CHAPTER 2

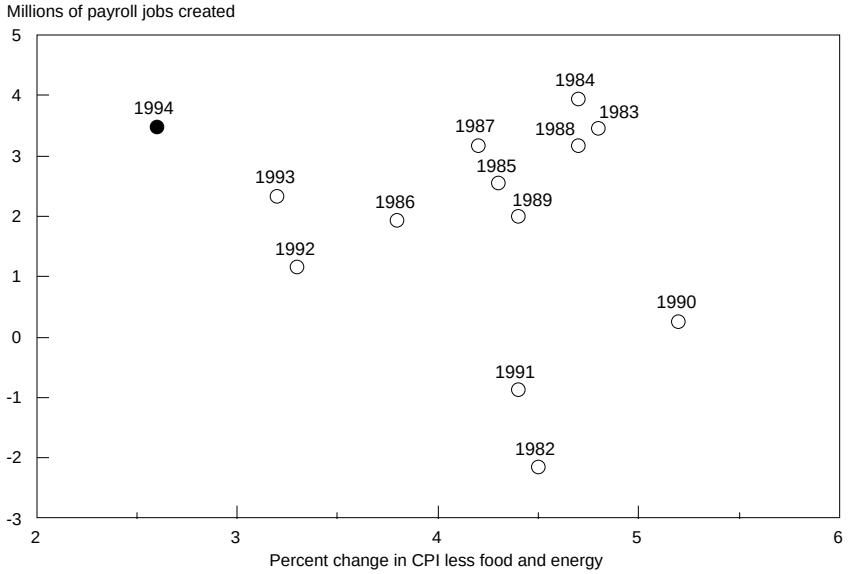
The Macroeconomy in 1994 and Beyond

IN 1994 THE AMERICAN ECONOMY enjoyed a balanced and broad-based expansion, marked by rising real output, declining unemployment, and modest and stable inflation. Over the year, real gross domestic product (GDP) advanced 4.0 percent and real disposable income rose 4.3 percent. Between January and December 1994 the unemployment rate declined 1.3 percentage points, and 3.5 million more payroll jobs existed in December 1994 than in December 1993. The consumer price index (CPI) rose by 2.7 percent, essentially the same rate recorded over the past 3 years. The economy's performance in 1994 was a dramatic improvement over its performance at the beginning of the recovery from the 1990–91 recession, when output growth was fitful and anemic, and over its performance in 1992, when despite a strong gain in output, employment growth remained lackluster. Indeed, the combination of rapid job growth and low inflation gives 1994 one of the best macroeconomic performances on record (Chart 2–1).

Initially, recovery from the 1990–91 recession was hampered by several special factors including large household and business debt burdens, high vacancy rates in commercial real estate, tight credit practices by many lenders, stagnant growth in much of the rest of the world, and declining Federal purchases, especially of military goods and services. As the recovery progressed, all but the last of these impediments diminished in importance, providing a more favorable environment for a pickup in economic growth and job creation. As described in last year's *Report*, the pace of expansion also improved as a result of a substantial decline in long-term interest rates in 1993 that accompanied first the anticipation and then the passage of the Administration's deficit reduction package in August of that year. Lower interest rates strengthened the interest-sensitive components of private spending, which in turn bolstered the rest of the economy.

The expansion of output and jobs that characterized the second half of 1993 persisted and strengthened in 1994, despite a shift toward tighter monetary and fiscal policies. In February 1994 the Federal Reserve began reducing the degree of monetary accommodation, and by the end of the year the resulting increase in interest

Chart 2-1 **Job Creation and Inflation**
Compared with the experience of the 1980s and early 1990s, the economy in 1994 produced a large number of jobs with low inflation.



Note: Data represent changes from December to December.
Source: Department of Labor.

rates was substantial. Continued fiscal restraint was also significant, as evidenced by a decline of $20 billion in the structural budget deficit ($40 billion excluding special factors like deposit insurance) during fiscal 1994. Nevertheless, investment and consumption spending remained strong. High rates of inventory accumulation through most of the year signaled business confidence about future demand for output, as did business investment in equipment and structures, which rose 12.9 percent over the year. Households, too, showed substantial optimism about their income and employment prospects, as purchases of motor vehicles and existing homes as well as residential construction were at high levels despite rising interest rates. Overall, the economy grew at a faster rate than virtually all forecasters had projected at the start of 1994, and it did so despite interest rates that were much higher than forecast at that time.

The performance of inflation in 1994 was equally impressive, with most price measures near forecasts made at the beginning of the year, despite much stronger than expected levels of output and employment. These price developments reflected continued growth above trend in labor productivity and a surprisingly modest increase in hourly compensation. As discussed below, compensation increased less than would have been expected based on historical

experience, indicating possible changes in the dynamics of the labor market.

CLOSING IN ON POTENTIAL OUTPUT

Over the last 2 years the economy has grown at an average annual rate of 3.6 percent, as aggregate demand rebounded from the 1990–91 recession and the sluggish growth that initially followed it. In part the economy's expansion was accomplished through an increase in the quantity and quality of the labor force and through net additions to the capital stock, the latter financed by both domestic saving and foreign borrowing. In part average labor productivity increased as a result of efficiency-enhancing technologies embedded in the capital stock. But to a significant extent, output was able to satisfy the strong growth of aggregate demand in 1994, because workers who had been unemployed were reemployed, and because capital that had been idle or underutilized was brought back on line or utilized more intensively. By the end of 1994, however, both labor and capital utilization rates were in ranges that suggested little remaining slack.

As the margin of underutilized capital and labor reserves diminishes, the economy's growth rate becomes increasingly constrained by the rates of growth of new entrants into the labor force, net additions to the capital stock, and the productivity of labor and capital owing to technological progress and to improvements in the quality of the labor force. Over the long run these factors determine the economy's growth rate of *potential output*. If, in the absence of slack in labor or product markets, growth in aggregate demand outstrips growth of the economy's potential output, pressures to increase wages and prices are likely to mount, increasing the probability of a rise in inflation. In turn, the buildup of wage and price pressures is likely to cause interest rates to rise, dampening aggregate demand growth and bringing it back in line with the growth of potential output.

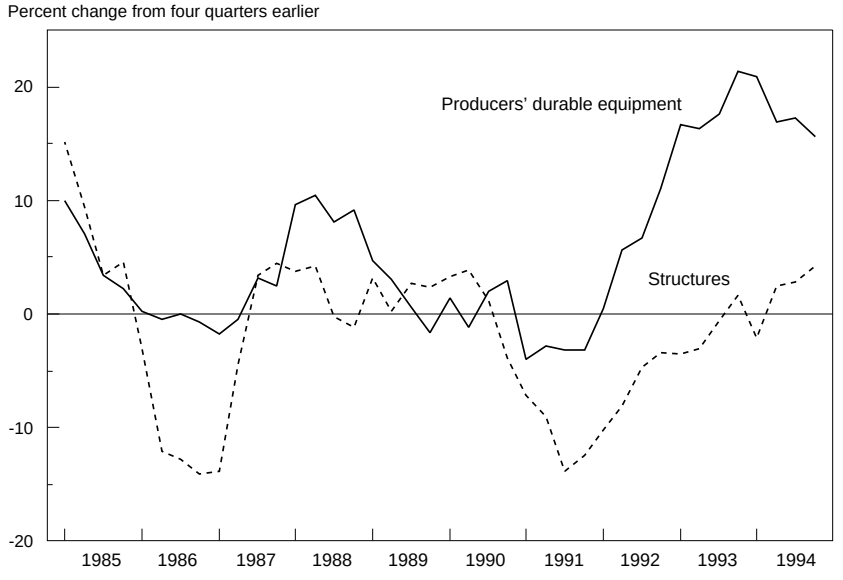
The preponderance of the available empirical evidence suggests that the growth rate of potential output is currently around 2.5 percent. But the economy's strong performance in 1994 has caused some observers to speculate that the growth rate of potential output is now, or soon will be, higher. This hypothesis is examined in Chapter 3, which analyzes the major factors behind the economy's long-run growth potential. The remainder of this chapter analyzes the economy's macroeconomic performance in 1994, a year during which the margins of slack were sharply reduced. This chapter also examines the course of fiscal and monetary policy in 1994, looks at the surprising rise in long-term interest rates, and presents the Administration's economic forecast for the 1995–2000 period.

A sector-by-sector look at economic performance provides a clearer picture of the factors contributing to the continued strong expansion in 1994.

BUSINESS FIXED INVESTMENT

A key factor driving the current expansion has been the rapid growth of business fixed investment, particularly spending on capital equipment (Chart 2–2). Between the trough of the 1990–91 recession and the end of 1994, investment in producers' durable equipment (PDE) increased at an average annual rate of 12.8 percent, while real GDP rose at an annual rate of 3.1 percent. (Table 2–1 summarizes the growth of GDP by component.)

Chart 2-2 **Growth in Real Nonresidential Investment**
Investment in business equipment has surged during the current expansion, but investment in nonresidential structures has just begun to increase.



Source: Department of Commerce.

The extraordinary growth in PDE reflects the strong growth posted by spending on both computers and noncomputer equipment. Since the current expansion began, real investment in computers and peripheral equipment has increased at an average annual rate of 33.9 percent, while real spending on equipment other than computers has increased at an annual rate of about 8 percent. As a share of real GDP, noncomputer investment during 1994 was higher than at any time since separate records were first kept for computer and noncomputer investment spending. Over 1994, PDE

TABLE 2–1.— *GDP Scorecard for 1994*

[Real growth fourth quarter to fourth quarter]

Component	Percent change, except as noted	Comments
Consumer expenditures	3.4	Strong gains in employment as well as in households' willingness to increase levels of indebtedness accounted for broad–based increases in consumer spending.
Producers' durable equipment	15.6	The real success story underlying the strength of the current expansion.
Housing	1.9	Residential investment showed remarkable resilience in the face of rising interest rates throughout 1994, partly due to adjustable–rate mortgages.
Nonresidential structures	4.2	This sector rebounded after a surplus of commercial and industrial real estate led to no growth during the early part of the expansion.
Change in inventory investment [1] (billions of 1987 dollars)	$37.1	A key to maintaining momentum in the economy during 1994.
Federal Government purchases	–6.2	Corporations were not the only organizations downsizing in the current expansion. Federal spending was a net drag on economic growth in 1994.
Exports of goods and services	10.2	A marked increase in exports reflected the pace of economic recoveries abroad.
Imports of goods and services	14.9	Strong consumption and investment demand showed up in imports during 1994. Computers and computer components accounted for much of the runup.

[1] Change between 1993 and 1994 in annual inventory investment.

Note.—Data are preliminary.

Source: Department of Commerce.

spending reflected especially robust investment in cars and trucks, total sales of which to business and households rose to 15 million units.

Whereas *gross* investment in PDE has been on a fairly steady upward trend for most of the postwar period, the trend in *net* investment (that is, net of depreciation) is less pronounced. Because the composition of PDE investment has shifted toward short-lived equipment, such as computers, a growing proportion of gross investment each year represents replacement of existing capital stock rather than a net increase in its overall level. The growing wedge between gross and net real PDE investment is illustrated by the fact that depreciation of PDE, relative to GDP, rose to roughly 6.5 percent in 1994 from about 5.8 percent a decade earlier. Gross investment has beneficial effects on the economy, contributing to income growth and facilitating the introduction of new technologies into the production process. But net investment is even more important to the Nation's economic well-being, because by adding to the amount of capital per worker, it raises labor productivity and the long-run earning potential of workers.

The other major component of business investment is spending on nonresidential structures, including office buildings, shopping malls, and retail stores. During 1994 the shadow cast over this sec-

tor of the economy by overbuilding during the 1980s began to fade, and nonresidential investment in structures increased 4.2 percent. The supply of bank credit for new construction appeared to be plentiful, and increased demand for office and industrial space was reflected in a fall in vacancy rates in some parts of the country. Contract awards for commercial and industrial construction increased during the second half of 1994, and sales prices for office, industrial, and other commercial structures posted solid increases during the year.

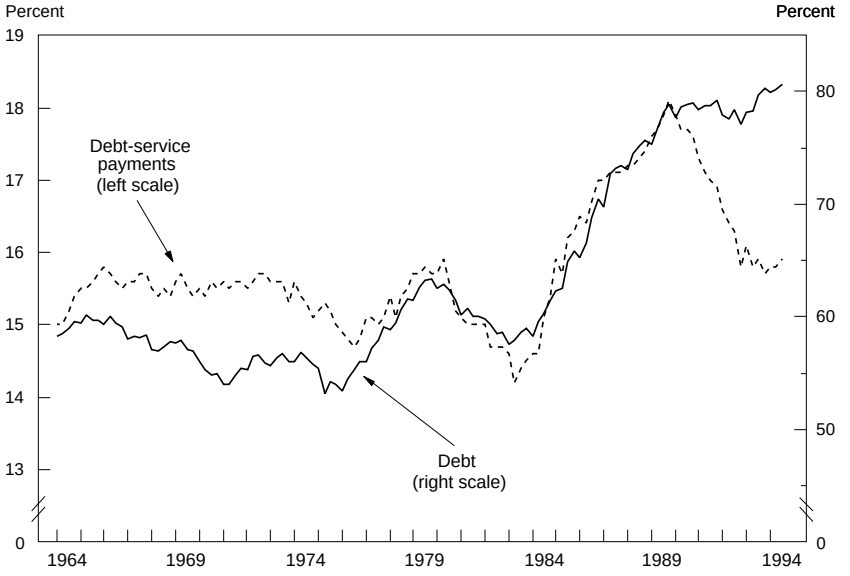
CONSUMER SPENDING

A favorable environment for consumer credit and strong gains in employment contributed to healthy increases in consumer spending and sentiment during 1994. Personal consumption spending advanced at a 3.4-percent pace during the year, led by an 8.1-percent rise in purchases of consumer durables. In turn, durable goods purchases were buoyed by double-digit growth in consumer expenditure on furniture and household equipment, especially video, audio, and computer equipment. Consumer sentiment returned to prerecession levels early in the year and surged to a 5-year high at the end.

