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ECONOMIC OUTLOOK USA is designed to aid private and public decision makers in achieving a better understanding of the economic and social environment in which they will be operating. The analysis of this publication incorporates direct measurements of the expectations, attitudes and plans of both consumers and business firms with the economic and financial variables traditionally used in forecast models. The philosophy of this publication is that a blend of anticipatory and traditional measures provides richer insights into prospective developments, insights which will produce more consistently reliable forecasts of both economic and social change.

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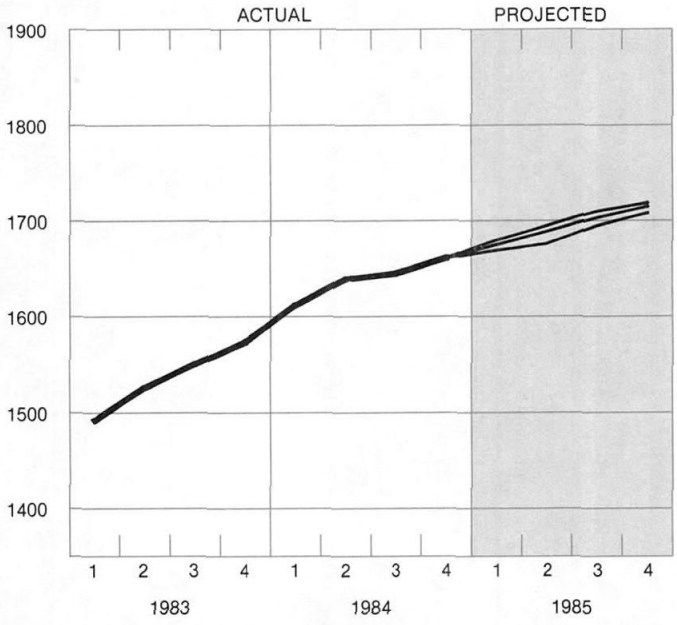
ECONOMIC PROSPECTS: Actual and projected seasonally adjusted quarterly data at annual rates.

GROSS NATIONAL PRODUCT

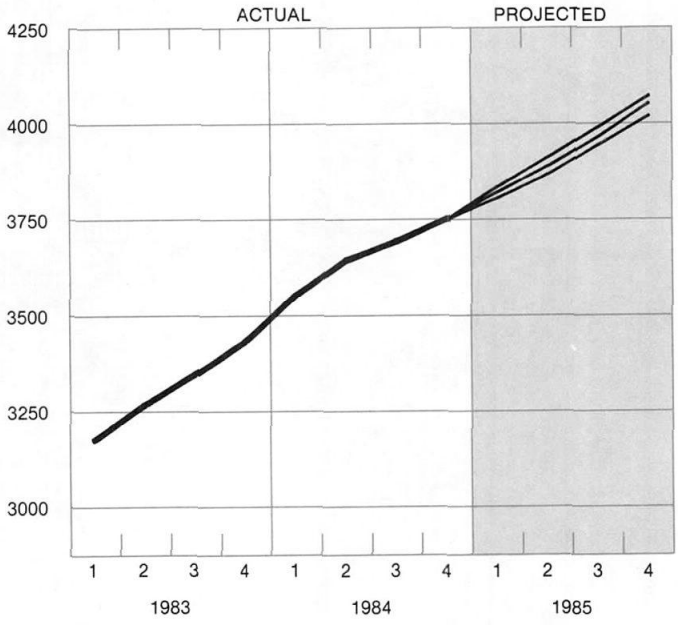
IN CONSTANT 1972 DOLLARS
Billions of Dollars



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.

GROSS NATIONAL PROCUCT

IN CURRENT DOLLARS
Billions of Dollars



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The U.S. Economic Outlook for 1985-86

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Review of the Forecast for 1984

A year ago at the Economic Outlook Conference we predicted that real GNP would grow by 6.5 percent for calendar 1984. For the second successive year, the RSQE forecast was among the most optimistic then on record. The data currently available for the first three quarters of this year and our present forecast for the fourth quarter indicate that real GNP will actually increase by nearly 6.9 percent – a bit more than we had predicted. In terms of 1972 prices this translates into an increase of $105 billion compared to our forecast of $99.3 billion made one year ago. Our forecast of real GNP for 1984 now appears to have been in error by only about one-third of one percent.

