Economic Analysis

CBO Releases Updated Budget Projections

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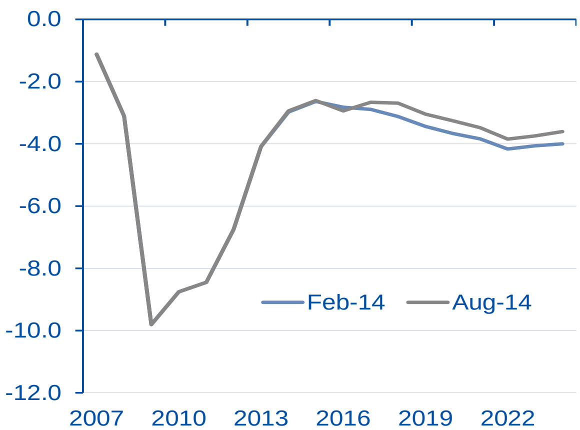
Short-Term Improvements but Long-Term Fiscal Outlook Remains Shaky

- **Budget deficit expected to hit 2.9% of GDP in 2014, a significant decline from the 10% reached in 2009**
- **Revenues and outlays likely to increase 2% and 8%, respectively**
- **CBO's economic outlook adjusted for slower-than-expected start to 2014, with real GDP growth forecast revised down from 3.1% to 1.5%**

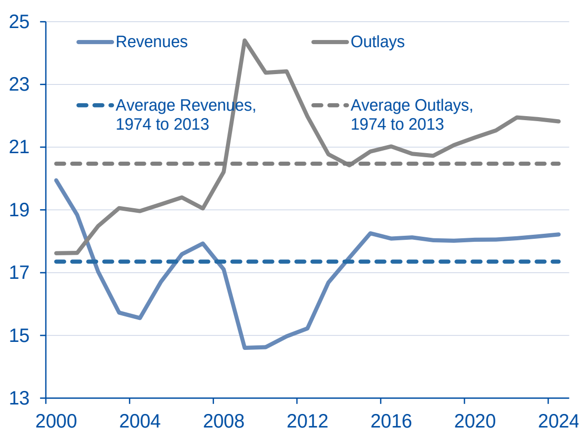
The Congressional Budget Office (CBO) recently released an update to the budget and economic outlook for the next decade (2014-2024). Compared to the previous report released back in February, the latest projections hint at short-term improvements in the fiscal balance but growing deficits and federal debt in the longer-run if current laws for federal spending and taxes remain in place. For the fiscal year 2014, the federal budget deficit is expected to reach $506bn (2.9% of GDP), with $3.5tn in outlays and $3.0tn in revenues. The CBO expects that spending will increase nearly 2% this year on account of a 4% rise in mandatory outlays and a 3% decline in discretionary spending. It is important to note that the CBO has factored in an estimated 15% increase in spending for Medicaid and a 5% increase in Social Security spending. Declining outlays for other mandatory programs will help to partially offset this significant increase, including a 40% drop in unemployment compensation related to the expiration of emergency benefits in December 2013. Revenues, on the other hand, are projected to rise 8% in 2014, reflecting increases in individual income taxes (6%), payroll taxes (8%), and corporate income taxes (15%). Due to the Federal Reserve's ongoing monetary policy actions and increasingly large balance sheet, the CBO expects that remittances from the Fed to the Treasury will increase 33% this year.

Chart 1
Fiscal Balance as % of GDP



Source: CBO & BBVA Research

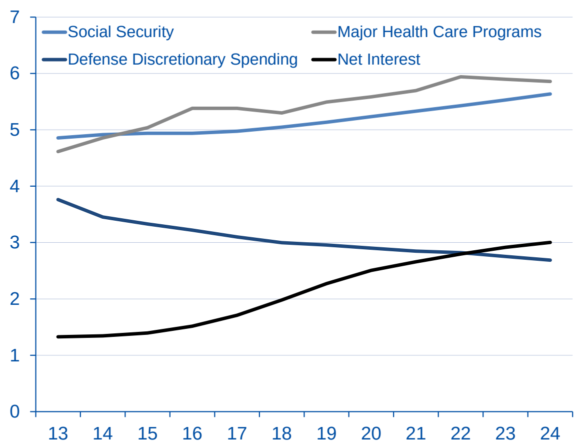
Chart 2
Revenues and Outlays as % of GDP