Households increased their indebtedness in 1994, as the ratio of debt to disposable personal income reached a record 81 percent (Chart 2–3). Undoubtedly, households were reacting in part to the fact that the cost of borrowing had declined dramatically during 1993 and remained low throughout much of 1994. Growth of consumer credit may also have been spurred by the proliferation of credit card programs that offer rewards to cardholders—such as direct rebates on purchases or frequent-flyer miles—based on amounts charged. Nonetheless, as in 1993, Americans devoted the smallest fraction of their disposable income to scheduled payments on principal and interest since 1984. The decline represented a substantial windfall for debtor households: had the debt-service burden remained at its 1989 peak, the average American household would have paid about $965 more in principal and interest during 1994. The reduction in the debt-service burden, which primarily reflected lower financing costs on mortgages, freed up income, fueling part of the increase in household discretionary spending.

An increase in the personal saving rate occurred toward the end of the year, with the rate rising to 4.6 percent in the fourth quarter from 3.6 percent in the first quarter. In part this rise reflected a likely worsening in the ratio of net worth to income, as household debt burdens rose relative to income, while household assets—such as corporate equity—declined slightly relative to income.

Chart 2-3 **Consumer Debt and Debt-Service Payments**
Despite an increase in the ratio of debt to disposable income, debt-service payments declined relative to income.



Sources: Department of Commerce and Board of Governors of the Federal Reserve System.

INVENTORIES

The sustained pace of inventory accumulation during 1994 was in marked contrast to the early stages of the recovery, when businesses refrained from rebuilding inventories out of concern that the recovery might lose steam. A hefty accumulation of inventory stocks occurred in the second, third, and fourth quarters, particularly in the wholesale and retail trade sectors. Although it is impossible to know with certainty to what extent the accumulation was intended, sales and shipments were also robust, so that there was little evidence of an inventory overhang that would warrant significant production cutbacks over the near term. Instead, the pace of inventory accumulation in the trade sector suggests that business expected continued growth in demand for its production. Inventory accumulation was modest in the manufacturing sector, and movement in the manufacturing inventory-to-sales ratio was dominated by the strong downward trend seen the past several years.

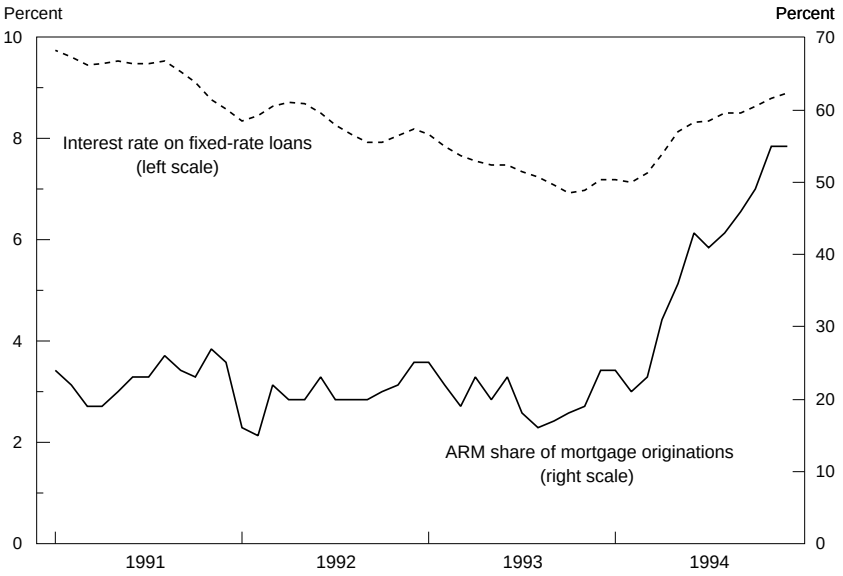
RESIDENTIAL INVESTMENT

Residential fixed investment was buoyed throughout 1994 by growth in incomes and employment. This traditionally interest-sensitive sector of the economy showed remarkable resilience in the face of rising interest rates. Housing starts totaled 1.5 million

units, their highest level since 1988, with single-family home starts posting their highest annual total since 1978. Although a slowdown in residential investment took hold during the second half of the year as real investment dropped at an annual rate of 4.3 percent, average 1994 residential investment was still over 8 percent greater than the average for 1993. Sales of existing single-family homes, at just under 4 million, posted the highest resale total since 1978.

One factor that sustained the strength in housing in 1994 was the increased reliance on adjustable-rate mortgages (ARMs) in financing home purchases. During the summer of 1993 the ARM share of mortgage originations was only about 17 percent—near the historic low for this series. By November 1994, however, more than half of all mortgage originations were ARMs—the highest proportion in more than 5 years. Not only were many ARMs priced with a first-year discount, but they also allowed borrowers to structure their payments in a variety of ways; for example, some ARMs offered fixed rates for the first 7 or 10 years. The pricing of ARMs mitigated the initial cash crunch facing many home buyers and meant that fewer families were priced out of the market as interest rates rose (Chart 2–4).

Chart 2-4 **Fixed-Rate Mortgage Interest Rates and the Share of ARMs**
Over the past year, more home buyers turned to adjustable-rate mortgages (ARMs) as rates on fixed-rate mortgages rose.



Source: Federal Housing Finance Board.

Construction of multifamily units gradually picked up following the overbuilding of the 1980s. The willingness to build new units

was boosted by the increased availability of credit for such construction over the course of the year. During 1994, multifamily housing starts rose by 59 percent relative to 1993.

EMPLOYMENT AND PRODUCTIVITY

The strength of the expansion in 1994 was accompanied by a rapid pace of job creation. According to current estimates the economy generated an average of 290,000 new payroll jobs per month, for a total of 3.5 million jobs, more than 90 percent of which were in the private sector. An early analysis of forthcoming revisions to estimates of payroll employment indicates that the job gains in 1993 and 1994 may prove to have been even stronger. For the 12 months ending in March 1994, the Bureau of Labor Statistics (BLS) estimates that as many as 760,000 additional jobs may have been created. When the revised data are released next summer, it is expected that the job gains since the Administration took office will have exceeded 6 million.

The employment gains of 1994 were spread widely throughout the economy (Table 2–2). Among goods-producing industries, construction employment posted its largest annual gain in a decade, while manufacturing employment recorded its largest increase since 1987. However, almost 85 percent of the advance in payroll employment was concentrated in the services sector, with 20.3 percent originating in the business services category (temporary agencies, building maintenance, and the like) and another 7.3 percent in the health services industry. Employment of Federal workers declined by 46,000.

TABLE 2–2.— *Growth in Nonagricultural Payroll Employment*

Sector	Employment in December 1994 [1] (thousands of persons)	Change since December 1993 [1]	
		Thousands of persons	As percent of total change
Total nonagricultural employment	115,864	3,490	100.0
Goods–producing industries [2]	23,779	553	15.8
Construction	4,956	298	8.5
Manufacturing	18,226	277	7.9
Durable goods	10,419	250	7.2
Services-producing industries [2]	92,085	2,937	84.2
Retail trade	21,297	811	23.2
Business services	6,817	710	20.3
Health services	9,153	256	7.3
Government	19,491	252	7.2
Federal	2,872	–46	–1.3
State and local	16,619	298	8.5

[1] Preliminary.
[2] Includes industries not shown separately.
Note.—Data are not seasonally adjusted.
Source: Department of Labor.

Although job creation has been exceedingly strong during the past 2 years, some analysts have expressed concern about the qual-

ity of the jobs created. In particular, it has been noted that, during the late 1980s and the early part of this decade, job growth in the traditionally high-wage manufacturing sector lagged increasingly behind gains in the relatively low-paying services sector. Less frequently cited, however, is the fact that recent gains in employment, although concentrated in relatively low-wage industries, have at the same time favored high-wage occupations.

For example, according to BLS, managerial and professional occupations represented 26.5 percent of total employment in 1992. In 1993 this share rose to 27.1 percent. Although the data for 1994 are not directly comparable because of the introduction of a new survey of household unemployment, the share of total employment accounted for by managerial and professional occupations last year rose to 27.5 percent. Managerial and professional jobs paid a median wage for full-time employees of $680 per week—some 47 percent above the median wage of all full-time workers.

One characteristic of recent job growth that warrants concern has been the increase in the share of new jobs accounted for by temporary jobs. Employment at so-called help supply services (the best available measure of temporary employment) has accounted for 13.8 percent of all new jobs created during the current expansion. By comparison, over the 1982–90 period, only 4.4 percent of total growth in employment was in the help supply services category.

With the sharp job gains in 1994, the civilian unemployment rate fell by more than 1 percentage point, from 6.7 percent in January to 5.4 percent in December. Despite the fact that the new survey method is likely to have raised the measured unemployment rate, December's rate was the lowest since 1990 (Box 2–1). Nevertheless, over the current expansion, the average duration of unemployment has increased, and the share of unemployed workers reporting permanent job losses has risen.

Not only were more people working in 1994, but they were working longer hours. In the manufacturing sector, employment posted its first annual increase since 1988, and both the factory workweek and manufacturing overtime hours increased to postwar records. Labor productivity in the nonfarm business sector has also been strong: since the trough of the recession in 1991, output per hour in the nonfarm business sector has risen at an annual rate of 2.1 percent, well above most estimates of its long-run trend. Because productivity generally grows at above-trend rates during a cyclical rebound, it would be premature to conclude that there has been an increase in the long-run trend in productivity growth. Chapter 3 provides a more detailed discussion of the factors affecting long-run productivity growth.

Box 2–1.—The Redesign of the Current Population Survey

The Bureau of Labor Statistics' Current Population Survey, a monthly survey of households, is a major source of information about the U.S. labor market. The monthly unemployment rate statistics are based on this survey. In January 1994 a major redesign of the survey was implemented to give a more accurate picture of the work force, taking into account changes in the patterns of employment by industry and changes in the labor force participation of women. BLS currently estimates that the effect of the new survey is to raise the measured aggregate unemployment rate by 0.2 percentage point relative to the old survey.

INCOMES AND PROFITS

The gains in employment during 1994 were reflected in strong aggregate income growth. Real disposable income increased 4.3 percent over the year. Nonetheless, the gain in real compensation per hour remained modest. Hourly compensation, as measured by the employment cost index, increased 3.0 percent, barely outpacing the 2.7-percent increase in CPI inflation.

Based on a statistical relationship between the unemployment rate and the growth rate of hourly compensation, actual growth in compensation (with the compensation measure taken from the national income and product accounts, or NIPA) was lower than would have been expected. The same was true in 1993. Statistical relationships are meant to explain only average historical experience, and their predictions can err substantially on a year-by-year basis. Nevertheless, the shortfall in actual relative to predicted growth in hourly compensation averaged 1.4 percent in the 2 years—a shortfall that by its size and persistence could suggest some substantial changes in the dynamic behavior of the labor market.

The increase in corporate profits in 1994 was impressive. Although the January 1994 earthquake in Northridge, California, depressed profits (so that first-quarter profits fell by 18 percent at an annual rate), they rebounded quickly. Despite the earthquake-related drop, corporate profits increased at an annual rate of 5.6 percent over the first three quarters of 1994.

INFLATION

Some observers expressed concerns during 1994 that the strong gains in employment would translate into upward pressure on labor costs and prices by the end of the year. Indeed, the prices of some highly visible commodities, including coffee, cotton, and basic

metals, did rise by significant amounts during the year. In addition, surveys of industrial prices by the National Association of Purchasing Managers and the Federal Reserve Bank of Philadelphia indicated that prices in the industrial sector were accelerating. Although increases in commodity prices, particularly among industrial goods, made for some disturbing headlines, rising commodity prices are a normal phenomenon during a cyclical rebound in the economy and do not typically lead to a noticeable increase in broader measures of inflation. However, with capacity tight in many industries, there was concern that commodity price increases would spill over into increases in other goods. Moreover, for the first time in 4 years, import prices began edging up more rapidly than overall inflation.

Despite the episodes of price acceleration for some commodities, and despite real GDP growth that sharply reduced slack in labor and capital markets, broad measures of inflation remained stable throughout the year (Table 2–3). Inflation ended the year about in line with the consensus forecast made at the beginning of the year. Core CPI and PPI inflation rates (measures that exclude volatile food and energy components) were lower during the second half of 1994 than during the first half of the year. Core CPI inflation was just 2.6 percent last year—the lowest rate since 1965 (Chart 2–5). (Box 2–2 Contains a discussion of problems in the CPI as a measure of changes in the cost of living.) A major source of the restraint in inflation was modest growth in employee compensation accompanied by strong growth in labor productivity.

