Research Department
Federal Reserve
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January 26, 1979

FRBSF Weekly Letter

Budget: New Foundation

President Carter this week presented Congress with his budget for fiscal 1980, which begins October 1. The budget calls for expenditures of $531.6 billion, an increase of 7.7 percent ($38.2 billion) over the fiscal-1979 estimate. Since reveenues are projected at $502.1 billion, the 1980 deficit will come out at $29.4 billion. This would be down $9.5 billion from the expected 1979 deficit, and would represent the smallest deficit of the past half-decade.

The realization of the President's budget depends upon what one observer describes as "the best of all possible worlds." The budget is aimed at slowing the rate of inflation by reducing stimulus from the public sector — but is also aimed at avoiding the restrictiveness which would shock the economy into a recession. The budget emphasizes the control and containment of expenditures rather than absolute across-the-board spending cuts. Altogether, it represents the financial support for the "New Foundation" which the President outlined in his State of the Union message.

Economic underpinnings

The 1980 budget will affect the economy by the degree of stimulus that it supplies to the income stream, but it in turn will be shaped by the state of the economy. The economic projections included with the budget help determine the estimates of Federal revenues, and thus are a significant factor in determining the projected deficit. In general, the Administration's forecast regarding economic growth and inflation is somewhat more optimistic than what most private forecasters are predicting.

The budget is predicated upon growth in real GNP — costant-dollar output — of 3.3 percent in 1979 and 2.5 percent in 1980. The pattern of growth should differ during the two years, however, so that on a year-end to year-end basis, real GNP should grow by 2.2 percent in 1979 and 3.3 percent in 1980. (The 1978 figure was 4.0 percent.) At the same time, the rate of inflation — as measured by the consumer price index — is expected to decelerate, year-end to year-end, from 1978's 9.2-percent figure to 7.4 percent in 1979 and 6.3 percent in 1980. (By a curious coincidence, the cost of the budget document for 1980 is 4.25 — which amounts to a 6.3-percent increase over the cost of the 1979 document.) The average unemployment rate is projected at 6.0 percent for 1979 and 6.2 percent for 1980, up from 5.8 percent for 1978.

Nonetheless, most private forecasters are distinctly more bearish than the Administration, with the consensus forecast indicating a brief and mild recession of about six months' duration during the second half of 1979. The consensus shows real GNP growing about 2.0 percent in 1979, compared with the 3.3-percent growth assumed in the budget. There is also disagreement over the price outlook, with most private forecasters expecting the inflation rate to be at least as bad in 1979 as in 1978. Ordinarily, slower growth would tend to lead to lower revenues, but if the inflation rate is higher, the upward pressure on incomes would actually boost revenues, given the progressive nature of the nation's tax system. Yet expenditures for unemployment compensation

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and other transfers could rise as employment falters, and the net effect could be a larger deficit.

Taking a longer view, the Administration expects real GNP growth to average nearly 4½ percent in the 1981-83 period, and to drop to 3 percent in 1984. With this sustained growth, the unemploymnt rate would drop to 4 percent by the end of 1983, while the inflation rate would drop to 2.7 percent by the end of 1984. This longer-run forecast assumes that policies would be implemented to achieve the goals set down in the Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act). Given such a pattern of growth, the budget would show a very modest deficit in 1981 ($1.2 billion), and would show increasingly large surpluses thereafter — reaching $106.5 billion by 1984, in the absence of major tax reductions.

The major, and possibly most controversial, tax measure built into the budget is the so-called "real-wage insurance" program. This would provide a refundable tax credit to employees whose compensation is kept within the 7-percent anti-inflation guideline if the inflation rate exceeds 7 percent. The cost is estimated at $2.5 billion in 1980, but it could run much higher if the inflation rate exceeds the Administration's estimate for that year.

Who gets less — and more?
Despite the projected 7.7-percent increase in 1980 spending, certain programs are expected to be sharply curtailed. One of the major cutbacks will be in the public-service employment program (CETA). In view of the sharp rise (3.3 million) in civilian employment over the past year, the countercyclical (Title 6) portion of the program is due to be cut about $600 million, with the number of jobs being reduced from 358,000 to 200,000 over the course of the calendar year 1980. The cutback is justified on the grounds that this program was initiated when unemployment was widespread, so that it should be reduced as labor markets become tighter. Also, the summer youth-employment program would be reduced by eliminating those under 15 years of age and by carrying 1979 funding in 1980, with the cutbacks amounting to about 250,000 jobs. Again, the number of additional low-income families receiving rental housing assistance would be cut by about 10 percent in 1980.

