Gramm-Rudmanizing the Economy

F. Thomas Juster
Director, Institute for Social Research
and Professor of Economics
The University of Michigan

Introduction

The economic policy legislation recently passed by the Congress and signed by the president, known as Gramm-Rudman-Hollings or more popularly Gramm-Rudman, is in principle one of the most far-reaching pieces of economic policy legislation ever enacted. It is also one of the most controversial, and has been roundly condemned by most economic policy-makers with academic credentials. It also appears to be widely regarded as bad legislation even by many of those who voted for it, who are essentially saying that while it is a bad piece of legislation it's better than the alternatives.

How Does Gramm-Rudman Work?

To understand the objections of many policy-makers to a piece of legislation like Gramm-Rudman, all one has to do is look at the process that the legislation calls for, and at the possible outcomes. Basically, the act says that federal government deficits must be reduced from their present level (estimated as roughly $190-$200 billion when the legislation was enacted) to zero over a five-year period. Thus deficits must be reduced by $36 billion annually over the next five years, going from $180 this fiscal year to $144 to $108 .... (During the first year to which Gramm-Rudman applies, FY 86, there is some slippage in that numerical calculation, but the general principle is as stated).

How is this to be accomplished? The first step, covering only part of the current fiscal year, has just been announced and involves cutting some $11.7 billion. It is being widely reported in the press as involving little hardship—just a few inconveniences here and there. But next year's problem will be different—and predictably much larger.

For future years, the president as usual will propose a budget to the Congress in late winter. The Congressional budget committees will then undertake the usual assessment of the president's budget proposal, modifying it to suit the preferences of the House and the Senate. At some point a conference committee will emerge with a budget that is agreeable to both House and Senate, and the president can either sign that budget or not. If the president signs a Congressionally-agreed budget, that document goes to the implementors of Gramm-Rudman to insure that it meets the law's requirements. If the deficit contained in the agreed budget does so, in the judgment of the implementors—the administration's Office of Management and Budget (OMB) and the Congress's Congressional Budget Office (CBO), as overseen by the General Accounting Office (GAO)—then it is enacted into law.

But if the deficit, as estimated by the tripartite Board of Overseers, is too large for Gramm-Rudman's requirements, then there is a complicated set of rules for deciding which expenditures are to be cut, and by how much. The rules exclude significant elements of the budget from being cut by way of Gramm-Rudman—Social Security, many other entitlement programs, some military programs—but everything else is more or less fair game. What the Board of Overseers does is simply to calculate how much must be cut to meet the Gramm-Rudman requirements, exclude the parts of the budget that are safeguarded from cutting, and then proceed to administer a "sequester" rule—if $15 billion must be cut and the eligible budget items total $450 billion, 3 percent must be cut from each of several thousand account numbers that govern federal government expenditures.

What happens if the president and the Congress cannot agree on a budget—that is, if either the two houses of Congress cannot agree on a conference committee budget that both houses will pass, or if the president will not sign a conference committee budget and the House and the Senate cannot override the president's veto? In that case the House and the Senate will presumably pass some kind of continuing resolution, which will authorize expenditures at their current levels or with some adjustment to current levels. That budget will then be Gramm-Rudmanized—the tripartite commission of OMB, CBO, and GAO will assess the deficit that is implied by the continuing resolution, exclude the parts of the budget that cannot be Gramm-Rudmanized, and do their thing on the parts that can.

How does the tripartite Board of Overseers work? The OMB obviously represents the president and the administration's position, the CBO represents the Congress's position, and the GAO is the referee. OMB and CBO each have to produce an estimate of what the deficit will be, given a set of laws that govern expenditures (either entitlements that can be drawn on by the entitlees, or discretionary outlays that are included in the current law), plus an estimate of tax revenue based on some set of assumptions about how the economy will perform during the next fiscal year. Estimates of both expenditures and revenue are to some extent judgments rather than facts—some people who are entitled to program support don't claim it, and tax revenues are clearly a function of a variety of economic activity variables. Thus the CBO and OMB estimates of the budget might well disagree. In that event, it is up to GAO to decide what shall be the operational deficit number before expenditures get Gramm-Rudmanized. The presumption is that GAO will split the difference between OMB and CBO estimates, although they don't have to.

What happens if the assumptions underlying either expenditure or revenue estimates are not realized during the fiscal year, as is almost bound to be true generally and looks to be likely during the current fiscal year? In that case, any shortfall in the Gramm-Rudman targets that occurs because expenditures or revenues or both are different from the GAO estimate will simply be added to (or subtracted from) the next year's target. That is, if expenditures are $10 billion more than expected and revenues are $10 billion less than expected, and thus the deficit is $20 billion higher than permitted by Gramm-Rudman, the next year's deficit reduction target will have to be $56 billion rather than $36 billion. And vice versa if the expenditure and revenue numbers are reversed—it will only have to be $16 billion lower. In the current situation, the estimated FY 86 deficit numbers have been growing steadily, and the $11.7 billion in cuts just announced will almost certainly not reach the Gramm-Rudman targets at the end of this fiscal year. Hence, next year's decline in deficit will have to be larger than $36 billion—possibly quite a lot larger.

Are there any safety valves in Gramm-Rudman? Yes there are—two. If the economy is determined to be in recession during the prospective fiscal year (or is forecasted to be in recession), then Gramm-Rudman is off. Of course, the $36 billion of deficit reduction that was forestalled because the economy was, or was forecast to be, in recession will have to be added to the following year's Gramm-Rudman target, which will then become a $72 billion reduction in deficit. Second, Gramm-Rudman is off if there is a war. As one senator is reported to have remarked in committee, "Is it OK if we declare war generally, or do we have to declare war on somebody?" It is unclear whether the spirit of Gramm-Rudman would be violated if the U.S. and, say, Iceland produced a mutual assistance pact which enabled either to declare war on the other without prior notice and without malice!

Does Gramm-Rudman put political pressure on either the president or the Congress to compromise their budget differences, or to dig in their heels? It's hard to tell. The president, who favors growth in military outlays and is adamantly opposed to a tax increase, may either have to acquiesce in a tax increase or face the likelihood that his defense budget will be Gramm-Rudmanized. The Congress, who would prefer to maintain social programs and other discretionary outlays at what they see as tolerable levels and are obviously reluctant to take the lead in suggesting a tax increase, may have to either face up to a tax increase or see the possibility that many of the social programs deemed most important will be Gramm-Rudmanized. Thus the president and the Congress have some incentive to agree on mutually acceptable levels of defense and non-defense outlays, since otherwise both get Gramm-Rudmanized and in roughly equal proportions. But, of course, if they could agree on some mutually acceptable compromise, there wouldn't have been any Gramm-Rudman bill in the first place. Or if they could agree that tax increases had to be part of any deficit reduction package, there also wouldn't have been any need for Gramm-Rudman.

Can Gramm-Rudman produce a recession all by itself? Technically, the answer is no. What happens is that OMB and CBO produce a deficit forecast based on the assumption that either expenditures or taxes or both will be adjusted to fit the stipulations of Gramm-Rudman. Hence if the economy were relatively weak before the application of Gramm-Rudman, reducing fiscal stimulus either by cutting expenditures or raising taxes or both might well produce a forecast of recession. But that forecast, if it was agreed to by the GAO arbiter, would eliminate the requirement for Gramm-Rudman in that particular year.