REGIONAL DEVELOPMENTS

The ongoing effects of the national economic expansion were felt in all major regions of the country during 1994. Although the pace of the expansion was uneven across the country, all major regions (that is, all nine Census divisions) enjoyed stable employment or outright employment growth, steady or declining unemployment rates, and real growth in income and retail sales.

In 1994 the Midwest and South continued along the moderate-to-strong growth path established over the preceding 2 years, with payroll employment rising 2 to 3 percent, unemployment rates falling steadily, and income rising more than 6 percent. In the Northern Plains States the unemployment rate fell below 4 percent—its lowest level in 15 years. Parts of the Northeast also grew strongly. In New England, employment rose nearly 2 percent in 1994, and the unemployment rate dropped to below the national average. The Middle Atlantic region displayed somewhat weaker growth but nevertheless generated increased employment, with the region's unemployment rate falling to 5.4 percent in December (Chart 2–6).

TABLE 2–3.— *Measures of Inflation*

Measure	1993	1994	1994 IV (annual rate)
	Percent change		
GDP fixed–weight price index	2.8	[1] 2.9	[1] 2.6
Non-oil import prices	1.5	3.9	4.6
CPI–U:			
All items	2.7	2.7	2.2
All items less food and energy	3.2	2.6	2.0
Medical care	5.4	4.9	6.1
PPI:			
Finished goods	.2	1.7	1.0
Finished goods less food and energy	.4	1.6	–.6
Intermediate materials less food and energy	1.6	5.1	9.0
Crude materials	.1	–1.1	2.8
Employment cost index: [2]			
Total compensation	3.5	3.0	2.6
Wages and salaries	3.1	2.8	2.4
Benefits	4.6	3.4	2.8

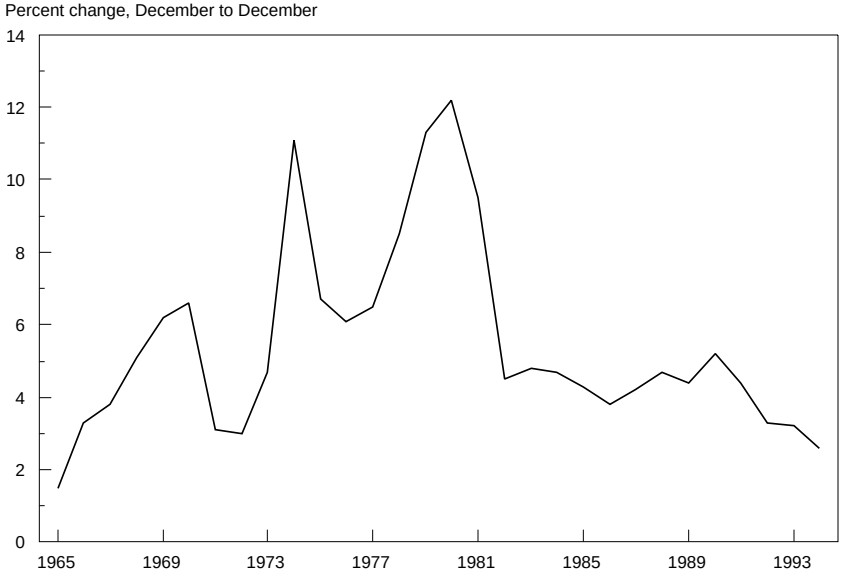
[1] Preliminary.

[2] For civilian workers.

Note.—Inflation as measured by the GDP price index is computed from fourth-quarter to fourth-quarter for 1993 and 1994, and from 1994 III to 1994 IV. All other measures are calculated from December to December for 1993 and 1994, and from September to December for 1994 IV.

Sources: Department of Commerce and Department of Labor.

Chart 2-5 **Consumer Prices Less Food and Energy**
In 1994 consumer prices less food and energy increased at the lowest annual rate since 1965.



Source: Department of Labor.

Box 2-2.—Problems in Measuring Cost-of-Living Increases

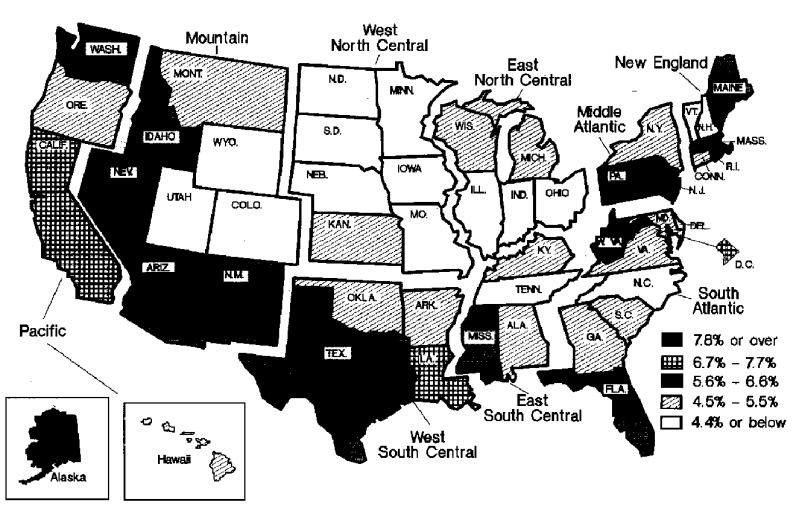
It is impossible in practice to calculate an index number that accurately reflects changes in the cost of living for American families, because no two families are alike and because the quality and the availability of goods and services change. Private companies and public policymakers, needing an objective measure of consumer inflation but aware of the limitations to which all are subject, have used what is widely regarded as the best available index, the consumer price index (CPI).

Researchers at the Bureau of Labor Statistics, which prepares the CPI, have identified several problems with the index, and the agency has moved, where possible, to address them. The most important technical problems remaining are *substitution bias* and the treatment of *quality changes and new products*. The net effect of these and other problems is probably to make the CPI overstate actual cost-of-living increases, but this is controversial and estimates vary widely.

Substitution bias arises because consumers regularly shift the composition of their purchases, substituting goods that have become relatively cheaper for goods that have become relatively more expensive. The CPI, which measures the price changes of a mostly fixed basket of goods, fails to capture such shifts. This is inherent in the nature of the CPI, which was designed originally to measure the average price increase for a fixed basket of goods and services, not to capture changing consumption patterns. Whenever the market basket used to calculate the CPI is updated (usually every 10 years), substitution bias is mitigated, only to worsen again over time as consumer choices diverge from the new market basket. More frequent changes in the market basket would reduce the bias but would require additional resources as well as research to determine how frequently the updates should occur.

The quality of the goods and services purchased by consumers also changes over time. In principle, a change in price that reflects a change in quality is not a change in the cost of living. The CPI cannot, however, adjust the prices of all the products in its market basket for changes in their quality: it is simply impossible to measure the extent of ongoing quality changes in the myriad products consumers purchase. Experts disagree about how well the CPI in practice has accounted for quality changes and how this accounting might best be improved.

Chart 2-6 **Unemployment Rates by State, December 1994**
Though gains in employment were spread widely across the Nation during 1994, state unemployment rates still vary greatly.



Source: Department of Labor.

The West was a region of sharp contrasts. The Rocky Mountain region was the star performer of 1994. Payroll employment rose more than 4 percent and personal income jumped more than 8 percent. Similarly, the Mountain region led the Nation in retail sales growth. Although the unemployment rate fell less sharply there than in other regions in 1994, by September the rate was less than 5 percent.

In contrast, the Pacific region's performance continued to lag well behind its strong growth of the 1980s, largely reflecting the subpar performance of California. Payroll employment growth in the Pacific region, although positive, trailed that of other regions; even by the end of the year the level of employment had not yet regained its prerecession peak. California's unemployment rate remained far above the national average throughout the year, and the pace of job creation there was much slower than in the rest of the country.

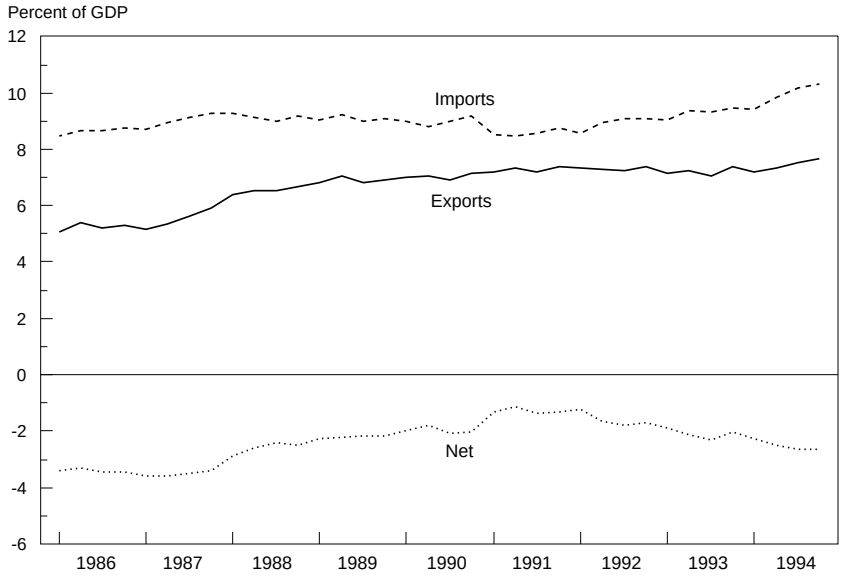
Much of the softness of the California economy reflected weakness in the southern part of the State. The loss of jobs associated with defense downsizing and the collapse of the Los Angeles area real estate market over the past few years has been well documented. Although the number of jobs in the aerospace industry continued to decline, there is now evidence that other sectors of Southern California's economy are picking up and that the real es-

tate market has finally stabilized. Moreover, California should benefit from the growth in incomes elsewhere in the Nation as it translates into increasing orders for California producers who "export" their goods and services to the rest of the country.

INTERNATIONAL DEVELOPMENTS

During 1994, America's merchandise trade deficit (the excess of merchandise imports over exports) increased to 2.7 percent of GDP, reaching a total deficit of $169 billion (Chart 2–7). More rapid growth at home than in the rest of the world was a major factor responsible for the deterioration in the Nation's external position.

Chart 2-7 **Merchandise Exports and Imports**
Since 1991 the deficit on merchandise trade has been widening.



Note: Trade data are on a balance-of-payments basis.
Sources: Council of Economic Advisers and Department of Commerce.

Real exports of goods and services expanded briskly, rising 10.2 percent in 1994, and the United States maintained its position as the world's largest exporter. The strengthening recovery in foreign industrial countries, continued robust growth in developing countries, the decline in the dollar's exchange value, the implementation of the North American Free Trade Agreement, and the ongoing improvement in America's underlying competitiveness all helped to boost export sales to record highs. But the rise in exports was outstripped by the increase in imports that accompanied strong domestic investment and consumption demand. The performance of the trade deficit in 1994 was consistent with estimates indicating

that, for the United States, the response of imports to a change in domestic income is generally greater than the response of exports to a similar change in foreign income.

America as an International Debtor

The United States remains critically dependent on foreign capital inflows to finance its sizable external deficit. Since the early 1980s, when America's claims on foreigners exceeded foreigners' claims on the United States, persistent current account deficits and the counterpart foreign acquisition of U.S. assets have led to a buildup of U.S. international indebtedness. By the late 1980s the value of U.S. assets owned by foreigners was larger than the value of foreign assets owned by American residents, and the gap has continued to grow since then (Table 2–4). Total net U.S. international debt exceeded $500 billion in 1993; the figure is $556 billion if direct investment holdings are valued at current cost, and $508 billion if those holdings are evaluated at market value. As a share of nominal income, the burden of net international debt has risen to between 8 and 9 percent of GDP. Regardless of whether it is measured in billions of dollars or as a share of income, however, the debt owed to foreigners remains high.

TABLE 2–4.— *U.S. Net International Investment Position*

End of year	Billions of dollars		Percent of GDP	
	At current cost	At market value	At current cost	At market value
1982	379	265	11.9	8.3
1987	–23	58	–.5	1.2
1990	–251	–224	–4.5	–4.0
1993	–556	–508	–8.6	–7.8

Source: Department of Commerce.

