Economic Outlook

Last January, the outlook for economic activity and prices appeared more favorable than it does now. Prices have risen faster than we expected -- mainly because of large increases in food prices, although not entirely. Depreciation of the dollar in exchange markets has also worsened the inflation outlook for 1978, and the underlying rate of inflation may also be creeping up somewhat because of a faster rise of average wage rates and costs. Largely because of the worsening of the price outlook and higher interest rates, economic activity this year and next will increase somewhat less strongly than we had earlier expected. Growth in consumer purchasing power is being damped by rising prices of food and imported commodities; increasing interest rates will be taking their toll in reduced homebuilding activity later this year and on into 1979.

Assumptions Underlying the Base Forecast

Our forecast for this budget exercise takes these developments, as well as our current fiscal policy assumptions, into account. The principal assumptions underlying the forecast are shown in Table 1.

Budget expenditures are assumed to grow at a moderate rate after 1978 -- with increases only a little higher than the rate of inflation. The rise in budget expenditures is less rapid than the growth of GNP, so that the ratio of Federal expenditures to GNP falls to about 21 percent in 1981-82. The path of budget expenditures assumed here is consistent with the Administration's long-term budgetary strategy to reduce the share of Federal expenditures in GNP to about 21 percent, and to rely on reductions in taxes to spur growth in the private sector. Holding to the path of expenditures assumed, however, implies a very tight rein on spending.

Table 1

Principal Assumptions Underlying the
Base Economic Forecast

I. Budget Expenditures increase moderately after 1978

	Fiscal years				
	1978	1979	1980	1981	1982
Level (billions of $)	453	500	545	588	638
Increase from previous year (%)	12.8	10.3	8.9	8.0	8.3
Share of GNP (%)	22.3	22.1	21.7	21.1	20.8

II. Tax reductions are used to maintain economic growth

1. $20 billion tax cut effective January 1, 1979

   - $5 billion net reduction for businesses
   - $1 billion reduction in telephone excise tax
   - $14 billion net reduction for individuals

2. $15 billion additional tax cut effective October 1, 1980.

Table 1 (con't)

III. Monetary policy remains accommodative

- Treasury bill rates increase from about 6-1/2 percent presently to about 7-1/4 percent late in 1978 and then level off.
- Growth in monetary aggregates remains near, and probably above, the upper end of the Federal Reserve's current target ranges.

IV. Anti-inflation policy is moderately successful

- Inflation rate is prevented from accelerating, but does not decelerate.
- Prices rise at a 6-1/2 to 7 percent annual rate.

The forecast assumes a $20 billion tax reduction, effective January 1, 1979, in accordance with the agreement worked out last week with Senator Muskie and Congressman Giaimo. The distribution of that reduction between individuals and businesses remains to be worked out with the Congress; we assume for this exercise a structure of tax cuts broadly similar to that proposed in January. The forecast also assumes a further tax cut of $15 billion effective October 1, 1980.

Monetary policy is assumed to remain accommodative. While interest rates do rise somewhat further, the increase is not enough to provoke more than a mild decline in housing starts next year. The trimming back of the size of the tax package should make it easier for the Federal Reserve to stick with an accommodative posture. The most important factor shaping the course of monetary policy over the near future, however, will probably be developments on the price front.

We assume that our anti-inflation policy is moderately successful -- so that inflation does not accelerate materially from the present underlying rate of around 6-1/2 percent. If this outcome is to be realized, some progress will need to be made this year in holding down the rise in prices of nonfood commodities and services, and moderating the wage settlements for postal and railroad workers. Next year, the critical issue will be to achieve some deceleration in wages and fringes granted in upcoming large union contracts -- teamsters, auto workers, and electrical workers.

Base Economic Forecast

The economic outlook we foresee, given these assumptions, is set forth in Table 2. Real GNP would increase by about 4 percent this year and 4-1/4 percent in 1979. The expansion next year would be led by strongly rising business fixed investment (7-1/2 percent real growth). Capital spending plans are strengthening this spring, and would be given added thrust by the incentives in the tax package. Tax reduction would also help to maintain a steady expansion of consumer spending.