But that relatively benign scenario may not be a good description of what actually happens. Suppose GAO assesses the growth rate of the economy as 2.0 percent, given the cuts stipulated by Gramm-Rudman, and the cuts are made. The first quarter data come in and the growth rate is –0.2 percent. That's not a recession, although it's not very good. The next quarter comes in and the growth rate is –1.2 percent—but the previous quarter is revised from –0.2 percent to +0.1 percent. Is that a recession? Not by the "two consecutive quarters of negative growth" rule. The third quarter arrives at –2.0 percent. We are now clearly in recession, unemployment would have been rising for the past 5 or 6 months, and the year is three-fourths complete. The Gramm-Rudman cuts can be stopped, but the damage has long since been done and will predictably continue for awhile.

Forecasts that are contingent on specified cuts in spending or increases in taxes or both depend on how one assesses the combined effect of reduced fiscal stimulus and the presumably easier monetary policy that would accompany it. After all, lower deficits have some automatic offset, given the same monetary policy stance, in the form of less borrowing and therefore lower interest rates. And of course a smaller deficit is likely to have some impact on the trade balance, the value of the dollar, etc., leading to further complications in producing a reliable Gramm-Rudman forecast. But forecasts are always uncertain, and it is important to keep in mind that any forestalling of Gramm-Rudman in 198x just makes the problem twice as large in 198x + 1!

The Impact of Gramm-Rudman

What's basically wrong with Gramm-Rudman? The difficulty is that it signals a breakdown of the economic policy formulation process, transfers important decisions about national priorities to a computer (represented by the GAO's determination of the percentage cutback to be applied to each of the eligible expenditure categories), creates adverse incentives for the managers of public programs, and effectively assumes that there is no important impact of fiscal policy on macroeconomic activity.

Breakdown of the Policy Process. Budget decisions in any democratic society are political decisions, and are reflective of national priorities. Prior to Gramm-Rudman, the administration and the Congress had to find a way to reconcile their different perceptions of priorities, or to live with the political consequences if they could not come to agreement. Under Gramm-Rudman, political posturing is rewarded and responsible compromise is (probably) penalized.

Decision Making by Computer. Under normal circumstances, there is a slow but perceptible response of policy-makers to changing circumstances that dictate changes in emphasis of different types of public programs—defense vs. social programs, research and development vs. current services, health vs. education and training, jails vs. highways, etc. If the differences in priorities that have plagued the past several years of budget discussions cannot be reconciled, everything gets cut proportionately by way of the sequesters applied to eligible programs—fat along with muscle, wasteful programs along with efficient programs, etc. This process is not a tribute to rational decision-making.

Management Incentives. Under normal circumstances, public as well as private managers provide policy-makers with assessments of what can be accomplished with various levels of budgetary support. It is predictable that managers who can accomplish more with the same resources than those who are less effective will be greeted with enthusiasm by agency heads for their efforts at achieving economies—but such managers will then find their programs Gramm-Rudmanized to exactly the same degree as the inefficient. Once that happens, everybody has incentives to pad their budget requests and to exaggerate the dire consequences of not meeting their requests.

Fiscal Policy Impact. Gramm-Rudman effectively specifies that the fiscal tightening implied by gradual reduction in the size of the deficit is entirely independent of the level of aggregate economic activity, excepting the loophole provision that Gramm-Rudman is inoperative when a recession is in process or is forecast. Thus it calls for the same reduction in fiscal stimulus whether the economy is in a growth recession, with real growth rates in the 2 percent zone, or whether the economy is booming, with real growth rates in the 5 percent zone. Of course the aggregate economic impact of the Gramm-Rudman cuts can be offset, at least in principle, by other macro-economic policies: hence it is hard to forecast exactly how much impact on real growth rate would actually be felt by comparing the Gramm-Rudman budget process with the results of some other budget process.

An Overall Assessment

Given that there is so little genuine enthusiam for Gramm-Rudman, certainly among academic economists and even among many of its supporters, how did it become current policy? The answer seems clear enough: Gramm-Rudman has been agreed to by a majority of the Congress and approved by the administration because, unappetizing as it may be, it is judged better than the budget process that it replaces or supplements.

Why did the budget process break down? Political partisans would provide different responses. The Democrats would presumably say that Gramm-Rudman is the simple consequence of an ideologically rigid president refusing to recognize that the original vision of supply-side economics is a demonstrable failure. After all, they would say, the president promised that he could rebuild defense, maintain Social Security, cut taxes, and balance the budget. His critics pointed out (including the current vice-president, who coined the term "Voodoo Economics") that it couldn't be done except with mirrors. On the evidence, the critics were right.

On the other side, administration partisans would argue that the real problem is that Congressional Democrats refuse to recognize that non-defense programs are not worth what they cost in terms of social gain versus social cost, that there is enough waste and profligacy in these areas to balance the budget if only the Democrats would cooperate, and that the deficit problem facing the society results from a stubborn Congressional refusal to go along with the president's program.

Be that as it may, there seems to be overwhelming consensus that whatever the causes of the present roughly \$200-billion-per-year deficit, they are having consequences for the future of the American economy and society that simply cannot be tolerated, and some way must be found to get the deficit under control. Since the normal process of political bargaining isn't working, some other process must be put in place that forces the outcome, even if it involves significant costs in terms of adverse side effects.

So far as this writer is concerned, the real culprit which has undermined the normal budgetary process, and which is therefore responsible for Gramm-Rudman, is the ideological position taken by the administration on taxes. Given the arithmetic of the total budget, there is simply no way that the deficit can be eliminated without a tax increase of significant proportions, or what is the equivalent, closing a significant number of tax loopholes.

A few relevant facts about federal government expenditures and receipts shows why virtually all serious budget analysts, of whatever political persuasion, have concluded that the deficit problem cannot be solved without a tax increase of some kind. Over the last three years, since mid-1982:

- Federal Government expenditures have grown by \$238 billion, receipts by roughly \$150 billion, and the deficit by about \$88 billion—to its present level of \$201 billion.
- Almost 80 percent of the spending increase—over \$180 billion of the \$238 billion—has come from three categories that the administration has declared off limits to budget cuts—roughly \$80 billion in defense, \$60 billion in Social Security, and almost \$45 billion in interest on the (rapidly growing) national debt.
- All other expenditures of the federal government, leaving out defense, Social Security, and interest on the debt, come to \$338 billion at present, have been roughly constant in real terms since mid-1982, and are mainly transfer payments to states and local governments and reimbursements under medicare and medicaid—items that have been strongly defended against further cuts by the Democratic House.
- The major discretionary item in the federal budget that has not either been declared off-limits by the administration or is not an entitlement program is nondefense purchases of goods and services—expenditures for items like highways, the criminal justice system, farm price supports, research and development, student loans, housing programs, airports and air traffic control systems, the Congress, the White House, etc.—and amounts to a little over \$80 billion in total at present.

The numbers thus say that *either* we cut one of the off-limits programs, cut sharply into entitlements like medicare and medicaid, or face the simple fact that \$200 billion in budget cuts cannot be obtained from \$80 billion of discretionary outlays.

And finally, there is simply no credible evidence that we can "grow ourselves out of the deficit," as the supply-siders originally argued and as some continue to believe. Supply-side tax cuts did not increase tax revenues—they reduced them, and substantially.