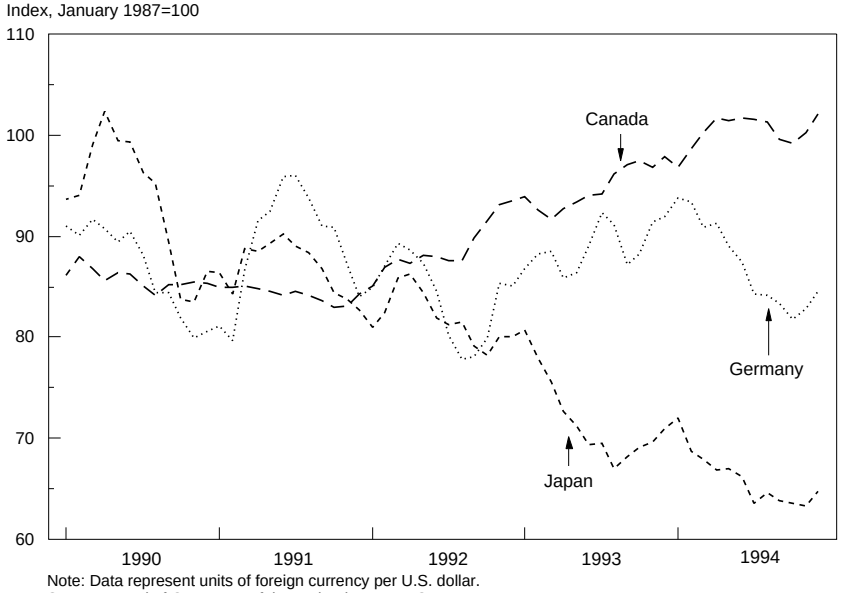
Yet despite its position as an international debtor, the United States until very recently registered a positive balance on net investment income. Higher rates of return on U.S. holdings abroad than on foreign holdings of U.S. assets reflected in part low rates of return on foreign holdings, most notably on investments in real estate. During 1993, however, the balance on investment income switched from positive to negative. Net investment payments now add to our current account deficit, increasing our financing needs and our dependence on foreign capital. Without a sizable reduction in the net debt owed to foreigners, either through an increase in U.S. holdings of foreign assets or through a reduction in U.S. liabilities to foreigners, net investment income payments are likely to remain in deficit through the end of the decade and beyond. Over time, net investment income payments to foreigners will constitute a larger and larger share of our current account position.

Exchange Rates

The value of the dollar declined about 8 percent last year when measured on a trade-weighted basis against the currencies of the nine major foreign industrial countries. However, the nominal value of the trade-weighted dollar has been broadly trendless since early 1987, following the Louvre Accord among the six major industrialized countries to stabilize exchange rates.

The dollar moved more substantially against some individual currencies than is reflected in the weighted-average rate (Chart 2–8). Between the end of 1993 and July 1994, the dollar declined some 12 percent against the Japanese yen, bringing the cumulative decline vis-a-vis the yen since the end of 1992 to 21 percent. After midsummer the dollar's value in terms of the yen was more stable, and the dollar ended the year trading at 99.6 yen. Movements in the dollar-yen rate reflected to some extent trade tensions between Japan and the United States (see Chapter 6). In addition, the rising current account deficit in the United States and surplus in Japan may have increased downward pressure on the dollar and upward pressure on the yen. Although both the American and the Japanese current account imbalances have been rising in recent years, external imbalance is not new for either country; thus it remains a question how much this factor influenced the behavior of financial markets in 1994.

Chart 2-8 **Measures of the Dollar's Value**
The dollar fell against the currencies of Japan and Germany in 1994 but appreciated against the Canadian dollar.



Note: Data represent units of foreign currency per U.S. dollar.
Source: Board of Governors of the Federal Reserve System.

The dollar also weakened significantly against some European currencies, most notably vis-a-vis the German mark and the currencies that are closely tied to it through the European Exchange Rate Mechanism, such as the French franc, the Belgian franc, and the Dutch guilder. Over the course of the year the dollar fell 11 percent against the mark. At the beginning of 1994 market participants expected some rise in the dollar's value relative to the mark, as monetary policy in the United States was widely expected to grow tighter and that in Germany to become easier over the year. The strength of the German recovery relative to expectations may have accounted for some of the appreciation of the mark against the dollar.

Against the currency of our largest export market—the Canadian dollar—the U.S. dollar appreciated 5 percent last year. Since mid-1991 the Canadian dollar has lost 19 percent of its value relative to the U.S. dollar. Major contributors to the slide in the Canadian dollar have been rising government debt and political uncertainty: the ratio of Canadian Government debt to GDP hit 95 percent in 1994 (up from less than 70 percent in 1989), and the increasing strength of the Quebec separatist movement has gained widespread attention.

At the end of 1994 the Mexican peso declined sharply—by some 31 percent—vis-a-vis the U.S. dollar. Details of the peso's fall and efforts by the Administration to address Mexico's resulting liquidity crisis are discussed in Chapter 6.

Other factors are likely to have influenced the overall depreciation of the dollar as well. First, the perception by at least some market participants that the Federal Reserve was slow to tighten the stance of monetary policy may have led investors to sell dollar assets. In addition, the widely discussed move by institutional investors out of dollar assets and into emerging-market funds in order to diversify portfolios no doubt contributed to the dollar's weakness.

FISCAL POLICY IN 1994 AND BEYOND

As noted in Chapter 1, the Administration's 1994–98 budget package, embodied in the Omnibus Budget Reconciliation Act of 1993 (OBRA93), resulted in a dramatic reduction in the Federal deficit in 1994 and markedly improved the deficit outlook for the remainder of this decade. The fiscal 1994 deficit was $52 billion lower than the fiscal 1993 deficit, and $72 billion lower if special factors, such as net receipts from sales of assets acquired from failed savings and loans, are excluded. Over the entire 1994–98 period, the Administration estimates that accumulated deficits will fall by some $616 billion relative to the pre-OBRA93 baseline—

roughly $500 billion from OBRA93's spending cuts and revenue increases, and the remainder from technical revisions as well as improved economic conditions, the latter in part due to the budget package. The Administration's 1996 budget package preserves OBRA93's deficit reduction measures and adds another $81 billion in budgetary savings through 2000, even as it provides full funding for the Administration's proposed middle-class tax cuts, which will total $63 billion between 1996 and 2000.

As a result of the Administration's deficit reduction measures, along with projected slowdowns in medicare and medicaid spending, the Federal deficit will continue to decline as a share of GDP, averaging about 2.5 percent during the 1994-2000 period, nearly 2 percentage points less than the 4.4-percent average for the 1982–93 period.

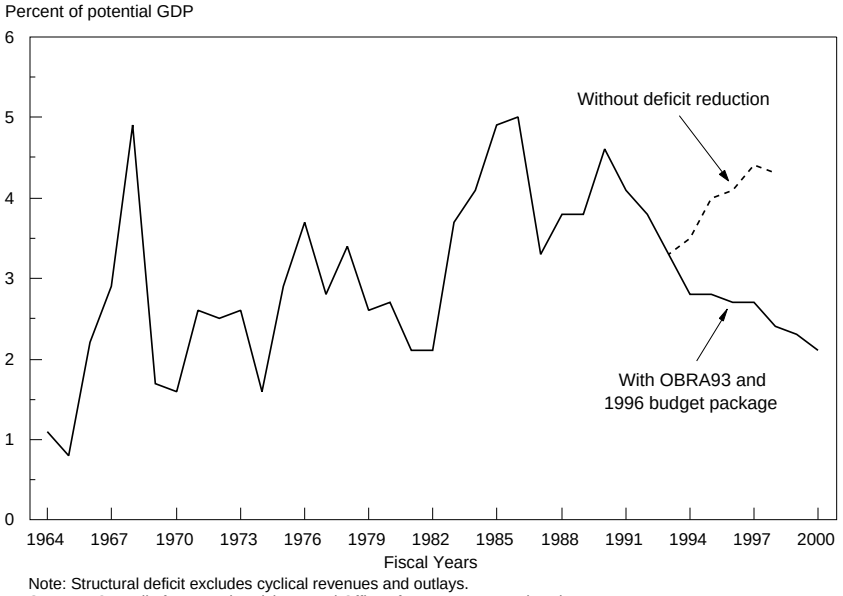
Because the size of the budget deficit depends not just on policy decisions but also on the state of the economy, economists prefer to use the so-called structural or cyclically corrected deficit to assess the stance and direction of fiscal policy. The structural deficit, defined as the deficit that would result if the economy were operating at or near its potential output level, is designed to capture the effects of policy and exclude the effects of the business cycle on the size of the deficit.

Chart 2–9 shows the Administration's estimates of the structural deficit relative to the economy's potential output. The chart reveals that this ratio rose dramatically during the 1980s, reaching a peak of 5 percent in 1986 and averaging 3.9 percent between 1982 and 1993. Between 1993 and 1994 the stance of fiscal policy became contractionary in response to OBRA93's implementation, and this ratio fell from 3.3 percent to 2.8 percent. The decline in the ratio of the structural deficit to potential GDP is even more impressive when special factors such as deposit insurance are excluded: from 3.7 percent in 1993 to 2.9 percent in 1994. Moreover, based on the Administration's current economic forecast, projected slowdowns in the growth of medicare and medicaid spending, and the Administration's deficit reduction policies, the structural deficit is projected to decline throughout the remainder of the decade as a share of potential GDP and to average 2.5 percent for the entire 1994–2000 period.

THE BUDGET OUTLOOK OVER THE LONGER RUN

Current long-run projections suggest that if the Administration's current policy proposals are enacted and the anticipated slowdowns in medicare and medicaid spending persist, the improvement in the deficit should be preserved for at least the next 10 years. Beyond 2000 the deficit is anticipated to remain roughly constant. Relative to GDP, however, the deficit is likely to continue its gradual de-

Chart 2-9 **Structural Budget Deficits**
Policy changes enacted in 1993 arrested the upward trend of the deficit, and the President's proposed budget for fiscal 1996 will achieve even more deficit reduction.



Note: Structural deficit excludes cyclical revenues and outlays.
Sources: Council of Economic Advisers and Office of Management and Budget.

cline, falling below 2 percent early in the next century. Over the longer run, changing demographics will put upward pressure on the deficit as the baby-boom generation, born during the first two decades after World War II, begins to retire. The aging of the population will contribute to rising expenditures for both Social Security and Federal medical programs, because medicare is primarily a program for those over the age of 65, and medicaid is increasingly a program for elderly people needing nursing home care.

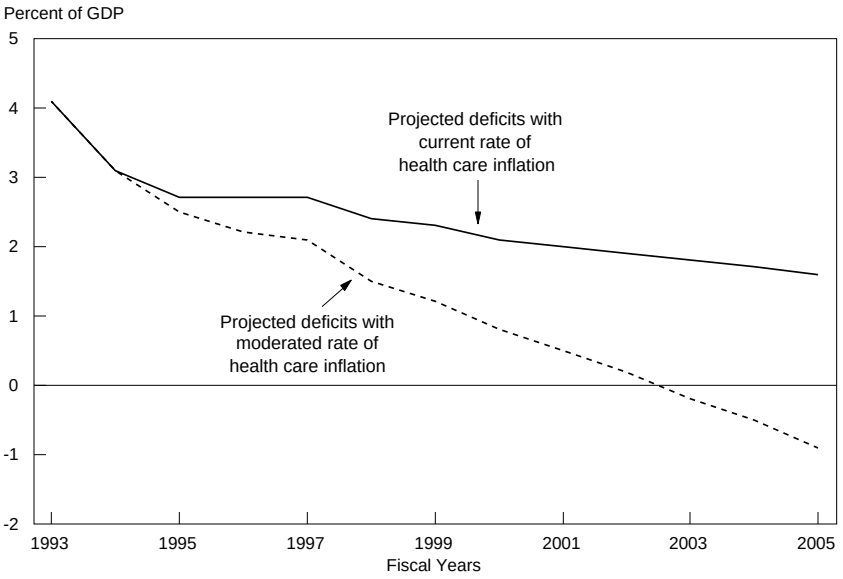
During the 1996–2000 period, spending for both medicare and medicaid is projected to increase at a slower rate than in recent years. This projected slowdown is the result of several factors including lower projected medical cost inflation, slower projected growth of the medicaid beneficiary population, and increased scrutiny of State claims for certain Federal medicaid matching payments. Despite these changes, however, the projected growth rates for both medicare and medicaid remain very high. Medicare benefits are projected to grow at an average annual rate of 9.1 percent, and medicaid benefits at an average annual rate of 9.3 percent. Both of these growth rates are nearly three times the projected general inflation rate of 3.2 percent, and at these rates both medicare and medicaid spending will double every 8 years. As a result, by 2000 spending on these programs will account for one-fifth of total Federal outlays, rising from 3.4 percent of GDP in fiscal 1994

to 4.1 percent by 2000. By 2005 these health care programs will amount to 4.9 percent of GDP.

The number of people participating in the Federal health programs is expected to increase as the medicaid population grows at an anticipated 3.8-percent annual rate on average between now and 2000. However, this expansion makes up a relatively small part of the increase in total Federal spending for medicare and medicaid—it could be accommodated without undue pressure on the deficit. The main reason why the fiscal impact of these programs is such a problem is that health care spending per beneficiary keeps rising faster than inflation—indeed faster than inflation plus the general increase in real per capita GDP.

Chart 2–10 illustrates the impact of rising medicaid and medicare spending on the deficit. If spending on these programs grew at the rate of increase of the beneficiary population, but spending per beneficiary rose in line with per capita nominal GDP, the Federal budget would be balanced by the year 2003. Obviously it is unrealistic to anticipate such a sharp change in health care spending trends given the long history of rapid growth, but this fact helps pinpoint the real problem behind the continuing large Federal deficit and confirms the need for genuine health care reform.

Chart 2-10 **Health Care Inflation and the Federal Deficit**
If per beneficiary costs of medicare and medicaid rose only at the rate of growth of nominal per capita output, the Federal deficit would vanish by the year 2003.