The Administration expects its largest savings to come from the containment of hospital costs, which if adopted would result in total (public and private) savings of $24 billion from 1980 to 1982 — and from other health-care measures, which would generate savings of around $3 billion in the same period. The Administration also proposes to "eliminate unnecessary and windfall benefits" in the social security system. In addition, it has revived a perennial proposal to terminate or reduce Federal aid to "impacted" school districts — those which have a heavy enrollment of children of servicemen or Federal employees because of their location near Federal installations.

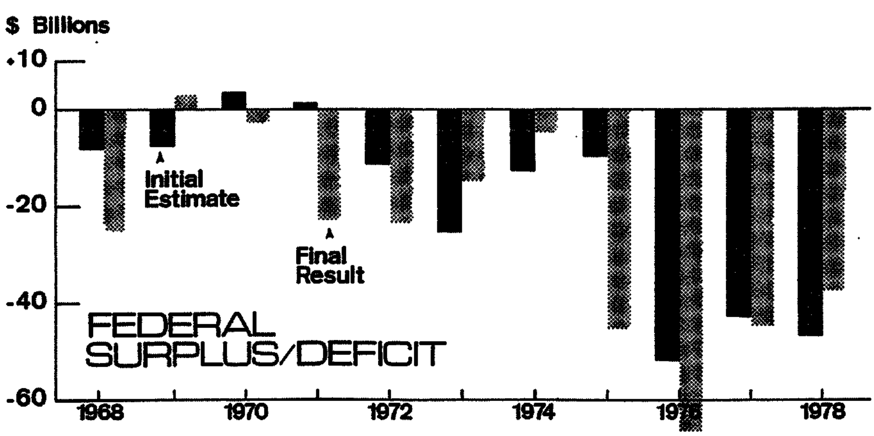
In contrast, defense-related spending is scheduled to increase by 3 percent in real terms — about 10 percent in currentdollar terms — to $125.8 billion in 1980. This represents the highest rate of real defense expenditure since 1972. The major increases will be directed toward beefing up strategic forces and re-equipping general-service forces. The development of a larger, more accurate intercontinental ballistic missile, and the procurement of an additional Trident submarine, are the major items in the strategic-forces budget. A strengthened NATO represents one of the chief aims in the general-forces budget, with the proposed addition of mechanized infantry and armored batallions in Europe. Additionally, the Navy will push forward a shipbuilding program.

Estimating the deficit
The actual Treasury deficit for fiscal 1980 will not be determined until the books are closed on September 30, 1980. Moreover, the track record of fiscal budget estimates does not exactly inspire confidence in the initial estimate. After all, the budget covers a period that is at least 18 months in the future, and the future has a habit of harboring unpleasant surprises that are not revealed until after the budgeting process is completed.

For confirmation, we need look no further back than the 1975 fiscal year. That year's budget was fashioned in late 1973 and early 1974, at a time when the economy was weakening but when no one foresaw the magnitude of the ensuing recession. Thus, the Administration estimated a $9.4-billion deficit for fiscal year 1975, only to be swamped by a massive $45.2 billion deficit as the recession unfolded.

The Administration's budget for fiscal 1980 is fully compatible with its economic scenario of modest growth for the year ahead. We should remember, however, that the world has become a riskier place in recent years, and that the variance of economic forecasts has grown accordingly.

Herbert Runyon



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/27/78	Change from 12/20/78	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	124,283	137	17,459	16.34
Loans (gross, adjusted) — total	100,951	40	18,440	22.35
Security loans	1,776	− 351	− 97	− 5.18
Commercial and industrial	29,080	− 1	3,638	14.30
Real estate	35,265	40	7,910	28.92
Consumer instalment	18,977	66	4,298	29.28
U.S. Treasury securities	8,475	67	− 955	− 10.13
Other securities	14,857	30	− 26	− 0.17
Deposits (less cash items) — total*	117,285	− 403	11,842	11.23
Demand deposits (adjusted)	31,553	− 293	2,123	7.21
U.S. Government deposits	309	− 287	− 413	− 57.20
Time deposits — total*	83,517	390	10,416	14.25
States and political subdivisions	7,229	62	561	8.41
Savings deposits	31,366	152	− 24	− 0.08
Other time deposits‡	42,472	220	10,459	32.67
Large negotiable CD's	20,628	146	5,732	38.48

Weekly Averages of Daily Figures	Week ended 1/10/79	Week ended 1/03/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves(+)/Deficiency (−)	− 43	+ 47	− 7
Borrowings	− 25	− 220	− 53
Net free(+)/Net borrowed (−)	− 68	− 173	− 60
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales(−)	+ 1,180	+ 694	+ 1,244
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 729	+ 369	+ 1,054

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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