We underestimated the change in real personal consumption expenditures and gross private domestic investment by about $13 billion in each case. The predicted change in real government purchases of goods and services was just about right. The major offsetting forecast error occured in net exports. We expected real net exports to fall from a 1983 level of some $12 billion to about zero in 1984. We now anticipate a real net export deficit of about $17 billion for the current year. Almost all of this error was due to our inability to anticipate correctly the rapid increase in real imports as the value of the U.S. dollar climbed by 10 percent from the third quarter of 1983 to the third quarter of 1984.

The rates of wage and price inflation experienced in 1984 were somewhat less than we had expected. We had forecast that wages and prices would increase more rapidly in 1984 than they had in 1983; but, with the exception of the measure given by the consumer price index, inflation rates have actually fallen this year. The personal comsumption deflator, for example, increased at a 3.7 percent rate for 1983. We predicted a 4.6 percent rate for 1984, and the actual rate appears to be 3.3 percent.

We correctly anticipated the sign but not the magnitude of the change in the unemployment rate for 1984. We forecast that the unemployment rate would decline from a 1983 average of 9.6 percent to 8.3 percent this year; it actually fell to an average level of 7.6 percent for 1984.

Finally, we had expected a modest decrease in interest rates, not the actual increase that took place.

The Current Expansion in Historical Perspective

As of the third quarter of 1984, the economy had been expanding for eight straight quarters. A comparison of the current expansion with some of its predecessors provides some useful insights into the strengths, weaknesses, and peculiarities of the current situation. Table 1 contains comparative statistics which can be used for this purpose. In each case, calculations are based on the first eight quarters following the trough quarter of real GNP.

It is clear from this table that there are many similarities with previous expansions. The eight-quarter increases in real GNP, final sales, personal consumption expenditures, and government purchases of goods and services show a great deal of uniformity with previous expansions. Two outstanding differences from previous expansions are found in residential construction and imports, both of which are running well ahead of historical norms. As already noted, the increase in imports has outpaced the growth in exports, leading to a substantial deficit in the real trade balance. Real interest rates remain at historical highs as well. The increase in real interest rates during this expansion is due to an increase in nominal rates coupled with a decrease in the rate of inflation.

It is at least somewhat surprising that business fixed investment has risen so strongly in the face of such high real interest rates. Consider, however, the following combination of factors which may help to explain this apparent inconsistency:

- strong growth in final demand even in the face of a deteriorating net export balance,
- new tax depreciation guidelines especially favorable to cash-flow,
- a prevalence of old and outmoded capital in many industries now faced with stiff international competition, and
- the advent of new computer-based technologies which hold the promise of providing substantial improvements in industrial productivity.

Note, in addition, that the increase in unit labor costs has been distinctly modest in the current expansion. In the two years since the trough of the 1981-82 recession, unit labor costs have risen by only 2.3 percent – compared with 8 percent in the first two years of the 1975-80 expansion and almost 13 percent for 1971-73. With a constant state of technology, one would expect that the combination of favorable wage costs and high real interest rates would encourage a substitution toward labor and away from capital in the structure of production. In the present circumstance of rapidly changing technologies and a quest to modernize America's smoke-stack industries, favorable wage costs may well be making a major contribution by enabling industry to afford investment in new capital in the presence of high real interest rates.

A final feature of the current expansion which requires noting is the magnitude of the federal deficit. In the third quarter of 1982, the deficit was 5.3 percent of GNP. After eight quarters of economic expansion, it has come down only to 4.7 percent of GNP. The current expansion began with the deficit unprecedentedly high for a peacetime period, and the deficit has fallen barely at all despite the vigor of in-

Editor's Note: This is an abridged version of Dr. Hymans' presentation to the 32nd annual Conference on the Economic Outlook at The University of Michigan, November 1984. Shortly before the conference took place, Dr. Hymans was awarded the Theodore H. Silbert Award for Economic Forecasting, given annually to recognize "accuracy, timeliness, and professionalism in economic forecasting." Forecasts of real GNP growth, the unemployment rate, and the inflation rate for the period 1981-1983 were evaluated for the award, which is sponsored by the Sterling National Bank and Trust Company of New York City.