Source: CBO & BBVA Research

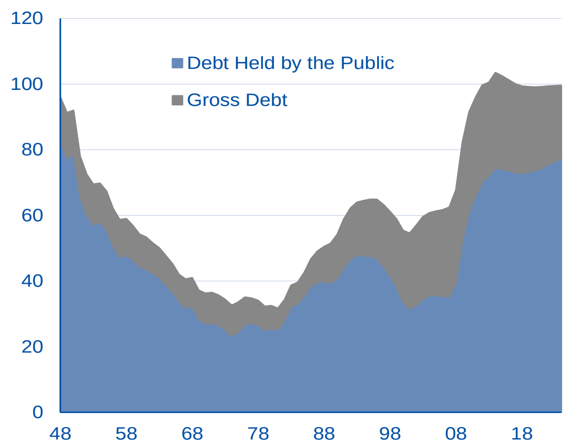
Overall, the deficit should remain stable through 2018 but may increase close to 4% thereafter, assuming that there are no significant changes to the current tax and spending laws. Federal debt remains an issue as it is expected to reach 74% of GDP this fiscal year, the highest since 1950 and nearly double the debt level seen in 2007 (35% of GDP). Unfortunately, the CBO's outlook for increasing federal debt does not bode well for the economic outlook, restraining growth in the long term and creating an environment more susceptible to a financial crisis.

Chart 3
Government Spending as % of GDP



Source: CBO & BBVA Research

Chart 4
Federal Debt Held by the Public as % of GDP



Source: CBO & BBVA Research

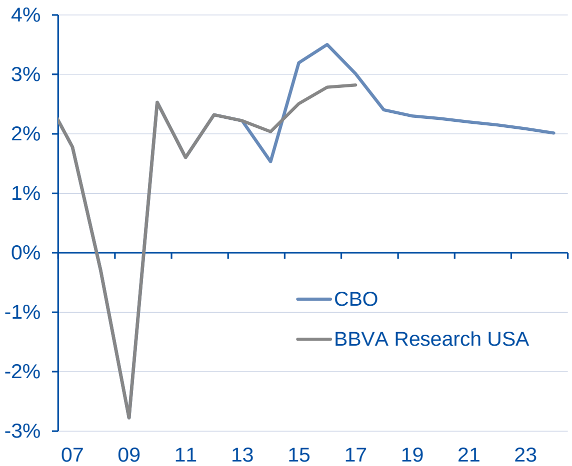
CBO Economic Projections Less Optimistic in 2014, Upside Going Forward

These budget projections are conditional on the CBO's updated economic outlook. The report notes that "economic expansion is on firmer ground", yet the slow start to the year has dragged down the CBO's real GDP forecast from 3.1% in February to 1.5% in 2014. This is slightly lower than our baseline forecast for 2.0% annual growth and is more reflective of our downside risk scenario. In the mid-term, the CBO expects that real GDP growth will accelerate to an annual average of 3.4% as a result of increased business investment in structures/equipment and labor, stronger consumer spending, and further progress in the housing market (i.e., increased construction due to fewer home vacancies and healthier mortgage markets).

Further down the road, the CBO expects that growth will converge closer to its potential, which will help reduce the amount of underutilization in the economy. In particular, the CBO projects that resource slack will "largely disappear by the end of 2017." The unemployment rate is expected to average 6.2% in 2014 and decline to about 5.6% by 4Q17, a slightly slower decline compared to our forecasts but accounting for similar assumptions regarding labor force participation.