If all that's true, tax increases must be brought into the picture, or else some other current untouchable—defense, Social Security, poverty entitlements—has to be reconsidered. But the politics of the 1984 election make tax increases an unpalatable budget choice, both for the president and the Congress. The president has made taxes his "make my day" issue—while the Congressional Democrats are not going to be found out in front on a tax increase given the political pummeling they received on that issue in the 1984 election. Perhaps Gramm-Rudman will force the tax issue, since it is likely to be a socially less damaging alternative than many of the others that will have to be faced by the budget protagonists this year and next.

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1986 Prospects for Consumer Demand: Diminished But Still Favorable

Richard T. Curtin
Survey Research Center
The University of Michigan

The most recent Survey of Consumers indicates a declining overall trend in consumer sentiment. The Index of Consumer Sentiment was 92.8 in the third quarter 1985 survey, down from 98.9 one year earlier (see the chart below).* Nonetheless, this was the tenth consecutive quarter with an Index figure in the 90s, the longest and highest sustained period of consumer optimism recorded since the 1960s.

The small overall decline recorded during the past year was widespread among all major population groups, defined by age, income, and region. The decline was not, however, shared equally by the several measures of attitudes and expectations. Consumers' views of their current financial situation and buying conditions remained at very favorable levels, while their evaluations of prospects for the domestic economy during the year ahead have declined to a significant extent.

Slower Economic Growth Limits Job Prospects

During the past two years there has been a sharp decline in the proportion of consumers that expected continued improvement in the national economy. In the third quarter 1985 survey, 25 percent of all families expected the economy to improve, down from 33 percent one year earlier, and the all-time peak of 52 percent in the second quarter of 1983. This sharp fall in favorable expectations, however, was not mirrored by a comparably sharp rise in unfavorable expectations. A worsening economy was expected by only 15 percent of all families in the third quarter 1985 survey. Most of the shift in opinion during the past two years has been towards the expectation that the performance of the national economy would remain unchanged during the year ahead, rising to 57 percent in the third quarter of 1985, from 39 percent two years earlier.

Because slower growth but no recession is expected, consumers view the economic outlook in somewhat dulled but nonetheless favorable terms. Among all families in the third quarter survey, 55 percent expected good times financially in the economy as a whole during the year ahead, not far below the 63 percent recorded one year earlier. Although the third quarter 1985 reading is the lowest level recorded during the past two years, it remains as favorable as the late 1970s peak. Overall, consumers' views suggest that economic conditions will be somewhat worse next year, but that they will still be good, on balance.

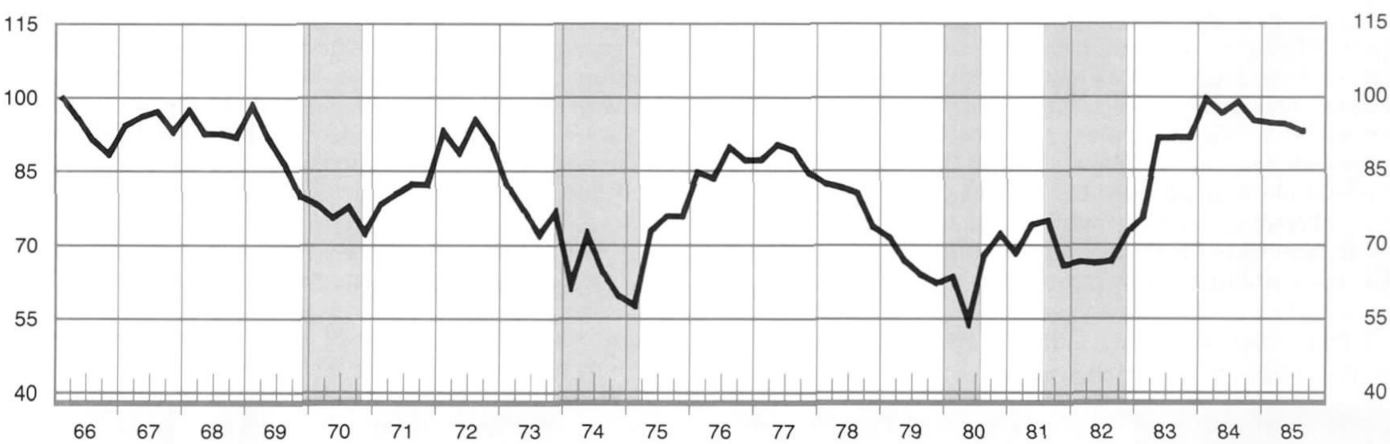
The major factor underlying the maintenance of favorable assessments of the economy has been the sustained declines in inflation. In the third quarter 1985 survey, consumers expected the annual rate of inflation to average 4.2% during the year ahead, the lowest level to be recorded in more than a decade. At their third quarter level, inflation expectations are approximately one-third of their 1980 peak.

The primary concern expressed by consumers about the outlook for continued slow economic growth involves limited job prospects. The proportion of families that expected the national unemployment rate to decline during the year ahead fell to just 15 percent in the third quarter 1985 survey, half the proportion that expected increases. That only small changes in the unemployment rate were foreseen is supported by the majority expectation (54 percent) that the unemployment rate would remain largely unchanged at its current level during the year ahead.

*The Index declined further, to 91.1, in the fourth quarter 1985 survey, which the author will discuss in the next issue.

INDEX OF CONSUMER SENTIMENT

February 1966 = 100



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

Confidence in government economic policies to control inflation and unemployment remained near record high levels in the recent survey. Apparently, the sustained declines in inflation have thus far offset the rising concern with unemployment in terms of policy evaluations. Nonetheless, consumers continue to view unemployment, rather than inflation, as the more serious problem facing the nation.

Interest rate expectations have remained unchanged since the start of 1985, at improved levels compared with mid-1984. Interest rate increases during the year ahead were expected by 40 percent of all families in the third quarter of 1985, down from 55 percent one year earlier. The majority (58 percent) now expect interest rates to remain at their current level or to decline during the year ahead.

Personal Finances Remain Favorable Despite Slower Income Growth

The financial situation of American families has remained favorable in the most recent survey, although the pace of financial improvement has slowed since the start of 1985. An improved financial situation was reported by 42 percent of all families in the third quarter 1985 survey, just below the cyclical peak of 45 percent recorded one year earlier. Even after this small decline, evaluations of personal financial progress have remained more favorable during the past two years than at any other time during the prior 10 years.

The major factor behind the substantial improvement recorded during the past few years has been sustained declines in inflation. When asked to explain how their financial situation had improved or worsened, just 14 percent of all families in the third quarter 1985 survey mentioned that rising prices had eroded living standards, less than one-third of the peak level recorded five years earlier. Twice as many families reported income increases as reported declines in the third quarter 1985 survey (32 versus 15 percent), a somewhat smaller margin than recorded a year ago (36 versus 13 percent). It was this moderation in the growth of income that was responsible for the small decline in overall evaluations.

When asked about prospects for their financial situation during the year ahead, consumers continued to hold a positive outlook in the most recent survey. In the third quarter of 1985, 35 percent of all families expected their financial situation to improve, not far below the cyclical peak of 41 percent recorded at the start of 1984. The small decline in financial prospects can be traced to less favorable income expectations. Among all families in the third quarter 1985 survey, 56 percent expected income increases, down from 64 percent one year earlier. Because inflation expectations have declined to a greater extent than income expectations, real income expectations have risen and have maintained favorable financial expectations. That consumers expect slow real income growth rather than declines during the year ahead is indicated by the few families that expected overall reversals in their financial situation. Just 12 percent of all families in the third quarter 1985 survey expected their financial situation to worsen during the year ahead.