TABLE 1. Comparison of Recent Economic Expansions

Indicator	Expansions				
	1958-60	1961-69	1971-73	1975-80	1983-??
Initial Trough Quarter	1958:1	1961:1	1970:4	1975:1	1982:3
Duration of Expansion (Number of quarters)	8	35	12	20	–
Percent Changes During First 8 Quarters of Expansion					
Real GNP and Components:					
GNP	11.3	10.5	16.8	11.2	11.7
Final Sales	8.3	8.9	14.8	9.0	9.1
Consumption	9.0	8.6	13.9	11.5	10.4
Consumer Durables	13.3	22.0	38.4	25.7	27.0
Business Fixed Investment	9.6	10.1	27.6	11.4	26.2
Residential Construction	32.3	20.1	29.0	43.9	66.3
Exports	13.0	5.0	45.4	6.7	2.4
Imports	18.1	16.9	21.6	23.4	42.9
Government Purchases	2.3	9.0	2.2	0.4	5.3
Wages and Prices (Private Nonfarm Sector):					
Hourly Compensation	9.3	8.0	22.8	16.1	8.6
Unit Labor Cost	1.9	0.1	12.7	8.0	2.3
Price Index	4.0	2.9	12.5	10.8	6.8
M2Plus	NA	15.9	34.4	29.6	22.7
Trade-Weighted Exchange Rate Index	NA	NA	−18.6	10.8	18.3

Level at Initial Trough (T) and After First 8 Quarters of Expansion (T+8)

	T	T+8	T	T+8	T	T+8	T	T+8	T	T+8
Civilian Unemployment Rate (Percent)	6.3	5.2	6.8	5.8	5.8	4.8	8.2	7.5	10.0	7.5
Interest Rates:										
3-Mo. T-bills	1.8	3.9	2.4	2.9	5.4	7.5	5.8	4.6	9.3	10.3
(Real T-bill)[1]	0.6	1.8	1.9	1.4	0.4	2.2	− 7.2	−0.5	4.2	6.9
Aaa Corporate	3.6	4.6	4.3	4.2	7.9	7.7	8.7	8.0	13.8	13.0
(Real Aaa)[1]	2.4	2.4	3.9	2.7	2.9	2.3	− 4.3	2.9	8.6	9.5
Variables as % of GNP:[2]										
Corporate Profits[3]	7.9	10.3	8.5	10.1	6.8	7.9	6.0	8.1	5.3	7.7
Federal Deficit	1.7	− 1.5	0.8	0.3	2.0	0.3	3.1	2.0	5.3	4.7
Business Fixed Investment	9.2	9.1	8.8	8.8	10.2	11.1	10.0	10.0	11.1	12.5
Imports	4.0	4.2	4.0	4.2	6.2	6.4	6.0	6.6	8.1	10.5

[1]The real interest rate for a given quarter is defined as the corresponding nominal rate less the rate of inflation of the private nonfarm deflator during the four quarters ending with the given quarter.

[2]Profits and the federal deficit are both in current dollars as a percent of current dollar GNP. Investment and imports are in constant dollars as a percent of real GNP.

[3]Includes inventory valuation and capital consumption adjustments.

come growth in the past two years. This is clearly the mark of a federal budget dominated by a substantial *structural* deficit. There seem to be considerable disagreements as to whether or not the huge federal deficits implied by current tax laws and expenditure plans will produce permanently *rising* interest rates. There is little doubt, however, that the high deficit outlook is a major contributing factor to the comparatively *high level* of interest rates which has characterized the current expansion. In turn, these high interest rates have attracted financial capital from aboard, pushed up the international exchange value of the dollar, and encouraged the sharp deterioration in our net export account.

Inputs to the Forecast

The *federal tax* program contained in our Control Forecast includes the provisions of the Deficit Reduction Act of 1984. This legislation provides for tax increases of $8.6 billion for fiscal '85 and $17.7 billion for fiscal '86. About half of the increase is in personal taxes; much of the rest is in corporate profits taxes. An increase in the federal excise tax on liquor and a delay in the reduction of the telephone excise tax together represent about 15 percent of the tax increase in fiscal '86.