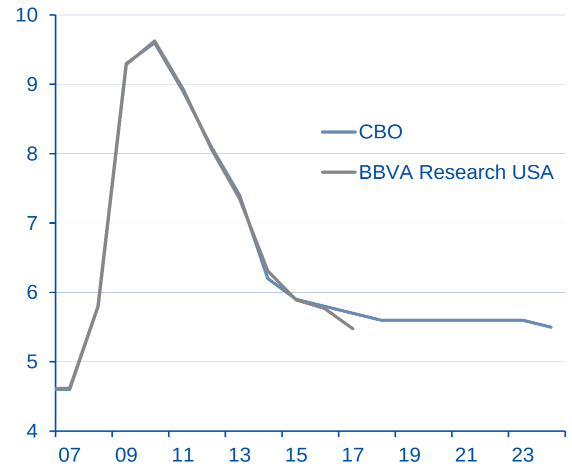
Inflation expectations remain low, and the CBO's forecasts are consistent with ours in that PCE inflation will remain below the Fed's target for the next few years. However, our CPI inflation forecasts are slightly higher after 2014. Finally, the CBO has lowered their interest rate projections over the forecast horizon, though the 10-year Treasury note remains slightly lower in our baseline scenario, averaging 3.9% vs. the CBO's estimate of 4.2% in 2017.

Chart 5
Real GDP Growth, Annual % Change



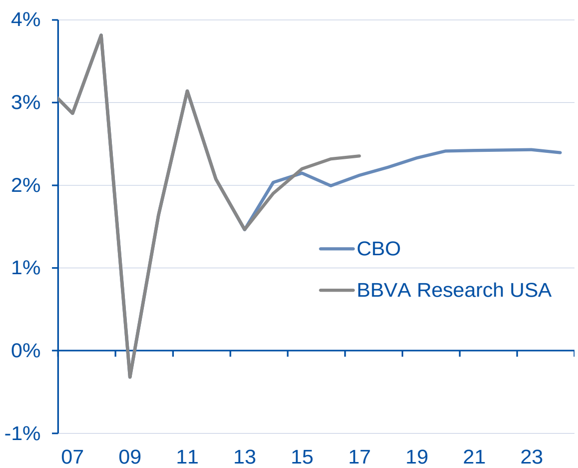
Source: CBO & BBVA Research

Chart 6
Unemployment Rate, Annual Average %



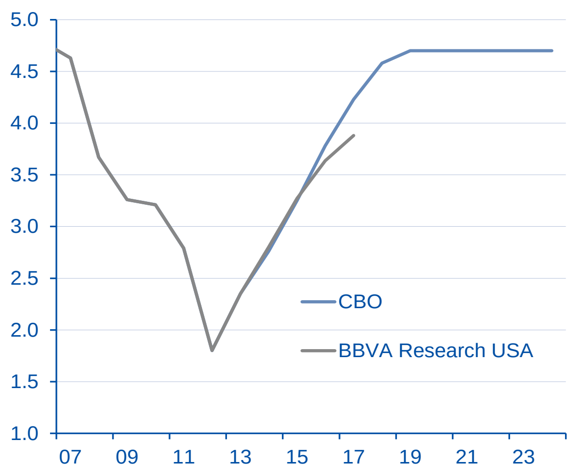
Source: CBO & BBVA Research

Chart 7
CPI Inflation, Annual % Change



Source: CBO & BBVA Research

Chart 8
10-Year Treasury Note, Annual Average %



Source: CBO & BBVA Research

Bottom Line

Throughout the past few years, the CBO's updated budget projections have reflected significant policy uncertainty as the debt ceiling and fiscal cliff debates wreaked havoc in Congress. However, the latest report suggests a calmer picture for the fiscal situation. The fact that Congress agreed to a two-year budget plan back in December 2013 has helped provide some stability to the CBO's budget projections in the short-term. On the downside, the economic outlook has deteriorated slightly over the past year and could hinder fiscal improvements in the longer-run. Ultimately, we are encouraged by the short-term improvements in the budget outlook but remain wary of a still-vulnerable economic recovery throughout the next few years.

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