Consumers Remain Willing to Use Credit Amid Rising Indebtedness

The continuation of favorable personal financial prospects, coupled with declines in interest rates, has maintained consumers' willingness to use accumulated savings and to incur new debt in order to make major purchases. Among all families in the third quarter survey, 36 percent reported their willingness to use savings, just below the 40 percent cyclical peak recorded one year earlier. Willingness to incur new debt was reported by 29 percent of all families in the third quarter 1985 survey, the highest level during the past five years.

Consumers incurred debt at a much faster pace during the past year, but the overall level of debt incurrence has thus far remained below the levels recorded in the late 1970s. The ratio of net increases in mortgage debt to personal disposable income was 5.2% in 1984, well below the 1978 peak of 7.5%. In contrast, the net increase in installment and other consumer credit as a proportion of disposable income was 3.7% in 1984, above the 1978 peak of 3.3%. In the first half of 1985, net increases in consumer credit continued to rise, reaching 4.5% of income in the second quarter. Given the high level of vehicle sales in the third quarter, the primary component of installment debt, this ratio can be expected to establish a new record level for the year 1985 as a whole.

Do these elevated levels of debt imply that consumers are overextended? The total outstanding amount of home mortgage, installment, and other consumer debts was 1.9 trillion dollars at year-end 1984. The household sector held $1.31 in savings deposits for each dollar in mortgage and consumer debt at year-end 1984, substantially above the low of $1.18 recorded in 1979. When all deposits, bonds, and equities are summed, representing a less liquid pool of financial assets, they amounted to $2.54 for each dollar of mortgage and consumer debt. When all financial assets are compared with all financial liabilities, households held $3.04 in assets for each dollar in debt. Although these ratios had only fallen slightly by year-end 1984, based on the first half of 1985, the estimated ratio of savings deposits to mortgage and consumer debt fell to $1.24, at annual rates, a level comparable to the late 1970s.

Given the lower growth rates expected in both wages and prices, consumers can no longer look toward inflationary increases in incomes to ease the burden of high repayment amounts. Rather than reacting by lowering the amount borrowed, consumers have focused more attention on lengthening the repayment period, so as to accommodate the higher amounts borrowed within their budgets.

The average transaction price for a new car, as well as the amount financed, has approximately tripled from 1972 to 1984. During this time period median household income did not rise as much. As a consequence, the ratio of transaction prices to income rose from 35% to 43%, and the ratio of amount financed to income rose from 28% to 36%. But because the average maturity of vehicle loans has also increased, the payment amount as a proportion of income has not shown any significant increase. From 1972 to 1984, the repayment ratio has remained between 11% and 12%, with only small variations.

Buying Attitudes Reach New Peaks as Discounts Become The Norm

Favorable attitudes toward buying conditions reached new all-time record levels during 1985 for each of the major types of discretionary purchases studied: purchases of homes, vehicles, and large household durables. It was in the spring of 1983 that buying attitudes first reached record favorable levels. Following small declines in the balance of 1983, attitudes toward buying conditions rebounded to peak levels by the spring of 1984. Small declines were again recorded in the second half of 1984, only to once more rebound to peak levels in 1985. The major reason for this pattern of surges followed by declines has been changes in the availability of discounted prices and reduced interest rates.

These trends indicate important shifts in how consumers evaluate market conditions. The cyclical peaks recorded in the 1970s were driven by an inflationary psychology, which created incentives to purchase in advance of the then escalating inflation rates. At the present time, very few consumers cite the advantage of buying in advance of rising prices. In contrast, the current recovery has been built on the widespread appeal of price discounts. It is now the positive appeal of discounted prices, not the negative pressures to act before further increases, that determines consumer reactions to prices. Rather than inflation, higher and more variable interest rates now represent the primary source of uncertainty about future buying conditions. Consumers have thus come to view interest rate trends as the most important factor in the timing of their purchases.

As a result of these changes in consumer attitudes, the availability of price and interest rate discounts has become the expected norm. And the presence or absence of these incentives will shape future trends in buying attitudes.

Household Durables. In the third quarter 1985 survey, 72 percent of all families held favorable attitudes toward buying conditions for large household durables. This is just below the all-time peak of 74 percent recorded in each of the two previous quarters. The maintenance of buying attitudes at these very favorable levels has been due to favorable perceptions of current prices for durables. Among all families in the third quarter 1985 survey, 38 percent mentioned the availability of price discounts on household durables, just below the all-time record of 41 percent recorded at the start of 1985. Just 12 percent of all families complained about high prices in the third quarter 1985 survey. On balance, these trends represent the most favorable perceptions of market prices for large household durables since the 1960s.

Homes. In the third quarter 1985 survey, the proportion of families that held favorable attitudes toward buying conditions for homes set a new all-time record, rising to 71 percent, reversing the small decline recorded in the second half of 1984, as shown in the chart on p. 93.

The reasons underlying these very favorable home-buying attitudes are quite different from those of the past. Whereas in the late 1970s consumers evaluated buying conditions in terms of expected future prices, consumers now hold favorable perceptions of home prices. At the 1977 peak, 46 percent supported their favorable views by referring to the advantages of buying in advance of rising home prices. In the most recent survey, just 6 percent gave buy-in-advance price rationales. At the 1977 peak, four times as many families complained about high home prices as mentioned the availability of reduced home prices (22 versus 4 percent). At the 1985 peak, in contrast, twice as many families mentioned the availability of reduced home prices as complained that prices were too high and cause for postponement (24 versus 12 percent). Throughout the past two years, favorable references to current home prices have outnumbered unfavorable references, a trend not seen since the 1960s.

In addition to shifting price perceptions, the current recovery in attitudes is distinctive in its reliance on interest rate trends. In the third quarter 1985 survey, 57 percent of all families cited trends in mortgage interest rates in support of their favorable assessments. At the 1977 peak, in comparison, just 12 percent of all families favorably mentioned interest rates when asked to explain their views. During the past year, the reasons underlying these favorable references to mortgage interest rates have shifted from the appeal of borrowing in advance of expected increases to the current availability of lower rates. In the third quarter 1985 survey, 52 percent of all families mentioned the current availability of reduced mortgage interest rates, up from 22 percent one year earlier. References to the advantages of borrowing in advance of future increases in mortgage rates fell to 5 percent in the third quarter of 1985 from a peak of 20 percent one year earlier.

Vehicles. In the third quarter 1985 survey, favorable attitudes toward buying conditions for cars were unchanged at the all-time record level first established in the second quarter (see the chart on p. 93). Among all families, 67 percent held favorable vehicle-buying attitudes in the third quarter of 1985, which completely offset the small decline recorded in late 1984. The recent improvement was due to the increased availability of reduced interest rates on vehicle loans, mentioned by 38 percent in the third quarter of 1985, three times its year-earlier level.