The Control Forecast also includes the inflation indexation of the personal income tax which is scheduled to begin

January 1, 1985. With indexation, the personal income tax brackets will be adjusted to remove the impact of inflation on effective tax rates under the progressive tax structure. In effect, taxpayers will move through the existing tax brackets on the basis of changes in their real incomes rather than their current dollar incomes. We estimate that indexing will reduce tax revenue by about $3 billion in fiscal '85 (when it is only in effect for three-fourths of the fiscal year) and by $14 billion in fiscal '86. Even with modest inflation the tax reduction from the indexing program will grow substantially. We estimate that in the final quarter of calendar 1986 indexing the personal income tax will cost the Treasury almost $24 billion at annual rate.

The *federal expenditure* assumptions in our forecast are summarized in Table 2. Current estimates indicate that expenditures for fiscal 1984 totalled $860 billion—up $44.4 billion from the previous year. We are assuming increases of about $70 billion for both fiscal '85 and fiscal '86. The larger increases in expenditures can be traced to three areas of the budget. The rapid decline in unemployment which occurred in fiscal 1984 is replaced by a much slower decline over the next two years. The result is a smaller reduction in unemployment benefits in fiscal '85 and fiscal '86 than was posted for fiscal '84. The totals for both nondefense purchases and federal subsidies in fiscal '84 were affected by the Payment-In-Kind (PIK) program, which provided surplus commodities to farmers who agreed to set aside productive land during the 1983 growing season. When these categories are purged of the effect of the PIK program, they both show a drop in expenditures from fiscal '83 to fiscal '84. We have assumed that both nondefense purchases and subsidies will instead show some increase for fiscal '85 and fiscal '86.

After growing by 10.3 percent in fiscal '84, defense spending is assumed to increase by 9¾ percent for each of the next two fiscal years. This represents about a 5 percent real increase in the procurement portion of the defense budget for each year.

TABLE 2. Federal Government Expenditures and Receipts (National Income and Product Accounts, billions of dollars)

Expenditures, Receipts, and Deficit	Fiscal 1984[1]	Fiscal 1985[2]	Fiscal 1986[2]
Total Expenditures	860.0	929.9	1001.6
Purchases of Goods and Services	284.5	320.0	349.0
National Defense	216.7	237.5	260.8
Nondefense	67.8	82.5	88.2
Transfer Payments	350.1	364.9	388.5
Unemployment Benefits	16.9	14.5	12.8
Grants-in-Aid to State and Local Governments	90.7	93.9	96.3
Net Interest Paid	110.3	133.4	149.8
Subsidies less Current Surplus of Gov't. Enterprises	24.4	17.8	18.0
Total Receipts	690.1[3]	754.6	828.0
Deficit (−)	−169.8	−175.3	−173.7

[1]Data for Fiscal 1984 are from the *Survey of Current Business*, October 1984.
[2]RSQE projections and forecasts for fiscal years 1984 and 1985.
[3]Receipts and Deficit for 1984:3 are RSQE Projections.

The Deficit Reduction Act of 1984 also provides for some expenditure cuts to help reduce the deficit. The largest component of this part of the legislation is a reduction in transfer payments of $3.2 billion in fiscal '85 and $1.8 billion in fiscal '86, consisting of a decrease in medicare benefits and a one-time shift in the payment of military retirement benefits, which saves the payment of one month's benefits in fiscal '85.

The net result of our budget assumptions and our Control Forecast is the federal deficit path shown in the bottom line of Table 2. The deficit figures show very little change over the three years, ranging from $170 to $175 billion. The Deficit Reduction Act is, as advertised, only a downpayment on the deficit. The next Congress will need to consider what steps must be taken—whether expenditure cuts, tax increases or both—to make further progress on the deficit.