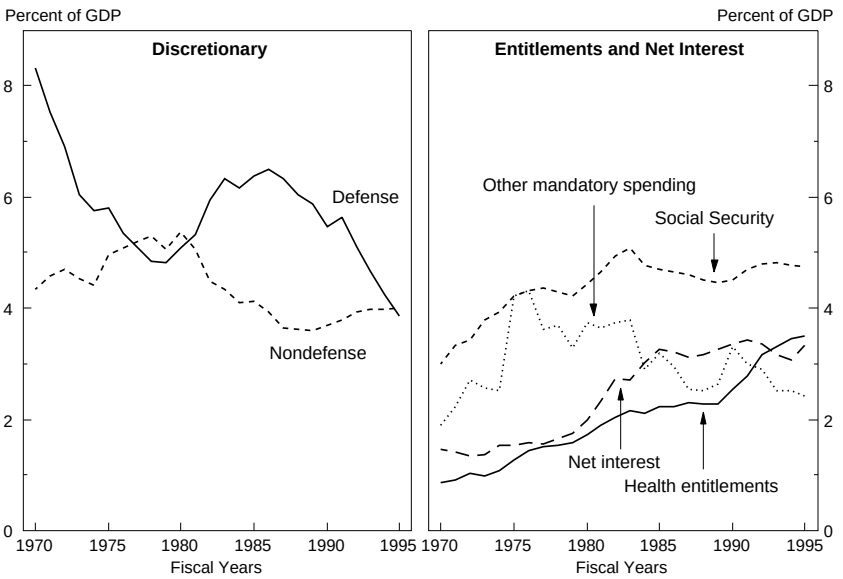
Source: Office of Management and Budget.

As noted in Chapter 1, the Administration remains committed to such reform, to provide health security to all Americans and contain health care costs for families, businesses, and Federal, State, and local governments. Because of the linkages and interactions between public health care programs and the private health care market, attempts to stem the growth of Federal programs by such mechanisms as spending caps will not solve the underlying problem of costs. Instead, the imposition of caps will shift costs to the private sector and threaten the availability and quality of services for the medicare and medicaid populations.

THE CHANGING COMPOSITION OF FEDERAL SPENDING

One of the underappreciated aspects of fiscal policy is the change in fiscal spending priorities that has emerged during the last three decades. Chart 2–11 presents the major categories of Federal spending over this period. The chart indicates that—contrary to conventional belief—the long-run growth of nondefense discretionary spending has been considerably slower than GDP growth for much of this period, and the ratio of nondefense discretionary spending to GDP is projected to remain well below the peak realized in 1980.

Chart 2-11 **Composition of Federal Spending**
Relative to GDP, discretionary spending has fallen during the past two decades, while entitlement spending and interest on the debt have grown.



Source: Office of Management and Budget.

To some extent, the diminishing claim on economic output of nondefense discretionary spending reflects competition between defense and nondefense spending. But to a larger extent the contraction of nondefense discretionary spending relative to GDP reflects the pressure on the budget of rapid growth in both net interest payments on the debt and entitlement spending. Over the early 1980s the buildup in Federal debt was particularly large. As a result, 1994 interest payments on the debt constituted 3.1 percent of GDP, compared with an average of 1.6 percent between 1970 and 1981.

The most dramatic feature in the changing expenditure mix is the growth of spending on entitlement programs, especially health care programs. Federal health care spending grew from an average of 1.3 percent of GDP over the 1970–81 period to close to 3.4 percent of GDP by 1993–94. Between 1970 and 1994, average annual growth in health care spending was about 1¾ times average annual growth in nominal GDP.

Chart 2–12 provides detail on the projected composition of Federal spending for fiscal 1995. The four largest components of Federal spending are Social Security, national defense, interest on the debt, and medicare, in that order. Together these categories account for about 65 percent of total Federal spending. Expenditures for medicare, the smallest of these four components, are over five times spending on food stamps, over eight times spending on international affairs, and over nine times spending on aid to families with dependent children.

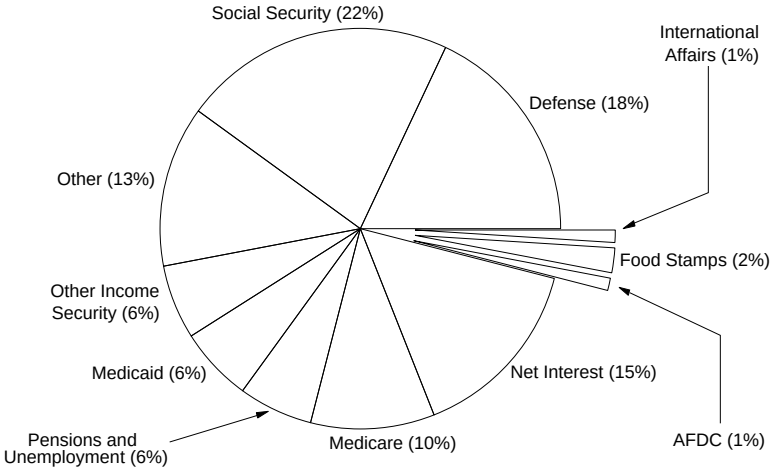
PRINCIPLES FOR EVALUATING ALTERNATE TAX PROPOSALS

As already noted and described in Chapter 1, the Administration's 1996 budget proposal contains a package of tax cuts for middle-class Americans. These include a child-based tax credit, a tax deduction for postsecondary education and training expenses, and expanded availability of individual retirement accounts (IRAs). These initiatives are paid for primarily by discretionary spending cuts.

In its assessment of various tax proposals that are likely to be considered by the Congress during the coming year, the Administration will rely on four basic principles:

- Do the proposed changes in tax policy enhance long-run economic growth?
- Are they consistent with norms of economic efficiency?
- Are they fair?
- Are they fiscally responsible?

Chart 2-12 **Federal Outlays by Function, Fiscal 1995**
Social Security, defense, medicare, and net interest on the debt comprise 65 percent of Federal spending, dwarfing outlays on international affairs and social insurance programs.



Note: AFDC is aid to families with dependent children.
Source: Office of Management and Budget.

Although each of these principles is important in its own right, any set of tax proposals should be evaluated in terms of how it measures up against all four.

The first of these principles focuses on the incentive properties of tax measures and takes a long-run view of their likely results. The Administration's proposed tax deduction for postsecondary education and training expenses, for example, is designed to strengthen individual incentives to invest in these activities, both of which have been demonstrated to offer good rates of return on average. Similarly, the Administration's proposed IRA expansion is intended to focus more attention on household saving. The goal of these tax proposals is to increase the economy's aggregate amounts of human and physical capital, thereby increasing incomes in the long run.

The second principle concentrates on economic efficiency by examining the distortions that proposed taxes might create in basic economic choices. In the early 1980s, for example, changes in tax policy produced a proliferation of tax shelter activity, with adverse consequences for both investors and the tax system. Another example of a proposal that is deeply flawed from an efficiency point of view is the "neutral cost recovery system" proposed in the House Republican Contract with America. This system offers, for certain types of assets, depreciation allowances that are indexed for infla-

tion and then increased by a factor of 3.5 percent per year. However, it does not index debt, so that businesses can deduct all of their interest expense rather than only that portion associated with the real interest rate. Thus it effectively shields businesses from taxation on many of their investments while permitting them to deduct fully the costs of debt to finance those investments. This would create a large economic distortion in investment choices both because it would result in a negative income tax on a significant fraction of total business investment and because it would treat different types of capital differently.

The third principle for evaluating tax proposals is fairness, an important dimension of which is vertical equity, or the distribution of the tax burden among families at different income levels. As noted earlier, about 87 percent of the benefits of the Administration's proposed tax cuts would go to families with annual incomes under $100,000. In contrast, according to analyses by the Treasury Department, about 50 percent of the benefits of the tax cuts proposed in the Republican Contract would go to families with annual incomes over $100,000—only 10 percent of all American families. The overall effect of the Contract's tax package would be to reduce substantially the progressivity of the Federal tax system. A second important dimension of fairness is horizontal equity—that is, providing similar treatment to taxpayers in similar economic situations. By further increasing the gap between the tax burdens on labor income and capital income, the capital gains rate reductions proposed in the Republican Contract fall short on this score as well.

Finally, whether a proposed tax reduction is desirable economic policy depends on whether it provides social benefits greater than its revenue cost. As already noted, the revenue losses resulting from the Administration's tax proposal are fully offset by specific spending cuts, allowing continued progress on deficit reduction through the end of the decade. Specific revenue offsets have not been offered for the substantial costs of the tax proposals in the Republican Contract; those costs have been estimated by the Treasury Department at $205 billion between fiscal 1995 and fiscal 2000, and $725 billion between fiscal 1995 and fiscal 2005.

Moreover, the Administration uses conventional accounting methods to "score" the impact of its tax proposals. In contrast, some members of the Congress have proposed using so-called dynamic scoring methods to evaluate the budgetary impact of their proposed tax reductions. For the reasons noted in Box 2–3, although such methods sound reasonable in theory, in practice they would pose grave risks, because they could easily be used to rationalize tax reductions that would sharply increase the deficit over time.

Box 2-3.—Scoring the Revenue Consequences of Tax and Expenditure Changes

Current "static" budgeting techniques recognize and incorporate many kinds of behavioral responses to proposed changes in government policies. For example, if an increase in the tax on gasoline is being considered, budget analysts will estimate the likely reduction in gasoline purchases and adjust their revenue estimates. But current techniques also assume that these behavioral responses are not large enough to significantly affect the level of total output or its growth rate within the 5-year budget window.

Nearly all economists would agree that in principle policymakers should consider the effects of policy changes on the aggregate economy. But the consensus quickly falls apart when it comes to the details of how such "dynamic" scoring should be conducted. The lack of consensus reflects the fact that models of the macroeconomy are very complex, embodying myriad assumptions about the behavior of individuals and businesses. Even small differences in these assumptions can lead to different conclusions.

For example, different assumptions about the sensitivity of labor supply decisions to changes in income tax rates, and about the sensitivity of saving to changes in the after-tax rate of return, can lead to very different conclusions about the extent of revenue loss resulting from a reduction in the income tax rate or the capital gains tax rate. Unfortunately, existing empirical techniques make it impossible to determine which estimates are the best predictions of behavioral responses to tax rate changes with the degree of precision necessary for reliable dynamic analysis.

Although static scoring techniques rest on simplifying assumptions, budget decisions involving tens of billions of dollars are too important to leave to dynamic scoring techniques which are fraught with uncertainties and easily manipulated. It is not hard to imagine how dynamic scoring techniques could be used to justify generous tax cuts on the grounds that they would pay for themselves, when it is all too likely that they would cause a large increase in the deficit.

The Debate over Further Reduction in the Capital Gains Tax Rate

One of the fiscal initiatives that is likely to be proposed and debated during the coming fiscal year is a further reduction in the tax rate on capital gains. Under current law, capital gains income

already receives a tax preference relative to other forms of income. This preference arises from several provisions. First, the statutory rate on capital gains is capped at 28 percent, compared with a 39.6-percent marginal rate on other forms of income for upper income households. Second, capital gains are taxed only when an asset is sold, not as the gain accrues. Third, the tax liability against an appreciated asset is forgiven when the owner of the asset dies. Fourth, the tax liability on the sale of a principal residence is deferred provided the seller purchases another house at least as expensive within 2 years. Finally, taxation on up to $125,000 of the capital gain on the sale of a principal residence is forgiven if the owner is over the age of 55 (this exclusion may be taken only once in a taxpayer's lifetime). OBRA93 further expanded the tax preference for capital gains by exempting from tax one-half of all capital gains generated by equity investments held for at least 5 years in certain small businesses.

Arguments in favor of yet more generous treatment of capital gains are based largely on claims that a cut in the tax rate would spur saving and investment and would raise, rather than lower, government tax revenues, especially capital gains tax receipts. Although a reduction in capital gains tax rates would increase the after-tax rate of return on savings (for a given before-tax rate of return), the preponderance of the available empirical evidence suggests that private saving is not likely to increase much in response. Indeed, private saving (both from domestic sources and from an inflow of foreign capital) has historically been fairly insensitive to changes in the rate of return. In addition, as discussed below, government revenues from capital gains are likely to fall with a cut in the tax rate, unless there are feedback effects on the growth of the economy (for instance from channeling more, or redirecting existing, resources into new ventures) that are implausibly large. If total saving—the sum of private saving and government saving—did not increase, neither investment spending nor aggregate output would increase.

Can lower capital gains tax rates raise capital gains revenues even if they do not induce an increase in the economy's growth rate? In the short run, revenues could increase as lower tax rates caused asset holders to accelerate the sale of their assets. Especially if the tax cut is thought to be temporary, the incentive could be strong to realize the gain and pay the tax sooner rather than later. But such a shift in the timing of the tax would probably mean a reduction in total capital gains taxes paid on a given asset over the long run. Indeed, the acceleration in payment would occur precisely because asset owners view this as a tax-minimizing strategy.

