March, the current quarter may prove to be stronger than it now appears. Should this be the case, short-term interest rates might rise sharply and the projected downturn could well be later but deeper than forecast by CBO. Overall, however, there does not appear to be any basis for changing CBO's forecast of 0 to 2 percent growth from the fourth quarter of 1978 to the fourth quarter of 1979.

IMPLICATIONS FOR LOCAL PUBLIC WORKS

Let me now turn to the implications of the economic outlook for one of the questions before this Subcommittee: whether to authorize a countercyclical local public works (LPW) program and, if so, in what form. Such programs can be effective anti-recession devices to the extent that they create jobs and increase incomes in a timely fashion in those geographic areas and sectors of the economy that are suffering from slack demand.

The initial impact of a LPW-type program is on the construction sector, which was severely affected by the 1975 recession and only last year significantly surpassed its 1974 level of activity. Overall, the industry does not now appear to be in a weak condition. The unemployment rate in the construction industry has declined significantly since the 1975 recession. In 1978,

construction unemployment was below the average rate for the industry since 1950, and the spread between the overall unemployment rate and the construction unemployment rate was slightly less than the historical average (see Table 3).

Despite the relative strength of the construction sector as a whole, public construction remains quite depressed; activity in 1978, as measured in constant dollars, was some 12 percent below 1974 levels (see Table 2). The slowdown in public construction since 1974 has been attributed largely to secular factors, such as the completion of the national highway system and the declining school-age population, rather than to cyclical developments.

The Congressional Budget Office has not made a separate forecast of public construction, but it is generally expected that tight monetary policy and demographic factors will exert a depressing effect on the sector this year. Some expect the political atmosphere reflected in California's Proposition 13 to reduce growth in future years.

If, as CBO forecasts, there is a relatively mild and short downturn, any LPW-type program that is authorized should stress projects that can be completed rapidly. The recent LPW program, by historical experience, was relatively effective at spending money rapidly--about 90 percent of the funds appropriated for round 2 will have been spent within two years. It would be difficult, however, to concentrate the stimulative impact of an LPW program on the periods of economic decline or early recovery if the downturn were shortlived.

TABLE 2. VALUE OF NEW CONSTRUCTION PUT IN PLACE IN THE UNITED STATES: SEASONALLY ADJUSTED ANNUAL RATES, IN BILLIONS OF 1972 DOLLARS

	1974	1975	1976	1977	1978	Jan. 1979 p
Total New Construction	109.6	97.2	103.8	109.9	114.5	111.4
Private Residential	41.7	35.1	42.7	50.4	51.0	48.1
Private Nonresidential	22.7	19.1	18.8	19.4	21.5	22.1
Public	29.1	28.6	26.8	24.6	25.6	24.7
Highways	8.8	7.3	6.9	6.1	5.5	5.0
Education	5.6	5.6	4.6	3.7	3.7	3.9
Sewers	2.1	3.4	3.5	3.3	3.8	3.6
Other public buildings	3.6	3.1	2.7	2.4	3.0	2.6
Conservation and development	2.2	2.3	2.5	2.4	2.6	2.7
Water supply facilities	1.1	1.2	1.0	1.1	1.4	1.3
Hospitals	0.9	1.3	1.3	1.1	1.1	1.0
Housing and redevelopment	0.8	0.6	0.7	0.8	0.8	0.6
Other	4.0	3.9	3.7	3.8	3.8	3.9

p = preliminary

TABLE 3. UNEMPLOYMENT IN THE CONSTRUCTION INDUSTRY: BY CALENDAR YEAR

Unemployment Rates	Average Since 1950	1974	1975	1976	1977	1978	Feb. 1979
Total	5.1	5.6	8.5	7.7	7.0	6.0	5.7
Construction	11.0	10.8	18.4	15.6	12.5	10.5	11.5

Considering this, one option would be to authorize a standby program that would be automatically triggered when the economy weakened, if the downturn appeared to be either deep or prolonged. Under such an option, projects would be authorized in advance so that they could go to construction on short notice should the program be triggered. This strategy might also help ensure that, in any new LPW program, federal funds would not be used to pay for capital projects that state and local governments would have built at that time anyway. Although substitution of federal funds for state and local funds can lead to increased jobs and incomes if state and local governments use their freed-up resources for tax cuts or increased operating expenditures, such actions are likely to occur only after a considerable delay.

The targeting of grants on geographic areas and labor markets experiencing the greatest slack, such as was done in the last LPW program, is worth continuing in any newly authorized program. Such targeting can minimize the impact of this kind of fiscal stimulus on wages and prices.

Conclusion

Reducing inflation has become the primary goal of economic policy. Increased fiscal stimulus now, when resource utilization is at high levels, would work against the anti-inflationary policies recently adopted by the Administration and the Federal Reserve. Many forecasters, however, expect these policies to lead to a significantly weaker economy in 1980. Historically, restrictive monetary policies have had quite an uneven impact on the

economy, with much of the effect falling on the construction industry. If it can be implemented in a timely fashion, targeted fiscal stimulus can be used to spread the burden of restrictive policies more evenly. Such an effect would be most useful if there were a sharp downturn with a substantial rise in unemployment for the targeted group. Given the uncertainty in the economic outlook, this Subcommittee might want to consider authorization of LPW on a stand-by basis, whereby local public works could be initiated quickly in the event of a long or deep recession.