In the presence of what has been very expansionary fiscal policy, the monetary authorities have had to assume all responsibility for keeping the expansion under control. As we noted earlier, this resulted in a policy which supported the rise in interest rates during the first eight months of this year as the economy grew at a robust annual rate of 8.6 percent during the first half of the year. With the slowing of economic activity in the third quarter, the pressure on interest rates has eased somewhat. Three-month treasury bill rates have fallen from a high of 10½ percent for the month of August to 9½ percent for the second half of October. We believe that with modest growth and low inflation continuing in the fourth quarter, *the Federal Reserve will continue to ease policy* through the winter, supporting a further reduction in interest rates. Specifically, we are assuming that

- the Fed will lower the discount rate from the current level of 9 percent to 8.5 percent early next year and hold it there through the end of 1986, and
- the monetary base will grow at an average rate of 5 percent per year over the next two years.

The further reduction in interest rates which we are forecasting to continue through most of 1986 will permit the governments of our major trading partners to position their interest rates higher relative to U.S. rates but lower than they have been in recent months. The relatively less attractive position of our interest rates and our deteriorating nominal trade balance are expected to imply a decline in the value of the dollar. We are anticipating that—on a trade-weighted basis—the *U.S. dollar will decline* in value by about 3½-4 percent during each of the next two years.

The expected depreciation of the dollar and the strengthening of the economies of our major trading partners should yield an *increasing volume of exports.* We are forecasting that real exports will grow at a 6 percent annual rate during the first half of 1985, a 6½ percent rate during the second half of 1985, and almost a 7½ percent rate during 1986.

Thus far the economic expansion has been characterized by modest inflation in most commodity prices and an evident *weakness in oil prices.* The recent decision by the members of OPEC to cut supply in order to shore up oil prices should be sufficient to prevent a sizeable drop in the price of oil. We have assumed that, after dropping by just under 2 percent in the current quarter, oil prices will stabilize and then begin to rise at a 2 percent annual rate in mid-1985, a 4 percent rate through early 1986, and a 5 percent rate through the rest of 1986.

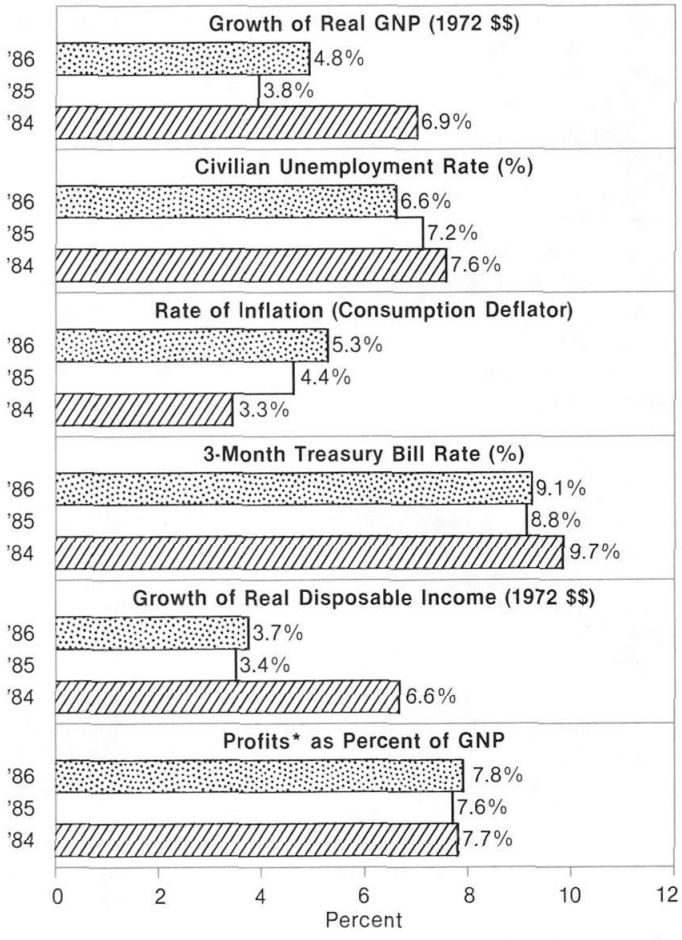
Our other assumptions regarding price movements include:

- For the *prices in own currencies of goods and services which we import* (other than oil), we have assumed an inflation rate of 4½ percent in early 1985, 5 percent for the last three quarters of 1985, and 5½ percent during 1986.
- *Farm prices* are assumed to rise at a 6 percent annual rate through the end of 1986.
- *Natural gas prices* are assumed to rise by 5½ percent during 1985 and by 7 percent during 1986.