Summary Outlook

How to summarize these various findings? Recent trends in consumer attitudes and expectations have exhibited many of the characteristics of the later stages of expansion. The overall level of consumer confidence remains high, with partially offsetting changes limiting the amount of the overall decline. Lower interest rates and favorable perceptions of market prices have maintained buying attitudes at record favorable levels. Although consumers expect slow economic growth during the year ahead, they expect it to be accompanied by low rates of inflation and lead to only small increases in the unemployment rate. This outlook for slow but sustained growth, given the economic turbulence of past years, has supported the view among consumers that good times financially will continue in the country as a whole.

Since the upward momentum in consumer sentiment has now been exhausted, these results point toward diminished but still favorable prospects for consumer demand in 1986. The strongest aspects of consumer sentiment—personal finances and buying attitudes—have resulted from low inflation and widespread discounting. The weakest aspects involve lowered prospects for income and employment. The pace of real income growth during the year ahead will thus play a pivotal role. Increases in consumer spending are not likely to outpace growth in incomes, indicating a rising saving rate. But the decline in sales rates, while small on an annual basis, is not likely to follow an even pace. The response of consumers to the recent interest rate reductions has demonstrated not only their willingness to spend, but also their resolve to wait for discounts on prices and interest rates. Gone are the days when consumers felt pressured to act by ever-escalating prices. Today, consumers are more willing to engage in comparative price shopping and expect to be enticed by discounts on prices as well as interest rates. Rather than the consumer scrambling to keep up with price increases, now sellers must scramble to keep up with the more demanding consumer.

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The 1986 Economy

Paul W. McCracken
Edmund Ezra Day Distinguished Professor of Business Administration
The University of Michigan

Whether 1986 produces a 4 percent growth for the economy, as the administration projects, or something in the 3 percent zone, which seems to be about the median expectation of private prognosticators, will depend crucially on three inter-related matters. One is whether 1986 will see further declines in interest rates. The second is whether the year will see a significant strengthening of our external trade. And the third, and one which we must not ignore, is whether the price level will continue to behave. A moderate degree of optimism seems justified about all three.

Interest Rate Trends

There is, of course, the potential also for further domestic gains in the demand for output. Interest rates are already down and ought to move somewhat lower. The gap between current market rates and the rate of inflation still leaves a real interest rate of roughly 5 percent. In the two decades from 1950 to 1970 the real interest rate (measured as the difference between the yield on 10-year Treasury obligations and the rise in the consumer price index) averaged just over 2 percent. During the 1970s it was just under 1 percent, but this represented the usual tardiness of interest rates to adjust to accelerating inflation. While market interest rates also adjust tardily as inflation recedes, the expectation that inflation will remain in the 4 percent zone through the year suggests that there is room for market rates to move still lower as they establish real rates more in line with our history.

Moreover, Treasury financing requirements will be headed moderately lower as Gramm-Rudman begins to influence events. No one would pretend that this legislation represents an elegant or even orderly process of budgetry. There will be cuts made that should not occur, because politically they are easy, and cuts that should occur but do not, because they are politically sensitive. And in the end some additional revenue will probably be required for projected deficits to be reasonably in line with the legislation's targets. When the dust has settled, however, the management of the budget will have been nudged in the direction of greater fiscal discipline and smaller budget deficits. If so one of the pressures on U.S. credit markets will be headed toward some easing, with favorable (downward) effects on interest rates.

Monetary policy also has been accommodative in recent months, and this, at least for 1986, should make its contribution to economic expansion. While the economy seems to respond less predictably to changes in the money stock than was true in the 1960s and 1970s, no one would suggest that what is happening to the money supply is irrelevant to the economic outlook. And what is happening to the money stock (at least short-run) has to be put on the positive side. The conventional measure (M-1) rose during 1985 at a 14 percent rate, and the pace of this monetary expansion was quite steady except for a flat spot in October.

Lower interest rates should have favorably diffused effects across the economy, but these should be particularly evident in the capital budgets of businesses and in housing. Businesses seem to be moving their hurdle rates (the minimum target rate of return on new projects) downward as market interest rates move to lower levels. And this should broaden the base of projects that businesses will now consider.

The response of businesses to more favorable credit markets must, however, be expected to be cautious. Profits of many industrial companies have been under pressure, particularly those in heavy industry, and the near-term outlook remains murky. Moreover, businesses face significant uncertainties about tax legislation, and uncertainty is never conducive to bold capital budgets.

Housing also has traditionally been sensitive to interest rates, and that should augur well as these rates move downward further. There is, however, some evidence that the response this time may be moderate by historical standards. Mortgage yields have already moved downward about 400 basis points from the high levels of 1982. Housing starts responded strongly for about a year, but since mid-1984 starts have remained essentially flat at roughly a 1.7 million per year rate. There should, however, be some further response to more attractive financing terms. The number of households is enlarging at roughly a 1.5 million per year pace. With even conservative assumptions about replacement of dwelling units demolished, in the wrong location, or otherwise removed from use, this means a basic market well above current levels of residential construction.

Trade Balance Trends

The most promising feature about the 1986 outlook is the possibility that at least by the latter half of 1986 our external trade will begin to turn in a more favorable direction. The ball-and-chain constituting a major drag on the current expansion has been, of course, the sharp deterioration in our foreign trade during the 1980s. During 1984, for example, the domestic demand for goods and services rose 6.2 percent, but domestic output rose only 4.7 percent. The impact of this has been particularly severe on manufacturing and agriculture. As we moved into this decade, U.S. exports of manufactured goods exceeded imports of these products by a modest amount. In the three-year 1978-80 period, for example, our net exports of manufactured goods were \$6 billion. By 1985 this had turned to a negative figure close to \$100 billion. And exports of farm products, in real terms, were 17 percent below the volume in 1978-80 (see Table 1).

The problem, of course, was caused by the 45 percent rise in the effective trade-weighted exchange rate of the dollar after 1980. Price tags denominated in D-marks or yen then looked quite attractive to Americans, but Germans and Japanese (and others) found that price tags denominated in U.S. dollars would cost a lot of their money.

The decline in the trade-weighted exchange rate of the dollar from its peak almost a year ago has probably set the stage for the beginning in 1986 of a significant turn-around in our external trade. And the September intervention in the foreign exchange markets did have the favorable effect of

TABLE 1. Measures of U.S. External Trade Position (dollar amounts in billions)

Year	Balance on Cur. Acct.	Balance on Mdse. Trade	Net Exports, Mfg. Goods	Exports, Ag. Prod.
1978	$-15.4	$- 33.9	$-5.8	$29.9
1979	- 1.0	- 27.5	4.4	35.6
1980	1.9	- 25.5	19.2	42.2
1981	6.3	- 28.0	12.0	44.0
1982	- 8.1	- 36.4	4.8	37.2
1983	-40.8	- 62.0	-31.2	36.1
1984	-101.5	-108.3	-79.2	37.8
1985*	-125.0	-130.0	-97.0	30.0

Source: Basic data, U.S. Department of Commerce
*Preliminary estimates based on incomplete data.

persuading many corporate executives that the administration was attempting to deal with the forces producing the trade imbalances rather than with the results. There is, of course, skepticism about whether our trade will show a substantial favorable response, and how soon. The dollar's exchange rate is still 10-15 percent too high. Companies forced to go off-shore for production will not now padlock those facilities and come back home. Lost markets are not quickly regained. History, however, is reassuring here. There have been other episodes when skepticism has been pervasive about whether economies would respond favorably to changed market conditions—but subsequently they did. By the latter part of this year, we can reasonably expect to see this once again.