In the long run, without an induced increase in economic growth, a cut in the capital gains tax rate could raise capital gains revenues only under the following circumstances. First, an increase in the differential between the tax rate on capital gains income and that on ordinary income might lead taxpayers to transform ordinary income into tax-preferred capital gains income, hence generating more capital gains revenue. Of course, aggregate income taxes inclusive of capital gains taxes would fall. Second, a reduction in the capital gains tax rate could induce a shift in investors' portfolios away from tax-exempt bonds or even housing into assets subject to capital gains taxes. Third, and most important, a reduction in the tax rate could encourage a decrease in the value of assets that are held until death in order to escape taxation. Whether the increase in the realization of capital gains that would otherwise escape taxation would be large enough to offset the decline in tax revenues from assets whose gains are generally taxed is an empirical question.

Although studies have found a wide range of responses, recent research suggests that capital gains realizations would rise over the long haul if tax rates were reduced, but not by enough to keep capital gains revenues from falling. In any case, eliminating the capital gains tax preference given to inherited assets is a more straightforward and certain way of eliminating the lock-in effect, and thus raising capital gains tax revenues, than a reduction in the capital gains tax rate itself.

Finally, income tax revenues other than on capital gains could increase if a reduction in the capital gains tax rate raised the turnover rate of assets subject to sales commissions that are either fixed or based on gross value rather than capital gain.

When judged by the four principles of long-run growth, economic efficiency, fairness, and likely effects on revenues and the deficit, the reduction in the capital gains tax rate proposed by the House Republican Contract with America—which calls for a 50-percent tax exclusion for all capital gains and, for certain assets, the taxation of only *real* capital gains (through the indexation for tax purposes of capital gains for inflation)—is problematic and ultimately ill-advised. For the reasons already noted, the direct effects of additional capital gains tax relief on private saving and investment—perhaps its only valid rationale—are likely to be small. The creation of a larger wedge between the rate of capital gains taxation and the rate of income taxation for higher income taxpayers is likely to encourage more-aggressive tax-sheltering activities. And a reduction in the capital gains tax rate that applied both retrospectively and prospectively would provide a substantial windfall to investments undertaken before the change in the tax code, which

does not serve the purpose of encouraging *new* saving and investment.

An across-the-board reduction in the capital gains tax rate also violates the principle of tax fairness. By providing different tax treatment to different classes of assets, the proposal would create an uneven playing field for investors. Moreover, according to available estimates, about 50 percent of the benefits of a uniform capital gains rate cut would go to the 1 percent of the population with the highest incomes, and over 75 percent of the benefits would accrue to the top 10 percent of the income distribution. Such a skewed distribution of benefits follows directly from the current distribution of wealth in the United States. According to the Survey of Consumer Finances, Americans in the top ½ percent of the net worth distribution owned 29.1 percent of aggregate net worth in 1989, while the bottom 90 percent owned only 30.7 percent. The share of the wealthiest ½ percent increased by 5 percentage points and that of the bottom 90 percent fell by 2.6 percentage points between 1983 and 1989.

Finally, a uniform and generous reduction in the capital gains tax rate is likely to be expensive in terms of forgone revenues. The Treasury estimates that the capital gains tax reduction currently proposed in the Contract with America would reduce tax receipts by about $60 billion between fiscal 1995 and fiscal 2000 and by about $183 billion between fiscal 1995 and fiscal 2005. These lost revenues would have to be offset by an equivalent amount of spending cuts (or increases in other revenues) to make the overall proposal deficit-neutral.

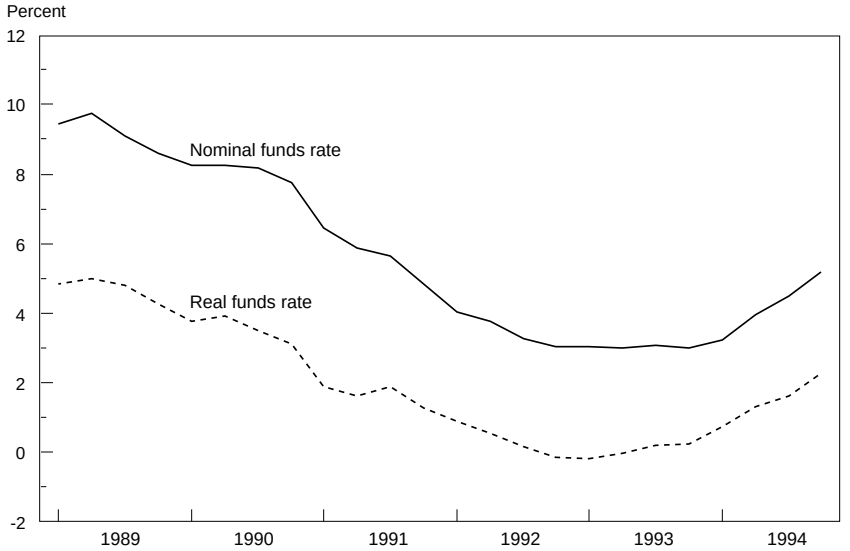
MONETARY POLICY IN 1994

At the beginning of 1994 a growing number of observers began to express concern that continued economic growth at the pace experienced over the second half of 1993 would soon close the gap between actual and potential output, precipitating increases in wage and price inflation. This concern was heightened both by a jump in GDP growth at the end of 1993, to a rate in excess of 6 percent, and by the degree of underlying momentum the economy carried into 1994.

Acting to forestall inflation, the Federal Reserve raised the Federal funds rate (the rate on overnight interbank loans) by one quarter percentage point in early February 1994. Monetary policy was tightened further in five subsequent Fed policy actions over the course of the year, and by December 1994 the Federal funds rate stood 2.5 percentage points higher than in January 1994. Although the year-end Federal funds rate was still considerably lower both in nominal and in real terms than it had been in 1989 and early

1990 (Chart 2–13), when the gap between actual and potential output was roughly comparable to where it was at the end of 1994, the cumulative rise in the rate was substantial when measured against changes in the first year of earlier episodes of tightening.

Chart 2-13 **Nominal and Real Federal Funds Rates**
The rising Federal funds rate in 1994 reflected the Federal Reserve's shift toward tighter monetary policy.



Note: The real Federal funds rate is the nominal rate less the rate of inflation, measured by the change in the GDP fixed-weight price index over the past year.
Sources: Department of Commerce and Board of Governors of the Federal Reserve System.

The Fed's action in February, in advance of any apparent increase in inflation, reflected its view that economic activity responds with a lag and then only gradually to changes in interest rates. In the belief that the risks on inflation had shifted to the upside, the Federal Reserve reduced the degree of monetary accommodation slowly but substantially. In the Fed's view, the risk of increased inflation was augmented by the actual and expected strength of real activity, and by the absence of any appreciable slack in labor markets. Additional factors that influenced the Fed included a significant pickup in inflation at the early stages of processing, and an acceleration in nonoil import prices. The Fed also saw signs that inflationary expectations had risen in the behavior of foreign exchange and long-term debt markets: bond prices rallied initially with many of the rate hikes, but retreated subsequently with the release of additional news confirming the persistent strength of the economy. Finally, the Fed believed that various practices of banks during 1994—lowering standards for business loans and passing through to consumer loans an unusually small

portion of the rise in market interest rates—were offsetting some of the effects of higher interest rates and thus warranted somewhat larger interest rate hikes.

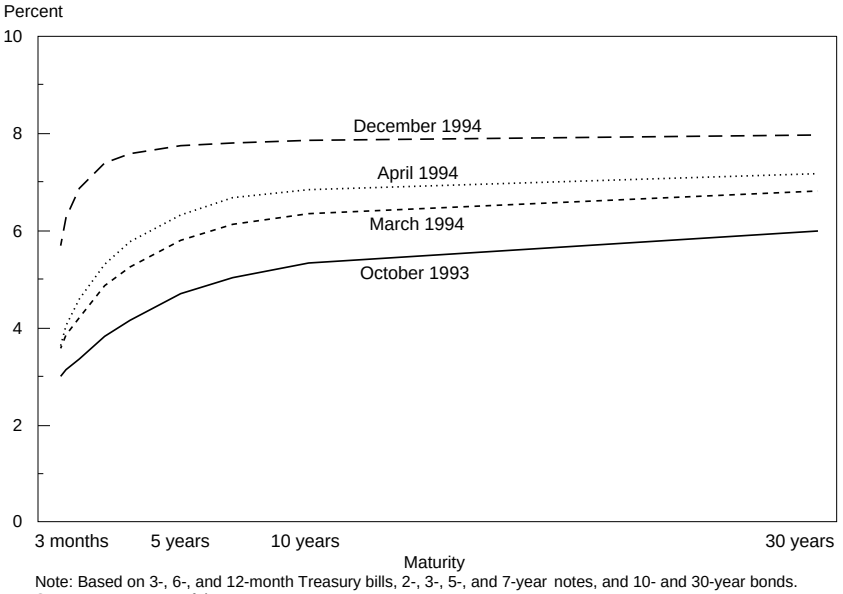
By the end of 1994 the effects of higher interest rates on real activity had shown up clearly only in the most interest-sensitive sectors, such as housing. Still, the expectation was that the bulk of the restraint imposed by higher rates in 1994 would materialize over the coming months, moderating the pace of economic activity in 1995. Although it is expected that the economy will slow just enough to bring it to its long-run sustainable path, neither the timing nor the ultimate size of interest rate effects is known with certainty. Thus, it is possible that the Fed will decide that another rise in interest rates will be required to slow the economy sufficiently, or that the Fed's monetary tightness will cause economic growth to slow more than anticipated by the Administration's forecast.

RISING INTEREST RATES

An element of considerable surprise in financial markets over the past year was the sharp increase in yields on long-term bonds in most industrial countries. Although bond yields might have been expected to rise somewhat with the increase in short-term rates engineered by the Fed, the yield curve (the rates of interest across all maturities that prevail at a given time) nevertheless would have been expected to flatten significantly. Instead, from a low of 5.78 percent on October 15, 1993, the yield on 30-year U.S. Government bonds rose markedly during 1994, peaking at 8.16 percent in early November and ending the year at 7.89 percent. Thus, even before the first Fed action in February, yields across the maturity spectrum had risen fairly uniformly relative to the yield on 3-month Treasury bills, and the spread vis-a-vis the 3-month bill rate continued to rise through early April. Over the remainder of the year, spreads between the 3-month bill rate and yields on 1- to 3-year notes were roughly constant, while the spread between the bill rate and yields on longer term debt narrowed somewhat, especially after the Fed's tightening in November (Chart 2–14).

All told, the increase in bond yields was unusually large when judged by the historical relationship between year-to-year movements in short- and long-term interest rates. Chart 2–15 plots the actual yields on U.S. long-term corporate bonds and the yields that would be predicted from historical experience. The chart shows the uncharacteristic size of the 1994 prediction error, with actual long-term rates much higher than expected. The prediction is based on a relatively standard equation that explains the relationship be-

Chart 2-14 **Term Structure of Interest Rates on Government Debt**
Contrary to most expectations, long-term interest rates rose by almost as much as short-term rates over the course of 1994.



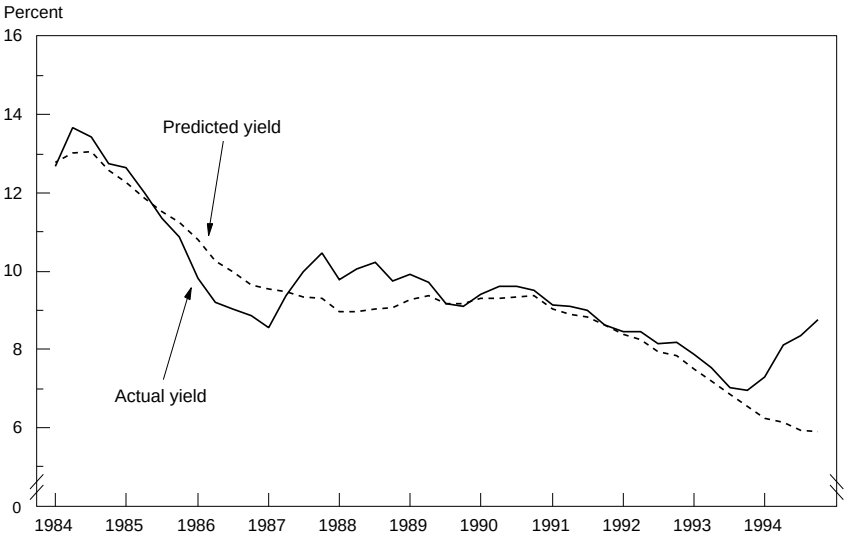
Note: Based on 3-, 6-, and 12-month Treasury bills, 2-, 3-, 5-, and 7-year notes, and 10- and 30-year bonds.
Source: Department of the Treasury.

tween short-term and long-term yields—the term structure of interest rates.

The rise in long-term interest rates in the United States was fully matched by increases in the weighted average of interest rates in Japan, Germany, France, Italy, the United Kingdom, and Canada (Chart 2–16). Since the end of 1993, the weighted average of 10-year interest rates in the foreign G–7 countries moved up 2.1 percentage points over the year. However, this average movement disguises experiences that differed markedly across individual countries—for example, long-term interest rates rose 1.3 percentage points in Japan and 3.6 percentage points in Italy.