Overview of the Control Forecast

The major features of our Control Forecast are summarized, on a calendar year basis, in Chart 1. We are now estimating that total national production—real GNP—for 1984 will be up by 6.9 percent over the 1983 level. That pace of growth is not expected to continue, and we are forecasting that real GNP will be up by 3.8 percent for 1985 and by 4.8 percent for 1986. As will be seen in our discussion of the dynamics of the forecast, some care is required in coming to a proper understanding of the higher growth rate being forecast for 1986 versus 1985. Specifically, we are *not* forecasting that the economy's growth rate will accelerate from now through the end of 1986, and such a pattern should not be read into the calendar-year growth rates shown in Chart 1. It is, however, proper to infer that our Control Forecast implies a continuation of the current expansion through both 1985 and 1986.

CHART 1. Overview of RSQE Forecast for 1985-86



*Includes inventory valuation and capital consumption adjustments.

Accompanying this persistence of economic expansion is a continuation of the most recent pattern of annual reductions in the rate of unemployment. For 1985 we expect a small reduction in unemployment to an average level of 7.2 percent for the year, and that is followed by a somewhat larger decline to a 6.6 percent average for 1986.

With growth continuing and the labor market strengthening, we anticipate that the rate of inflation will be edging up over the next two years. As measured by the personal consumption deflator, consumer prices are forecast to be 4.4 percent higher in 1985 than in 1984, and another 5.3 percent higher in 1986. As noted, the tightening of markets is one important reason for the rising rate of inflation during the next two years. Another is the international depreciation of the dollar, which is also a part of our Control Forecast. Thus, with the dollar having strengthened during this year, the average price level—in dollars—for our imports of goods and services is estimated to have declined by about one percent for 1984. In contrast, with the dollar dropping in value during 1985 and 1986, we estimate that import price inflation will average 5 percent for 1985 and 10 percent for 1986. These swings of roughly 5-6 percent annual increases in import inflation account for nearly one-half of one percentage point per year in the acceleration of the rate of inflation in consumer prices. If we were to back these out of the inflation forecast shown in Chart 1, we would have the price level up by about 4 percent for 1985 and less than 4½ percent for 1986. Thus, we are not forecasting any really substantial renewal of industrial inflationary pressures—sometimes called core inflation—during the next two years. But we will have to pay a penalty in higher prices as the overvalued dollar starts to move down.

As is seen in the fourth panel of Chart 1, we are forecasting that short-term interest rates will average nearly 100 basis points less in 1985 than in 1984, but will then move up slightly in 1986.

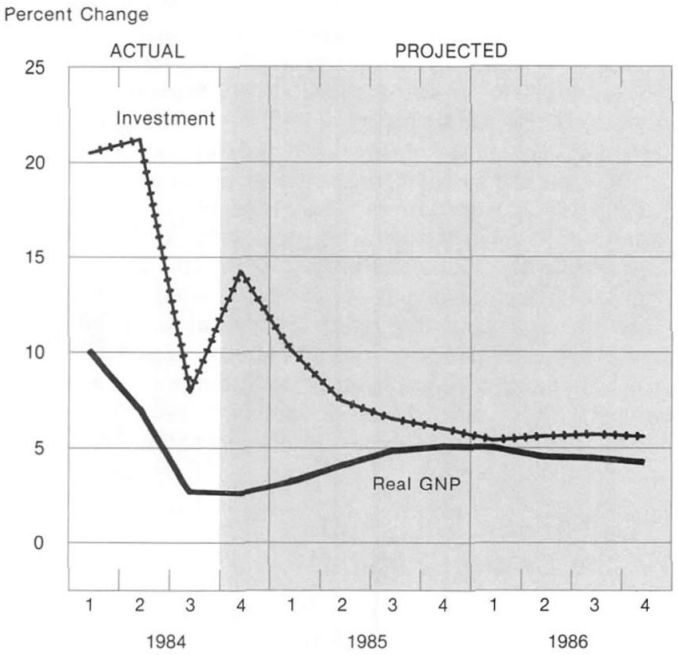
With respect to incomes, we are forecasting sizeable gains for the next two years. Consumer purchasing power—real disposable income—is forecast to be up by almost 3½ percent in 1985 and about 3¾ percent the following year. Corporate profits (including inventory valuation and capital consumption adjustments) should remain at about 7¾ percent of GNP—well above the postwar low of 5.2 percent reached in 1982.