Price Level Trends

As for the price level, the prognosis continues to be reassuring. It is true that the rate of inflation seems to have stabilized at about the 4 percent level, rather than the 2 percent more consistent with our history (see Table 2). And the declining import prices that have influenced favorably the domestic price level will not play their helpful role in 1986. Evenso the price level ought to remain reasonably quiescent in 1986. Labor costs per unit of output are still rising at about 4 percent per year, and this establishes the basic path for the price level. Moreover, wage and benefit decisions have continued to be negotiated in the 3-4 percent range.

The Outlook

Will these forces produce a 4 percent increase in our output of goods and services from 1985 to 1986? This is within the range of what is possible but well toward the upper end of the range. There is, as it were, a problem of geometry here. Since the rate of growth *during* 1985 was below 3 percent, an increase of 4 percent *during* 1986 would yield an increase of about 3½ percent in real GNP from the year 1985 to the year 1986. For this year-to-year increase to be 4 percent, the pace of expansion *during* 1986 would need to be about 5 percent. And more than half of that gain would probably have to be achieved in the second half of the year since the economy moves into 1986 at a sluggish pace. This is not impossible. These rates of growth have been achieved before. The target is, however, ambitious.

TABLE 2. Percent Change In Prices

Year	GNP	Imports	Exports
1981	9.3%	5.4%	8.0%
1982	6.3	-1.5	2.3
1983	4.1	-3.0	1.5
1984	4.2	0.6	4.7
1985*	3.5	-2.0	—

Source: Basic data from the U.S. Department of Commerce. Computed from fixed-weighted indexes.
*Estimated using incomplete data.

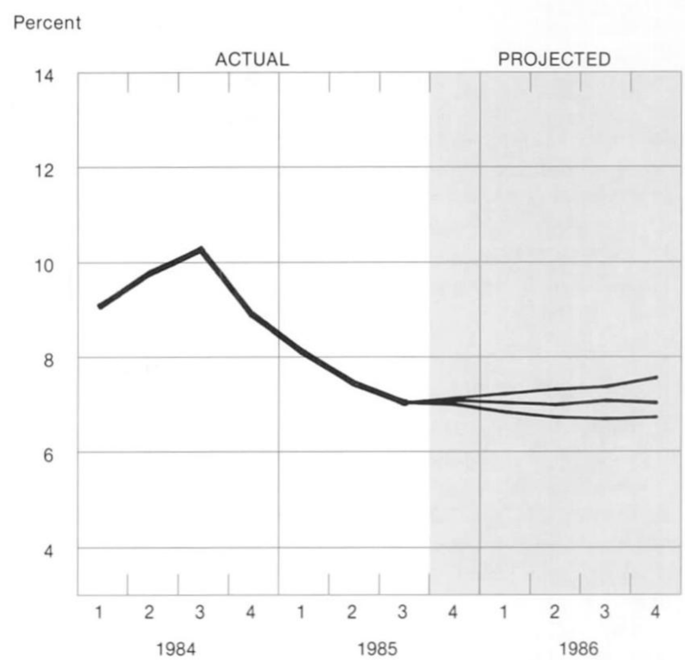
Two final quick comments. Beyond the usual policy problems of managing fiscal and monetary affairs, strengthening confidence in the price-level outlook, and expanding employment—which themselves can keep Parliaments, presidents, prime ministers, and their finance and economics ministers fully employed—two other matters must be kept in sharp focus.

1. There is still a debt or credit problem—international, agricultural, and in oil production areas. Depressions, in contrast to recessions, have usually been associated with serious financial disorder (e.g., the 1930s or 1907). The best way to avoid this is to be prepared to act decisively.

2. More explicit attention must be given to international economic policy. Washington must do a better job making it clear to the business community that it has a well-developed broad-spectrum policy. Frontal resistance to demands for trade protection are in order, but only part of a policy. There must also be policies to deal with the distortions and imbalances that produce these pressures for protection.

January 1986

3-MONTH TREASURY BILL RATE



Sources: Actual data are from U.S. Department of Commerce; projected data are from ASA-NBER Panel of Forecasters, revised when necessary to be consistent with latest actual data. The 3 lines display 3rd, 2nd (median), and 1st quartile values from the array of forecasts.

Actual and Projected Economic Indicators

seasonally adjusted

SERIES FORECAST BY THE ASA-NBER PANEL

ECONOMIC INDICATOR	Quarterly Data												Annual Data		
	Actual							Projected					Act'l.	Projected	
	84:1	84:2	84:3	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1984	1985	1986
GROSS NATIONAL PRODUCT	3,553	3,645	3,695	3,759	3,811	3,853	3,916	3,981	4,041	4,013	4,177	4,252	3,663	3,891	4,142
GNP IMPLICIT PRICE DEFLATOR (index, 1972 = 100)	220.6	222.4	224.6	226.1	229.1	230.5	231.9	234.0	236.3	238.1	240.5	243.3	233.4	231.6	239.5
CORPORATE PROFITS AFTER TAXES	150.6	150.2	141.7	141.0	137.0	137.4	144.7	142.0	144.5	146.4	150.0	153.0	145.9	139.2	150.0
UNEMPLOYMENT RATE (percent)	7.87	7.50	7.47	7.20	7.33	7.30	7.13	7.10	7.10	7.10	7.10	7.05	7.51	7.20	7.10
INDUSTRIAL PRODUCTION (index, 1977 = 100)	119.3	121.4	123.3	123.1	123.8	124.2	124.7	126.0	127.0	128.0	129.3	130.0	121.8	125.0	129.5
NEW PRIVATE HOUSING UNITS STARTED (millions)	1.947	1.858	1.663	1.598	1.795	1.772	1.664	1.750	1.760	1.776	1.780	1.765	1.766	1.740	1.770
CONSUMER PRICE INDEX (% change from prior quarter or year)	5.29	3.74	3.67	3.54	3.30	4.17	2.39	3.20	3.50	3.70	4.00	4.15	4.28	3.40	3.55
3-MONTH TREASURY BILL RATE (%)	9.13	9.84	10.34	8.97	8.18	7.52	7.10	7.15	7.10	7.06	7.15	7.10	9.57	7.50	7.40
NEW HIGH-GRADE CORPORATE BOND YIELD (percent)	12.94	14.18	13.72	12.63	12.57	11.88	11.46	10.90	10.50	10.53	10.66	10.70	13.37	11.50	10.50
GNP IN 1972 DOLLARS	1,611	1,639	1,645	1,662	1,664	1,671	1,689	1,698	1,710	1,721	1,735	1,748	1,639	1,679	1,728
PERSONAL CONSUMPTION EXPENDITURES (1972 $)	1,044	1,064	1,066	1,075	1,089	1,102	1,117	1,115	1,122	1,128	1,136	1,141	1,062	1,106	1,133
NONRESIDENTIAL FIXED INVESTMENT (1972 $)	193.3	202.9	209.5	213.8	213.0	220.3	218.2	220.5	221.5	222.9	224.0	225.0	204.9	218.0	223.0
RESIDENTIAL FIXED INVESTMENT (1972 $)	60.6	60.8	60.1	59.2	60.0	60.9	62.6	63.0	63.0	63.7	64.0	64.0	60.2	61.7	63.9
CHANGE IN BUSINESS INVENTORIES (1972 $)	31.6	20.3	30.6	16.8	19.1	8.3	2.5	9.0	9.8	12.2	13.5	13.1	24.8	9.2	13.2
NET EXPORTS (1972 $)	−8.3	−11.4	−27.0	−13.4	−28.4	−33.8	−38.4	−35.8	−33.7	−31.4	−29.3	−29.4	−15.0	−33.0	−29.6
FEDERAL GOVERNMENT PURCHASES (1972 $)	112.2	123.2	125.0	129.6	129.8	129.7	141.3	138.0	137.0	138.3	140.0	140.9	122.5	134.1	139.5
STATE AND LOCAL GOVERNMENT PURCHASES (1972 $)	177.3	178.9	181.1	180.9	180.9	183.9	186.2	187.0	188.0	188.2	189.0	190.0	179.5	184.8	189.0