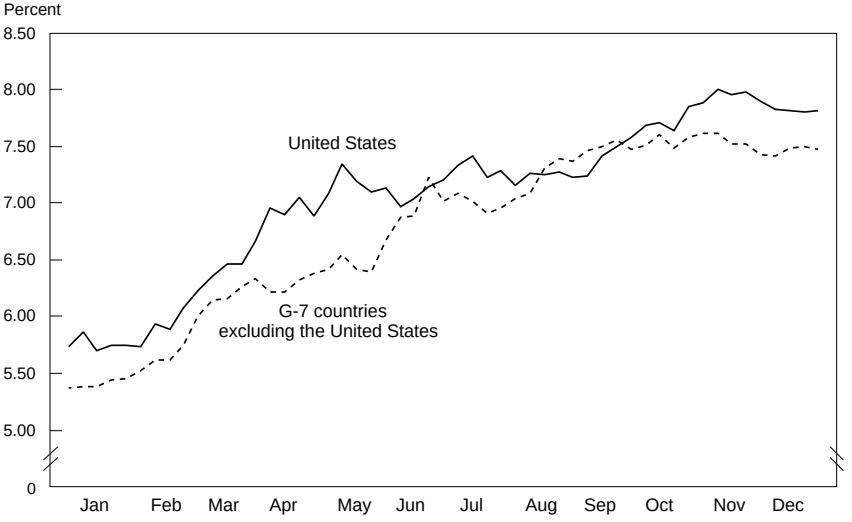
What explains the unusual rise in long-term rates both in the United States and in other industrial countries? To sort out the alternative explanations one must first determine the extent to which the increase in yields constituted a rise in *real* rates of interest, and the extent to which it reflected heightened expectations of inflation. If real rates have risen, the cause could be either stronger than expected aggregate demand or an increase in the risk premium (or some combination of the two). Only limited evidence exists to help make these distinctions. The relative importance of each factor is likely to have differed—perhaps significantly—across countries. The next section sets out a framework for examining the rise in interest rates and applies it to the U.S. experience.

Chart 2-15 **Actual and Predicted Long-Term Interest Rates**
The increase in long-term interest rates during 1994 is at odds with standard models of interest rate determination.



Note: Yields are for Moody's seasoned Aaa bonds and are reported as effective yields. The predicted yields are based on the term structure equation of the MPS model, estimated over 1957-1983.
Sources: Board of Governors of the Federal Reserve System and Moody's Investors Service.

Chart 2-16 **U.S. and Foreign Long-Term Interest Rates**
The rise in interest rates in the United States in 1994 corresponded to similar increases in foreign industrialized countries.



Note: Foreign rate computed as weighted average using shares in 1991 GDP, converted at purchasing-power-parity exchange rates. Interest rates are for 10-year bonds. G-7 (Group of Seven) countries excluding the United States are Canada, France, Germany, Italy, Japan, and the United Kingdom.
Sources: Board of Governors of the Federal Reserve System and Organization for Economic Cooperation and Development.

EXPLAINING THE RISE IN LONG-TERM RATES

Theories of the relationship between the yields on assets of different maturities generally argue that the yield on a 30-year bond should equal the average of expected yields on 1-year bonds over the next 30 years, plus some premium to compensate the bondholder for a loss of liquidity or other sources of long-term risk. Under the assumption that there was no change in the risk premium, the term structure theory suggests that the average expected 1-year rate over the next 30 years rose by 2.1 percentage points in the United States between October 1993 and the end of 1994, 0.4 percentage point less than the increase in the Federal funds rate during 1994. Moreover, because the rise in rates was roughly uniform for 1- to 30-year debt through most of the year, financial market participants acted as if the higher level of short-term rates would persist *indefinitely*. Thus, the market seemed to be saying that short-term rates would remain high for many years.

Based on historical experience—experience that is captured in equations used to model the term structure of interest rates—expectations about future short-term rates are not based solely on the value of the current short-term rate but also on values of past short-term rates. The almost contemporaneous increase in short- and long-term rates over 1994 thus signaled a fundamental change in the outlook for future rates. This change in interest rate expectations coincided with a growing consensus that the underlying strength of the U.S. economy was greater than first thought.

To see how the increased strength of the economy could raise rates, consider two alternative scenarios. Each scenario highlights one extreme on the spectrum of interpretations of the increase in interest rates. Both scenarios assume that the economy is operating close to its level of potential output and that something happens to raise the outlook for aggregate demand. For instance, foreign GDP growth could strengthen relative to prior expectations, thus enhancing the prospects for U.S. exports. Alternatively, housing starts or other elements of domestic demand could appear to be unusually immune to high interest rates.

In the first scenario, in order to prevent the economy from operating above its potential level following the increase in aggregate demand, the real interest rate would have to rise. Moreover, if the upward shift in aggregate demand is expected to be sustained for some years, the rise in the real interest rate must also be sustained. This scenario attributes the rise in expected short-term rates implicit in the rise in long-term interest rates to an expected and sustained increase in *real* short-term rates. This scenario is consistent with a view that the Federal Reserve's commitment to a goal of price stability will lead it to raise real rates when an in-

crease in demand would otherwise result in the economy operating above its potential.

The second scenario attributes the rise in long-term rates to an increase in the long-term forecast for *inflation*. It is based on a view that, although aggregate demand has shifted upward, the Federal Reserve either does not fully recognize the increased strength of demand or reacts only after some time has elapsed, during which price pressures build. In this scenario, in which the Fed is seen as tolerating an economy operating above its potential, the rate of inflation increases until either aggregate demand shifts back to its original level or the Fed steps in and raises real interest rates by the amount necessary to dampen the level of demand. Thereafter the inflation rate stabilizes, but at a higher level—the longer the economy is allowed to operate above potential, the larger is the sustained increase in the inflation rate.

Both of these scenarios assume that the impetus to the runup in long-term yields in 1994 was a reassessment of the fundamental strength of demand in the U.S. economy. How large would that upward revision have to have been to justify a sustained increase in expected real rates of 2.1 percentage points or an increase in the inflation premium of the same magnitude? And how plausible is such an upward revision in view of the behavior of the U.S. economy over 1994? In short, is either of the two scenarios plausible?

Rules of thumb derived from U.S. macroeconomic data can be used to quantify, albeit very crudely, the size of the perceived shock to aggregate demand under these two alternative scenarios. In the first scenario, the size of the upward shift to aggregate demand that can be offset by a given increase in real rates depends on the sensitivity of aggregate demand to changes in such rates. The more interest-sensitive is demand, the larger is the shift in aggregate demand associated with the observed increase in the real rate. Based on estimated statistical relationships, an increase in real interest rates of 2.1 percentage points would offset a permanent upward shift in aggregate demand of about 1.9 percent of GDP. That is, to keep the level of output unchanged—despite an increase of about 1.9 percent in the level of demand associated with any given real interest rate—real rates would have to rise by about 2.1 percentage points.

In the second scenario, where the entire rise in rates reflects an increase in the long-term inflation forecast, the cumulative output gap—defined as the excess of actual output relative to potential output over the period when the economy is operating above potential—is roughly 10.5 percentage points (Box 2–4 describes this calculation). A cumulative gap of this magnitude can arise either quickly or over a longer period of time. For instance, the anticipated shift in aggregate demand could be a near-term phenomenon,

with the level of output exceeding potential by 5.3 percent over each of the next 2 years. Alternatively, investors may think that the additional strength in the economy is likely to last about 5 years and be worth a little more than 2 percent on the output gap each year.

Box 2–4.—Calculating the Cumulative Output Gap

The output gap associated with a permanent increase in the inflation rate of 2.1 percentage points can be calculated by using Okun's rule and an estimate of the sacrifice ratio (defined as the percentage-point decline in the unemployment rate required to raise the long-term rate of inflation by 1 percentage point). From Okun's rule, every percentage-point increase in the gap between actual and potential output reduces the unemployment rate by 0.4 percentage point. Then, using a mean estimate of 2 for the sacrifice ratio, each percentage-point decrease in the unemployment rate that is sustained for 1 year adds 0.5 percentage point to the permanent rate of inflation.

EVIDENCE FROM THE UNITED STATES

Is there evidence to discriminate between these hypotheses—an expected permanent increase in the real interest rate or an expected increase in the long-term inflation rate? What evidence is there for some middle ground—a combination of an expected increase in both the real interest rate and the inflation rate? And is the magnitude of the implied shift in aggregate demand reasonable under either of these scenarios, or is it so implausibly large that alternative explanations of the rise in long rates must be sought?

Monthly Blue Chip forecasts help to shed some light on these questions (the Blue Chip forecast is a consensus forecast of some 50 private sector economists). Beginning with the Blue Chip forecast of real GDP growth made in October 1993 (the recent low point for long-term yields) and continuing through the forecast made early in January 1995, upward revisions were made to the level of real GDP projected to prevail in the fourth quarter of 1994. By January 1995 the forecast of the *level* of real GDP for the final quarter of 1994 was 2 percent higher than the forecast made in October 1993. Forecasts of 1995 growth (on a fourth-quarter-over-fourth-quarter basis) were essentially unchanged over this period, indicating that the upward shift in the level of demand was expected to be sustained at least through 1995. These forecast revisions underestimate—possibly significantly—the perceived upward shift in aggregate demand because they occurred at the same time that actual interest rates and projected interest rates were increas-

ing (and thus do not reflect the increase in demand that would have been consistent with unchanged yields).

Blue Chip projections for the U.S. economy over the next decade are broadly consistent with the notion that the upward shift in the underlying strength of the economy in 1994 was expected to be sustained for a period of years. In October 1993 the unemployment rate was projected to average 6.0 percent and the yield on corporate Aaa bonds was expected to average 7.4 percent between 1995 and 2004. By October 1994 the average unemployment rate projected to prevail between 1996 and 2005 had risen only to 6.1 percent (roughly 5.9 percent after correcting for the difference in the new and old unemployment rate survey) despite the sizable increases in interest rates that had already occurred and an upward revision of about 0.5 percentage point to 10-year forecasts of both nominal and real interest rates (as discussed below). Thus, sustained higher interest rates were expected to be necessary to restore the level of output approximately to where it would have been in the absence of the upward shift in demand.

The Blue Chip forecasts also offer some evidence on the decomposition of the rise in interest rates into real and inflation components. Between October 1993 and January 1995, forecasts of consumer price inflation over the year ending in the fourth quarter of 1994 were revised downward slightly—from 3.2 percent to 2.8 percent. Similarly, projections of inflation over the year ending in the fourth quarter of 1995 were revised upward modestly—from 3.3 percent to 3.5 percent. In addition, forecasts of the average annual increase in the CPI over the next 10 years were revised down between October 1993 and October 1994 by 0.1 percentage point. Taken as a whole, these revisions offer no evidence for an increase in the inflation premium and thus lend support to the hypothesis that the rise in long-term rates was largely due to an increase in the real component.

Clearly, revisions to Blue Chip forecasts of output growth and inflation provide at best imperfect evidence on long-run expectations, and even then are limited by their 10-year horizon. Moreover, there is some evidence to suggest that financial market participants saw a very different story. For instance, the dividend-price ratio of the stocks in the Standard & Poor's 500 index—a reasonable proxy for the expected real rate of return on equity—showed no significant sustained increase over the course of 1994. So, from the behavior of equity markets, the rise in long-term interest rates either was due to heightened expectations of inflation or represented some shift in the preference for equity over bonds. A popular view in the financial press was that, for much of the year, the Fed was "behind the curve"; in that case, some fraction of the rise in long-term rates would have reflected market fears of increased inflation. In fact,

the flattening of the yield curve that followed the Fed's November tightening is consistent with the view that the Fed had only then assumed the appropriately aggressive stance.

An increase in the market's required compensation for risk could also be an important factor in the rise in long-term yields. The risk premium is difficult to measure and can vary over time as perceptions change. The events in financial markets in 1994 no doubt heightened market participants' assessments of risk, as is evidenced by a rise in expected volatilities inferred from options prices. But expected volatilities remained well below levels recorded through much of the 1980s, and thus this measure of riskiness, by itself, does not support the hypothesis that higher risk premia accounted for a significant portion of the runup in U.S. long-term interest rates.

On balance, therefore, the evidence from the United States is mixed. The consensus of forecasts sees no major increase in inflation. But there are indications that financial markets did see inflation and that the increase in long-term rates was therefore not entirely due to an increase in its real component.

More direct and reliable readings of inflation expectations would be provided if one could compare rates of return on bonds whose yields are invariant to inflation with yields on conventional bonds (Box 2–5). Such inflation-indexed bonds have been issued in other countries, but not in the United States, and valuable information about inflation expectations has been obtained from their yields.

EVIDENCE FROM FOREIGN COUNTRIES

A number of factors appear to have contributed to the rise in long-term interest rates in foreign countries during 1994. Probably the most important development—virtually identical to the evolution of forecasts for the U.S. economy—was the better than expected recovery in real economic activity in the foreign G–7 countries. At the beginning of 1994, market forecasters expected real GDP growth to average 1.1 percent in the major foreign countries in 1994 and 2 percent in 1995. By the end of last year those expectations had been revised upward to 2.1 percent and 2.6 percent, respectively. As in the case of the United States, there is some limited evidence available to decompose the rise in nominal yields into real, inflation, and risk components.