The Dynamics of the Control Forecast

Proper interpretation of the Control Forecast requires an understanding of the dynamics underlying the annual changes and averages shown in Chart 1. The quarterly paths being forecast for a number of key macroeconomic variables are shown in Charts 2-6. Additional quarterly detail is contained in Table 3.

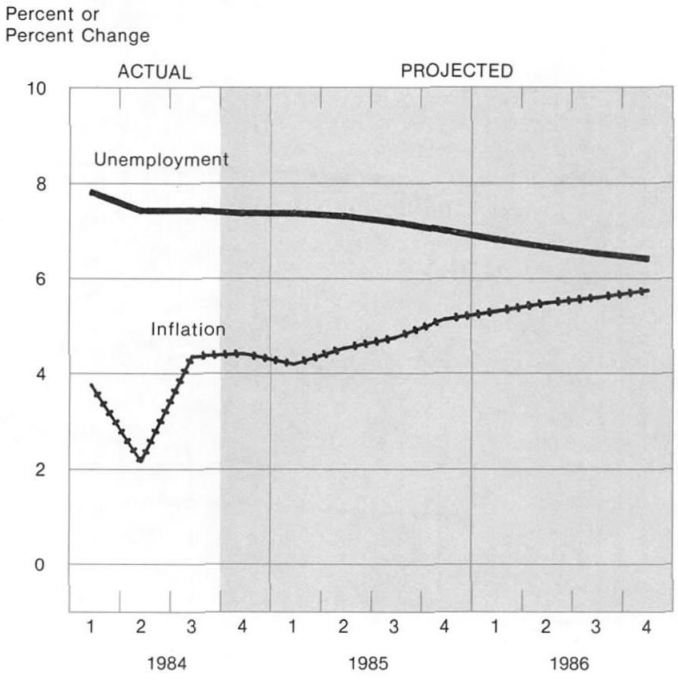
The forecast pattern for real GNP growth is shown in Chart 2. The 2.7 percent growth rate estimated for 1984:3 is forecast to be followed by a 2.6 percent annual rate of growth in the current quarter and 3.3 percent in the first quarter of 1985. The growth rate accelerates during the balance of 1985 and peaks at 5.1 percent in the closing quarter of next year. Thereafter, the growth rate decelerates

CHART 2. Annual Rates of Growth of Real Gross National Product and Business Fixed Investment (1972 dollars)



Sources: Actual data, U.S. Department of Commerce; projected data RSQE Forecast.

CHART 3. Unemployment Rate and Annualized Inflation Rate (Personal Consumption Deflator)



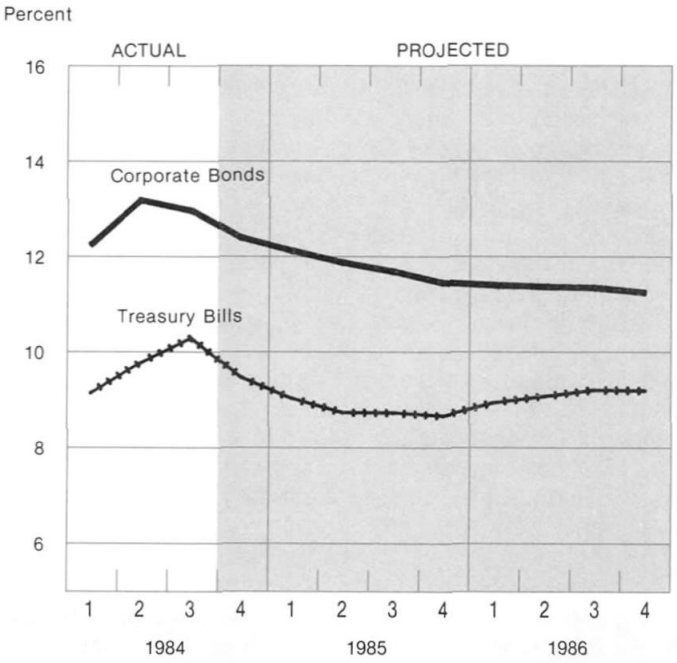
Sources: Actual data, U.S. Department of Commerce; projected data, RSQE Forecast.