SERIES FROM THE CURRENT-DOLLAR GNP ACCOUNTS

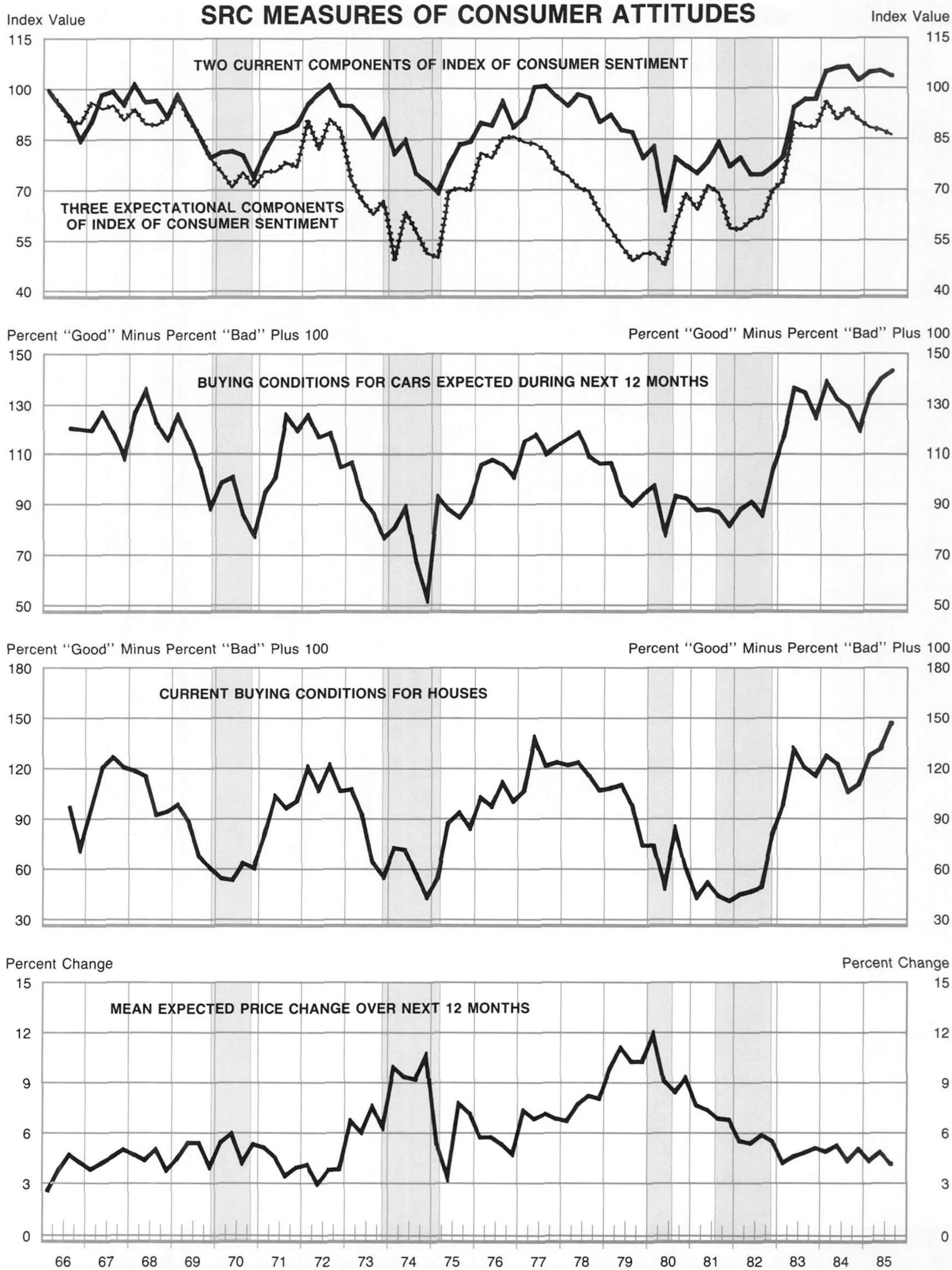
ECONOMIC INDICATOR	Quarterly Data												Annual Data		
	82:4	83:1	83:2	83:3	83:4	84:1	84:2	84:3	84:4	85:1	85:2	85:3	1982	1983	1984
GROSS NATIONAL PRODUCT	3,110	3,174	3,267	3,347	3,432	3,553	3,645	3,695	3,759	3,811	3,853	3,916	3,069	3,305	3,663
PERSONAL CONSUMPTION EXPENDITURES	2,046	2,070	2,142	2,181	2,230	2,277	2,333	2,361	2,396	2,446	2,493	2,539	1,985	2,156	2,342
GROSS PRIVATE DOMESTIC INVESTMENT	376.2	405.0	449.6	491.9	540.0	623.8	627.0	662.8	637.8	646.8	643.2	631.5	414.9	471.6	637.9
NET EXPORTS	6.3	19.6	−6.5	−16.4	−29.8	−51.5	−58.7	−90.6	−56.0	−74.5	−94.0	−104.0	19.0	−8.3	−64.2
GOVERNMENT PURCHASES	681.0	678.8	682.2	689.8	691.4	704.4	743.7	761.0	780.5	791.9	810.9	849.5	650.5	685.5	747.4
DISPOSABLE PERSONAL INCOME	2,238	2,261	2,303	2,367	2,429	2,502	2,554	2,606	2,645	2,655	2,727	2,711	2,181	2,340	2,577
PERSONAL SAVING RATE (% of disposable income)	5.8	5.7	4.2	5.0	5.3	6.1	5.7	6.3	6.2	4.5	5.1	2.7	6.2	5.0	6.1

Note: (1) All data are at annual rates and in billions of current dollars unless otherwise indicated. (2) Actual data through 1985:3 are those released by the Commerce Department in late November; projected data are from the ASA-NBER survey released in December.

Sources: Projections: American Statistical Association—National Bureau of Economic Research panel of forecasters.
Actual Data: U.S. Departments of Commerce and Labor, Board of Governors of the Federal Reserve System.

