



CBO's Growth Outlook

Economic growth in the United States has averaged about 4.5 percent per year since 1996. The Congressional Budget Office (CBO), the budget and macroeconomic analysis agency of the U.S. Congress, has raised its estimate of the growth rate of potential GDP for the period 1994-2000 (see chart). Potential GDP is defined as the output level that can be sustained for a substantial period without a rising inflation rate. GDP above its potential creates inflationary pressures, while output below its potential level puts downward pressure on inflation. Most observers agree that a substantial investment boom has played an important role in the economy's recent strong performance.

Current forecasts of large future federal government budget surpluses are based on the assumption that the economy can and will continue to grow at rates above those thought likely as recently as the mid-1990s. Current stock prices appear to incorporate expectations of continued rapid growth of the economy and corporate profits, also. The CBO's ten-year growth projections therefore may disappoint some as being too pessimistic. Its forecasting assumptions include slower growth of the labor force and no further increases in productivity growth rates.

After first exceeding the estimated level of potential GDP in early 1997, the economy grew faster than its accelerating potential each year in the late 1990s. Thus, the CBO now believes the economy is producing substantially beyond its potential (sustainable) level and must inevitably slow to below-trend growth for a while in the near future. The CBO now forecasts a gradual decline in the growth rate of potential GDP to about 2.85 percent in 2010, and an even sharper and sustained deceleration of actual GDP during the next few years. The average rate of growth of potential GDP projected for the 2001-2010 period is about 3.1 percent per year, only slightly higher than the

3.0 percent average annual growth rate of potential during 1991-2000.

From the CBO's perspective—i.e., that the U.S. economy was at its potential level in the first quarter of 1997—the U.S. economy clearly expanded at an unsustainable rate throughout the late 1990s. The unemployment rate fell steadily from 5.3 percent to 4.0 percent between the first quarter of 1997 and the third quarter of 2000, an average of about one third of a percentage point per year. A rough rule of thumb known as "Okun's Law" says that a decline in the unemployment rate of 1/3 percentage point per year corresponds to economic growth about one percentage point in excess of potential growth. In other words, if Okun's Law held precisely, the growth of potential GDP must have been about 3.5 percent during 1997-2000 (compared to CBO's estimate of 3 1/3 percent, which is loosely based on Okun's Law).

The last few years have been outstanding ones for the U.S. economy. However, the CBO and most private-sector forecasters continue to believe that the economy will perform on average during the upcoming decade much as it did during the 1990s—a decade that contained some very good years, even though it was not, on the whole, extraordinary.

—William R. Emmons