Table

Base Economic Forecast

Economic Results (Calendar Years)	1978	1979	1980	1981	1982
Real GNP Growth (Q4/Q4, Percent)	4.0	4.2	4.4	3.7	3.3
Unemployment Rate (Q_4, Percent)	5.7 to 6.0	5.6 to 5.9	5.4 to 5.7	5.3 to 5.6	5.4 to 5.7
Inflation Rate (Q_4/Q_4, Percent)	6.9	6.5	6.7	6.8	6.5
3-Month Treasury Bill Rate (Q_4, Percent)	7-1/4	7-1/4	7-1/4	7-1/4	7-1/4
Budgetary Results (Fiscal Years)					
Budget Deficit (-) or Surplus (+) (billions of $)	-57	-56	-43	-27	-8

Forecasts for more than two years ahead are, of course, extremely hazardous. Our best guess is that the economy would continue to grow at somewhat over a 4 percent rate in 1980, as housing starts would be turning up again, and business capital investment would continue to increase. Growth in 1981 and 1982, however, would be expected to slow to about our estimate of the long-term potential growth rate of real GNP -- that is, around 3-1/2 percent.

Since real GNP growth is moderately above the potential growth rate in 1978 through 1980, the unemployment rate would be expected to decline gradually, to a range around 5-1/2 percent by late 1980. Thereafter, with economic growth about equal to potential, unemployment remains about unchanged.

As shown in Table 3, the direct benefits of the recently reduced fiscal stimulus are not large relative to their direct costs. Reducing the tax cut to $20 billion, and postponing its effective date to January 1, 1979, decreases real GNP by about 0.3 percent by the end of next year, reduces employment by 150,000, and raises unemployment slightly. The direct effect on prices is very small. The reduced size of the tax cut is not an effective substitute for other strong anti-inflation measures. We will still need to work hard to make the deceleration program effective. On the other hand, the credibility of that program will be enhanced by the evidence of fiscal restraint, and the Fed's task of running monetary policy will be made easier. Moreover, the risk of disorderly conditions developing in the foreign exchange markets, or in money and capital markets, is reduced.

The budgetary results associated with the base economic forecast are disappointing, even with the smaller tax cut. The downward revision in our forecast of economic growth since January has lowered estimated revenues for fiscal 1978 and 1979, while estimates of expenditures for fiscal 1980 and beyond have been raised -- due partly to the greater inflation and higher interest rates now assumed. The deficit in fiscal 1979, even with the smaller tax cut, is expected to be about $56 billion. Thereafter, substantial progress will be made in reducing the deficit, but the budget does not come into balance even in fiscal 1982.

Table 3

Direct Effects of Reducing the Tax Cut
to $20 Billion and Postponing
Effective Date to January 1, 1979

Real GNP at the end of 1979 is reduced by 0.3 percent.

Employment at the end of 1979 is reduced by 150,000.

The unemployment rate at the end of 1979 is raised by 0.1 percentage point.

The rate of inflation in 1979 is reduced by 0.1 percentage point.

The Federal budget deficit is reduced by

$8 billion in fiscal 1979 and

$2-1/2 billion in fiscal 1980.

Reducing the size of the tax cut still further, to $15 billion, would reduce the deficit in fiscal 1979 by about $3 billion. Part of the increase in revenues due to higher tax rates would be lost because of slightly lower growth in the economy -- growth in 1979 would be down to a little under 4 percent, and the unemployment rate would edge up a tenth of a percentage point. Another alternative would be to reduce 1980 budget expenditures by $3 to $5 billion below the $545 level assumed in our forecast.

Major Problems and Uncertainties

There are two principal problems that concern us with the base forecast. The first is the behavior of unemployment, given our forecast of GNP growth; the second is the question of whether monetary policy will follow the course we have assumed.

Unemployment. As we have indicated to you in earlier memos, progress in reducing unemployment over the past year, and especially over the past six months, has greatly exceeded our expectations. Real GNP has grown no faster than we expected, but the increase in employment and the decline in unemployment have both been unusually large. Historical relationships between real GNP and the labor market are simply not holding.

There are three possible explanations for what has happened:

(1) A temporary aberration has occurred that will be reversed. If so, we would be in for a prolonged period in which unemployment would remain unchanged or rise a little, while real GNP "caught up" with the prior decline in unemployment.

(2) Growth in real GNP over the past year or so may have been underestimated. If so, we are further along in reaching both our real growth and unemployment objectives than we realized. We will therefore need to grow somewhat more slowly in the future. While some upward revision in estimated real GNP may occur in the Commerce Department's regular July revision, it is unlikely to be large enough to explain the surprisingly large drop in unemployment over the past year.