Evidence from the United Kingdom's well-established market for indexed bonds suggests that only about one-half of the rise in nominal interest rates in that country has shown up in real rates. The remaining increase in nominal interest rates during 1994 is viewed as compensation for inflation, a measure that includes the expectation of inflation as well as any premium for inflation risk. That the United Kingdom would have experienced such a large in-

Box 2–5.—Indexed Bonds

Although the inflation-indexed bonds that various countries have issued differ somewhat in their design, their terms generally guarantee that the principal and coupon payments are adjusted to reflect the cumulative change in a specified price index since a base period. For instance, consider an indexed bond that is issued with 2 years to maturity, a maturity value of $100 in real terms, and an annual coupon rate of 5.0 percent. One way of structuring the payments stream is as follows. If prices rise by 3 percent in the first year, the first-year coupon payment would be $5.15 (0.05 times $100 times 1.03). If prices rise by 4 percent in the second year, the second-year coupon payment would be $5.36 ($5.15 times 1.04). The maturity value at the end of the second year would be $107.12 ($100 times 1.03 times 1.04). If this bond sells for $100, its real yield is 5 percent.

For this indexed bond, the real yield to maturity is set once the purchase price of the bond is determined. The real yield does not vary with the rate of inflation, although the realized nominal yield to maturity does. By contrast, with a conventional bond the nominal yield to maturity is known given the purchase price, and the realized real yield to maturity will depend on the actual course of inflation.

An estimate of the expected rate of inflation can be derived by comparing the real yield on an indexed bond with the nominal yield on a conventional bond. For example, if the average annual nominal yield on a conventional bond is 9 percent and the average annual real yield on an indexed bond is 5 percent, then the average annual expected rate of inflation is approximately 4 percent, assuming that, except for the indexation, the bonds are perfect substitutes for each other in investors' portfolios. Differences between the bonds' maturity, coupon payments, tax treatment, and other features could affect the preference for one type of bond relative to the other, in which case the difference in yields would not correspond exactly to the expected rate of inflation. For example, investor preferences for certainty about the real rate of return are likely to cause the spread between yields on conventional and indexed bonds to overestimate the expected rate of inflation, because investors would be willing to pay a premium on indexed bonds (or would require additional compensation on conventional bonds). Similarly, if investors preferred certainty about nominal returns, the yield spread would be likely to understate the expected inflation rate.

crease in compensation for inflation over 1994 should come as no surprise, given that inflation there in recent years has been somewhat volatile. Moreover, the withdrawal of the pound sterling from the Exchange Rate Mechanism of the European Monetary System in September 1992 may have increased the risk premium attached to British assets. Notwithstanding this evidence of a greater likelihood of inflation, or increased uncertainty about inflation prospects, forecasts of U.K. retail price inflation for 1994 and 1995 were actually revised *downward* over the year.

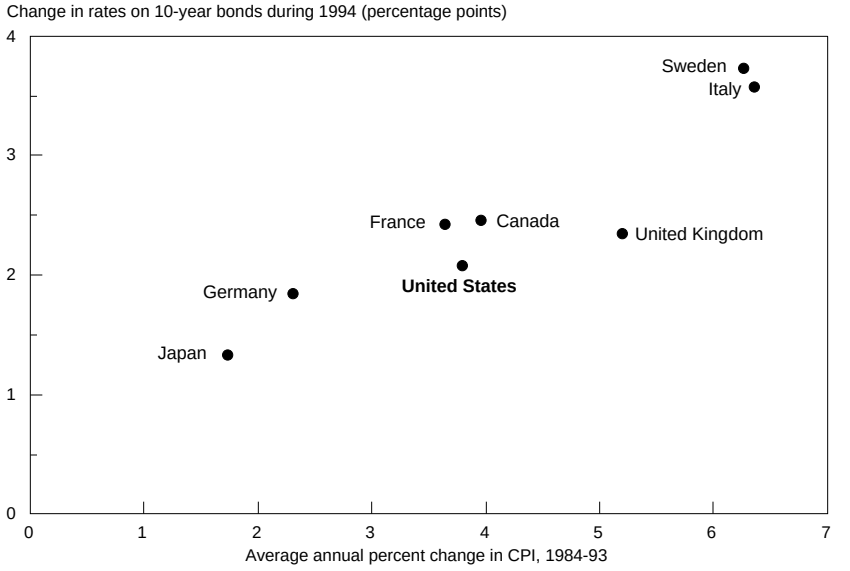
With the exception of Italy, inflation forecasts for 1994 and 1995 remained unchanged or declined between January and December 1994 in the foreign G–7 countries. This evidence, by itself, would suggest that in most countries the rise in yields was due to higher real rates or increased premia for risk. However, some analysts have suggested that the rise in long-term bond yields across countries in 1994 should be viewed in the context of each country's inflation history. Chart 2–17 demonstrates that the rise in long-term interest rates last year was smaller in countries with a history of lower inflation (such as Japan and Germany) than in countries with a history of higher inflation.

Others have suggested that the size of fiscal deficits may have played a role. But the evidence on the link between government spending and increases in long-term yields is more mixed. The total stock of government debt is a far better indicator of a nation's fiscal position than is the size of the deficit in a single year. Whereas in Italy and Sweden increases in long-term yields of 3.6 and 3.7 percentage points, respectively, seemed to be related to government debt levels around 100 percent of GDP, rates rose in Belgium by a smaller 1.9 percentage points, despite government debt near 150 percent of GDP. There was considerable discussion among analysts about the determinants of the rise in long-term yields, but past price and fiscal developments were not "news" in 1994, and therefore it is difficult to understand why financial market participants had not already incorporated such developments into their expectations. In some cases these variables, when coupled with an uncertain political environment, may have increased the market's required compensation for risk.

FISCAL DEFICITS, DEMOGRAPHICS, AND EMERGING MARKETS

Some analysts have pointed to other factors as possible contributors to increased capital demands and last year's global rise in long-term interest rates. One factor frequently mentioned is government deficits in industrial countries, which are sizable but generally did not increase appreciably last year. Another factor mentioned is demographic shifts that will begin in some countries by

Chart 2-17 **Inflation and Long-Term Interest Rates**
Interest rate increases were greater in countries with histories of higher rates of inflation.



Sources: Board of Governors of the Federal Reserve System and Organization for Economic Cooperation and Development.

the end of this century and are expected to bring with them increased health care costs and rising pension liabilities. Ultimately, fiscal deficits may grow significantly larger, as countries face the expenses associated with aging populations. Finally, increased investment opportunities in developing countries and transition economies are often viewed as having added to global demands for capital in 1994. Many commentators have pointed to the rise in stock market capitalizations in emerging economies and the increased flow of capital into those markets from U.S. institutional investors seeking portfolio diversification.

None of these factors was new last year, however, and it is difficult to see what would make them suddenly become important in 1994. Although the factors just enumerated may be important in assessing the expected competition in world capital markets over the longer term or the generalized rise in the level of real interest rates since the 1960s and 1970s, it seems improbable that they contributed substantively to increases in long-term interest rates during 1994.

THE ADMINISTRATION FORECAST

The Administration expects the economic expansion to moderate in 1995 as the effects of increases in interest rates to date spread

more broadly through the economy. The actual growth rate is forecast to approach the growth rate of potential output, with the economy achieving a so-called soft landing. Over the longer run, output is forecast to grow in line with potential output, and the rate of inflation to remain roughly constant at 3 percent (Table 2–5).

TABLE 2–5.— *Administration Forecast*

item	1994 (actual)[1]	1995	1996	1997	1998	1999	2000
	Percent change fourth quarter to fourth quarter						
Real GDP	4.0	2.4	2.5	2.5	2.5	2.5	2.5
GDP implicit deflator	2.3	2.9	2.9	3.0	3.0	3.0	3.0
Consumer price index (CPI-U)	2.6	3.2	3.2	3.2	3.2	3.1	3.1
	Calendar year average						
Unemployment rate (percent)	6.1	5.5–5.8	5.5–5.8	5.5–5.8	5.5–5.8	5.5–5.8	5.5–5.8
Interest rate, 91–day Treasury bills (percent)	4.3	5.9	5.5	5.5	5.5	5.5	5.5
Interest rate, 10–year Treasury notes (percent)	7.1	7.9	7.2	7.0	7.0	7.0	7.0
Nonfarm payroll employment (millions)	113.4	116.7	118.3	120.1	121.7	123.4	125.1

[1] Preliminary.

Sources: Council of Economic Advisers, Department of the Treasury, and Office of Management and Budget.

By early 1996 the forecast predicts an easing in short-term interest rates. Over the forecast horizon, long-term interest rates also are projected to decline, and the spread between long- and short-term rates is projected to narrow, as the near-term slowing of growth dispels any fears on the part of financial market participants of an overheated economy. The decline in nominal long-term rates reflects a decline in real long-term rates and, in turn, is a consequence of the growing restraint implied by the stance of fiscal policy. Absent the decline in the real rate, output growth would be likely to slow with the slowing in Federal Government spending. Thus the Administration's longer term outlook is consistent with a growing share of private sector spending (especially of its interest-sensitive components) and a declining share of Federal spending in GDP.

The unemployment rate is forecast to be between 5.5 and 5.8 percent. A range, rather than a single figure, is projected both because the relatively short experience with the new unemployment rate survey increases the uncertainty associated with its forecast, and because, as indicated earlier, some structural change could be under way in labor markets. Nevertheless, the Administration expects that economic growth over the next several years will be strong enough to absorb all new entrants into the labor force. For

budget purposes, the more conservative projection of a 5.8 percent unemployment rate was used.

As always, there are risks to the forecast. In assessing the near-term risks, some possibility exists that the interest rate increases to date will not succeed in dampening growth as quickly as anticipated and that the pace of the expansion could overshoot the projected growth rate of 2.4 percent for 1995. Were this to happen, interest rates would be likely to rise further, slowing the economy thereafter more than expected.

On the downside, there remains the possibility that interest rate increases already in the pipeline will moderate the expansion sooner and by more than anticipated. Compounding this risk is the risk that foreign economic growth may stall, reducing foreign demand for U.S. exports. The sharp decline in the Mexican peso and the ensuing slowdown in the Mexican economy will also cut into U.S. export growth. In addition, the substantial inventory accumulation over the past year may not be entirely intentional. If this is the case, production could be scaled back more than anticipated in order to reduce the degree of inventory overhang.

Finally, the course of the economy depends as always on budgetary and other policy decisions of the Congress. Perhaps more than usual in recent years, there is substantial uncertainty about future congressional action in matters that can influence the paths of output, deficits, and interest rates over the medium run.

CONCLUSION

Strong, investment-led growth with rapid job creation and low inflation is a winning combination, and this is what the U.S. macroeconomy has achieved over the past 2 years. In part, the robust pace of growth in GDP in 1993 and 1994 was possible because considerable slack existed in the economy in January 1993. Because most of that slack had disappeared by the end of 1994, it is unlikely that the economy will realize the same rate of growth over the next few years. That is why the Administration—and most private forecasters—predict a soft landing in which GDP growth moves to what is widely viewed to be its long-run potential rate of about 2.5 percent a year.

Despite the likely slowing of growth, the macroeconomic outlook remains very favorable. Continued increases in employment and incomes are expected. Job creation should be sufficient to keep the unemployment rate down, and sustained economic expansion with moderate inflation should allow more Americans to increase their real earnings and their family incomes over the next 2 years and beyond.

As always, there are risks in the economic outlook. The Federal Reserve has increased short-term interest rates, and long-term rates have risen almost in parallel. Indeed, long-term rates have risen around the world. The rise that has already taken place could slow growth more than expected. However, the Council of Economic Advisers views this as an unlikely outcome.

In the 1980s the U.S. economy collided with exploding budget deficits. That situation has changed. The deficit reduction measures already enacted have paid off, leading to an improved deficit outlook for the remainder of the decade. The President's 1996 budget proposal includes additional deficit reduction, as well as a middle-class tax cut. The Administration's progress on reducing the deficit has provided the basis for a stable and balanced long-term growth path.

One weak spot in the macroeconomic picture for 1994 has been the current account deficit, which widened significantly over the year as the strong U.S. expansion, combined with less robust growth overseas, resulted in stronger growth in imports than in exports. An improvement in the current account is anticipated for 1995, as growth overseas strengthens and U.S. import growth slows. Over the longer run, reductions in the budget deficit will aid in reducing the current account deficit.

With a budget deficit that is under control, strong growth of jobs and GDP, and continued low inflation, the macroeconomy has changed vastly for the better over the past 2 years, and the U.S. economy looks forward to continued growth with rising incomes in 1995.

Vigorous growth in 1993 and 1994, an expected soft landing in 1995, large increases in employment, and modest rates of inflation—these are noteworthy achievements for any economy. But the unemployment rate remains high—especially for teenagers, blacks, and Hispanics—despite a significant decline over the past 2 years, and the real incomes of many Americans have shown only meager growth. Chapter 5 discusses the Administration's proposals for lifelong learning, which have the potential to greatly improve the earning prospects of those Americans who have not participated fully in the economy's expansion. First, however, Chapter 3 discusses policies to enhance the economy's long-run growth.