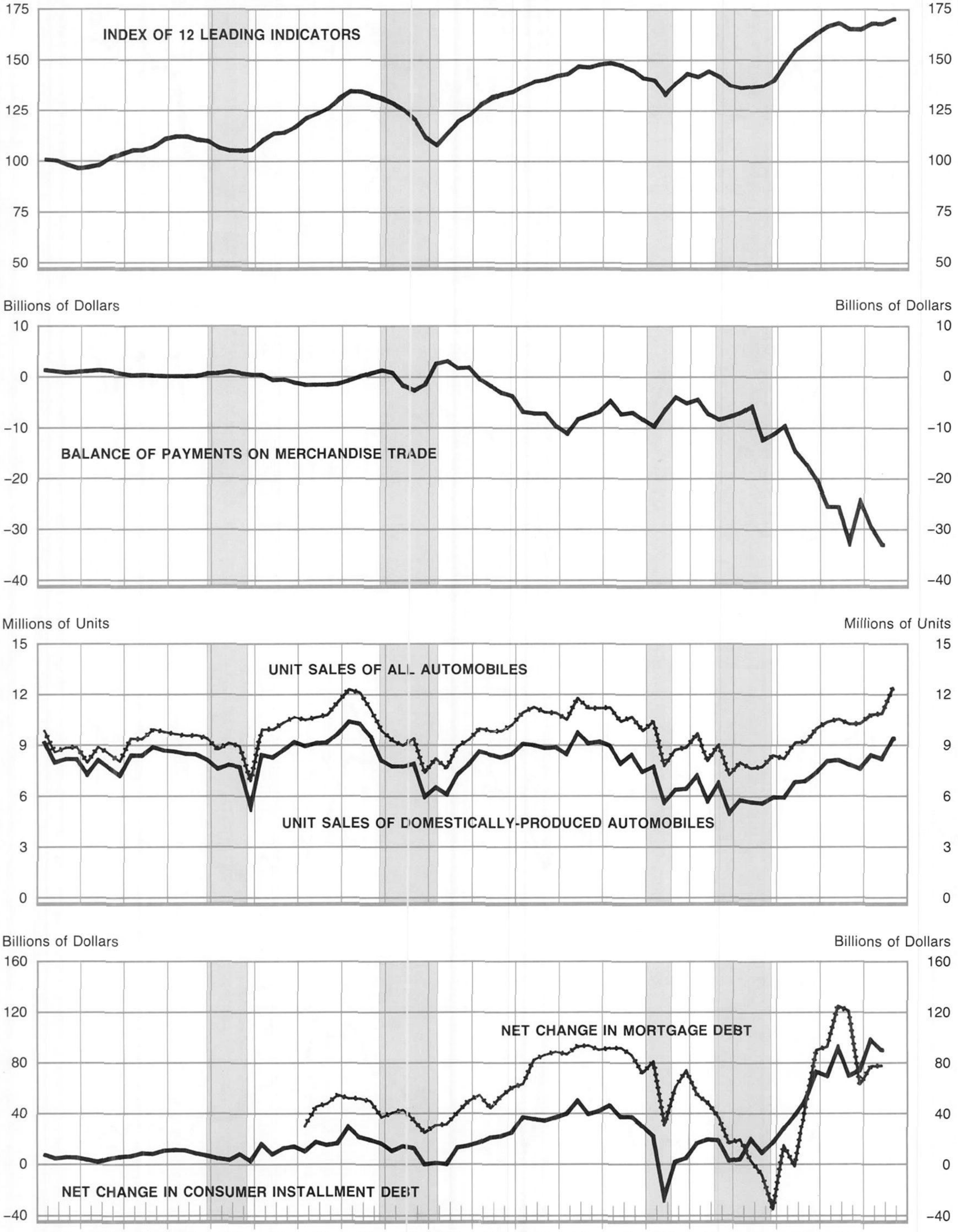
*Substantial revision of the data for variables marked with an asterisk has occurred since the last printing.

SRC MEASURES OF CONSUMER ATTITUDES



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

MEASURES OF NATIONAL ECONOMIC ACTIVITY



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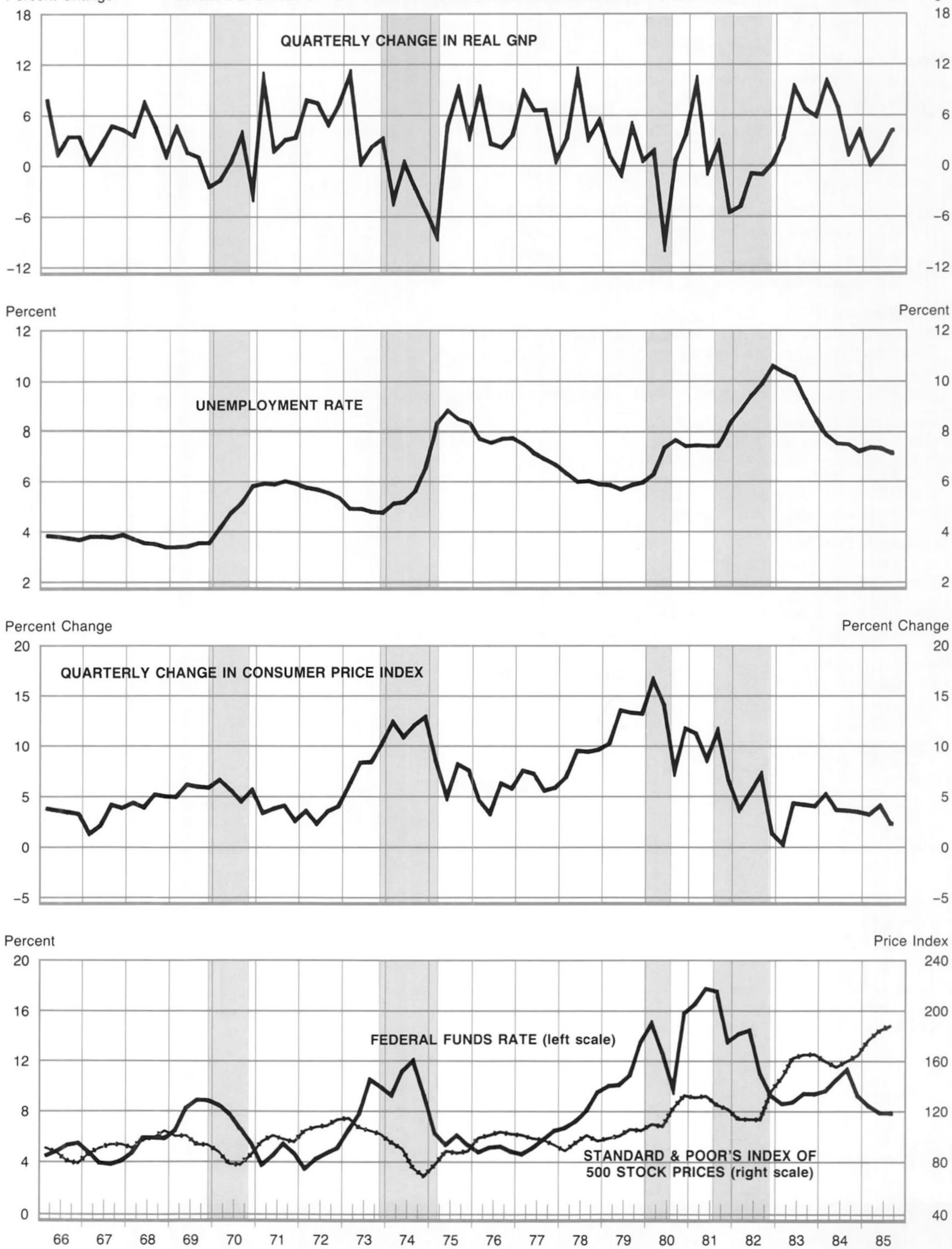
MEASURES OF NATIONAL ECONOMIC ACTIVITY



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Author Index to Volume 12 (1985)

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