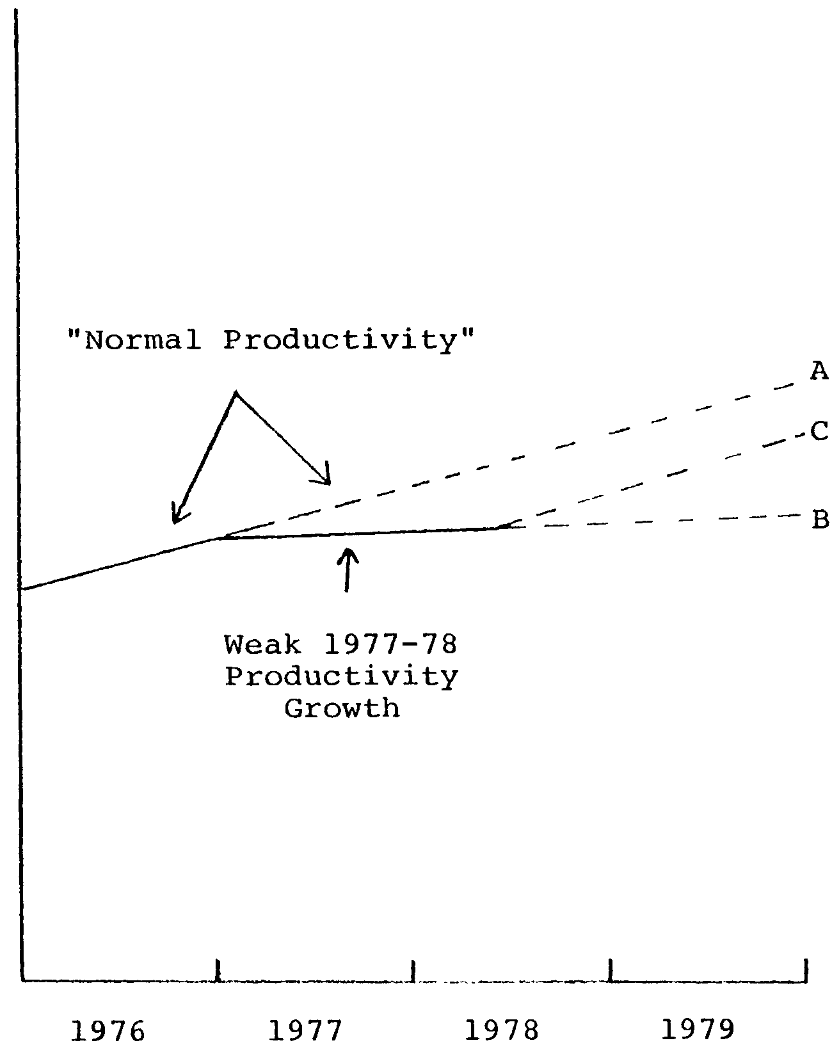
(3) Productivity growth over the past year has been very poor. This is the most likely explanation of what has happened. The implication for the future behavior of unemployment, however, depends on productivity growth in the future, which remains very uncertain.

The schematic diagram on an adjoining page may help to illustrate the problem. Productivity growth in 1977 and early 1978 was expected to follow the "normal" line that would put us at point A by the end of 1979. If it had done so, the unemployment rate would now be about 7 percent and would gradually decline to about 6-1/2 percent by the end of next year. Instead, productivity growth over the past 5 or 6 quarters has been very weak. If it continues to be as weak over the next 6 quarters -- that is, if we proceed to point B in the diagram -- the unemployment rate would decline to about 4-1/2 percent by the end of 1979. This seems to us extremely unlikely. Based on hunches, and it is more of a hunch than a well-documented conclusion, we assume that the very poor productivity experience of the past year is not continued into the future; on the other hand, we also assume that only a small part of last year's productivity loss is made up by greater than normal growth next year. On these assumptions, we will be back to point C by the end of 1979. The unemployment rate would then continue to decline slowly, to a level of around 5-1/2 to 5-3/4 percent late next year.

Our unemployment forecast is thus surrounded with a very large degree of uncertainty. If productivity growth is substantially weaker than we have projected, inflation will become more serious for two reasons: first, because unemployment may decline to a level at which wage rate increases begin to move up strongly; and second, because weaker productivity growth will magnify the effects of large wage increases on costs and prices.

A good part of the uncertainty we now face may be resolved by developments over the next 3 to 6 months. In the interim, our budgetary policy must be cautious to avoid an inadvertent rekindling of inflationary pressures. And, developments may be such as to require even greater stringency later on.

Productivity Growth



Monetary Policy. The second potential problem with the base economic forecast is the postulated course of monetary policy. We have assumed that the Federal Reserve -- in response to our reduction of fiscal stimulus -- will continue to pursue an accommodative monetary policy over the next few months, and that the current rate of price increase does taper off so that monetary policy is not tightened significantly later on. In the past, the Fed has frequently taken on the role of a tough inflation fighter if it feels that not enough is being done by the Administration to keep prices under satisfactory control, even when the price increases are of a kind -- e.g., food -- which monetary policy affects very little.

Monetary policy is a rather blunt instrument. There is a substantial lag between the tightening of monetary policy and its impact on the economy. While monetary policy itself can be measured out in small parcels -- e.g., a one-eighth to one-fourth percent rise in interest rates -- its effects on the economy are hard to control. A cumulation of small measures may show no impact for some time, and then suddenly begin to bite. If monetary policy tightens much more than we have assumed, the economy will be weaker in 1979 than we are forecasting, and there will be little or nothing we can do about it with budgetary policy.

Pessimistic Economic Forecast

The chances for a considerably tighter monetary policy would increase greatly if inflation accelerates beyond what we have allowed for in the base forecast. We have explored what might happen in this respect by developing an economic forecast in which the underlying inflation rate rises to the 7-7-1/4 percent range, and the Federal Reserve lets the interest rate on Treasury bills move up to around 8 percent by early 1979 (compared with 7-1/4 percent in our base forecast).

The combined effects of more inflation and tighter money would hit the economy hard (Table 4). Confidence of businesses and consumers would be adversely affected, and the continued rise in interest rates would produce a sharp decline -- 20 percent or more -- in housing starts by the end of next year. Real GNP growth in 1979 would drop below 3 percent, signalling a

Table 4

Pessimistic Economic Forecast

Economic Results (Calendar Years)	1978	1979	1980	1981	1982
Real GNP Growth (Q4/Q4, Percent)	4.0	2.7	3.3	4.5	4.2
Unemployment Rate (Q_4, Percent)	5.7 to 6.0	6.0 to 6.3	6.5 to 6.8	6.1 to 6.4	5.9 to 6.[illegible]
Inflation Rate (Q_4/Q_4, Percent)	7.1	7.3	7.1	6.9	6.7
3-Month Treasury Bill Rate (Q_4, Percent)	7-3/4	8	7-1/4	7	7
Budgetary Results (Fiscal Years)					
Budget Deficit (-) or Surplus (+) (billions of $)	-56	-58	-59	-49	-19

growth recession, and in that event the unemployment rate would rise significantly -- to as much as 6-1/2 to 6-3/4 percent by the end of 1980. The increased economic slack would keep the inflation rate from rising still further, and inflation might begin to moderate by 1981 or 1982, but the costs of achieving this result would be extremely high.

The deficit would be adversely affected -- it would still be in the $60 billion range in fiscal 1980.

While the pessimistic forecast is not our best guess, its probability is, unfortunately, too high for comfort. Should developments over the next several months proceed along lines that suggest an increasing likelihood of such an outcome, some further restructuring of monetary and fiscal policies may be needed. An outcome like the pessimistic forecast, or worse, will become nearly inevitable if large union contracts negotiated next year provide for 9 to 10 percent average annual increases in compensation, as did the last such contracts signed in 1976.

Optimistic Economic Forecast

We have also investigated the probable outcome of a more successful effort to obtain deceleration of wages and prices in the private sector. If we were to succeed in getting visible deceleration of both wages and prices beginning this year and continuing into 1979, a momentum would develop that would augur well for bringing inflation down over the longer run. In that event, the Fed would most probably feel able to relax its grip on the monetary reins, so that interest rates would come down substantially. The economic and budgetary results of these assumptions are shown in Table 5. Economic growth is stronger, and the unemployment rate is down in the 4-3/4 to 5 percent range by 1982 -- in a climate of decelerating inflation.

The budget deficit declines more rapidly than in the base forecast, but not dramatically so. However, a large part of the reduced inflation "dividend" is being taken in stronger economic growth. Alternatively, more of the dividend could be taken in the form of better budget performance -- by scaling down, or eliminating, the tax cut assumed for fiscal 1981.

Table 5

Optimistic Economic Forecast

Economic Results (Calendar Years)	1978	1979	1980	1981	1982
Real GNP Growth (Q4/Q4, Percent)	4.0	4.5	4.8	4.2	3.7
Unemployment Rate (Q_4, Percent)	5.7 to 6.0	5.5 to 5.8	5.1 to 5.4	4.8 to 5.1	4.7 to 5.0
Inflation Rate (Q_4/Q_4, Percent)	6.7	5.9	5.7	5.5	5.2
3-Month Treasury Bill Rate (Q_4, Percent)	7-1/4	6-3/4	6-1/4	6	6
Budgetary Results (Fiscal Years)					
Budget Deficit (-) or Surplus (+) (billions of $)	-56	-54	-38	-17	+10

The probability of realizing the optimistic forecast is fairly low, but it is a highly desirable objective at which our anti-inflation program ought to aim.