and closes the year 1986 at 4.3 percent. Correspondingly, the unemployment rate changes very little between 1984:3 and 1985:1, but then declines to 7 percent by the end of 1985 and to 6.4 percent a year later (Chart 3). The rate of inflation is seen to rise steadily after early 1985, increasing from a 4.2 percent rate in 1985:1 to 5.2 percent in 1985:4 and 5.8 percent in the closing quarter of 1986 (Chart 3).

The growth pattern during the next two years is, in part, a reflection of the pattern of interest rate movements. The rise of interest rates through the late summer of this year contributed to the sharp decline in economic growth during the second half of 1984. The subsequent turnaround in interest rates is a major contributor to the re-acceleration of economic growth during 1985. But short-term interest rates are forecast to bottom out in the second half of 1985 and head up again—though not sharply—during 1986. This shallow-U, or saucer-shaped, pattern to be followed by short-term interest rates over the next two years is basically a reflection of presumed Federal Reserve behavior. Currently, the monetary authorities are assumed to be nudging rates downward to permit the rate of growth to move back up from the 2½-3 percent range. As that happens, accelerating credit demands and a steady-growth-of-reserves policy on the part of the Fed will start to put upward pressure on interest rates which, in turn, will begin to retard demand growth among the most interest-sensitive components of aggregate demand—as shown in Charts 4 and 5.

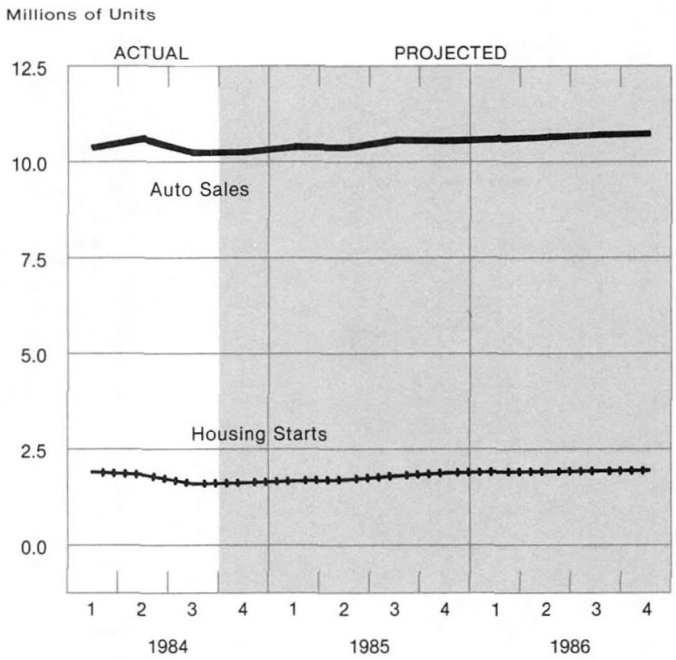
Auto sales and housing starts, for example, are forecast to exhibit nearly identical patterns during the next two years. Auto sales increase from an annual rate of 10.3 million units this quarter to 10.6 million units at the end of next year, rise further to a 10.8 million unit rate by mid-1986, and then remain at that level for the balance of 1986. Private housing starts increase from an annual rate of 1.69 million units this quarter to 1.94 million units by the end of 1985, and then remain virtually flat at or just below a 2 million unit rate during 1986.

CHART 4. Interest Rates for 3-Month Treasury Bills and Corporate Aaa Bonds



Sources: Actual data, U.S. Department of Commerce; projected data, RSQE Forecast.

CHART 5. Automobile Sales and New Private Housing Starts



Sources: Actual data, U.S. Department of Commerce; projected data, RSQE Forecast.

The growth of business fixed investment is forecast to remain strong during 1985 and 1986 as businesses continue to react positively to growing final demand and the need to modernize productive capacity (Chart 2). Even so, the rate of increase of real investment declines from an average of 8.8 percent (annual rate) during the first half of 1985 to 5.6 percent during 1986.

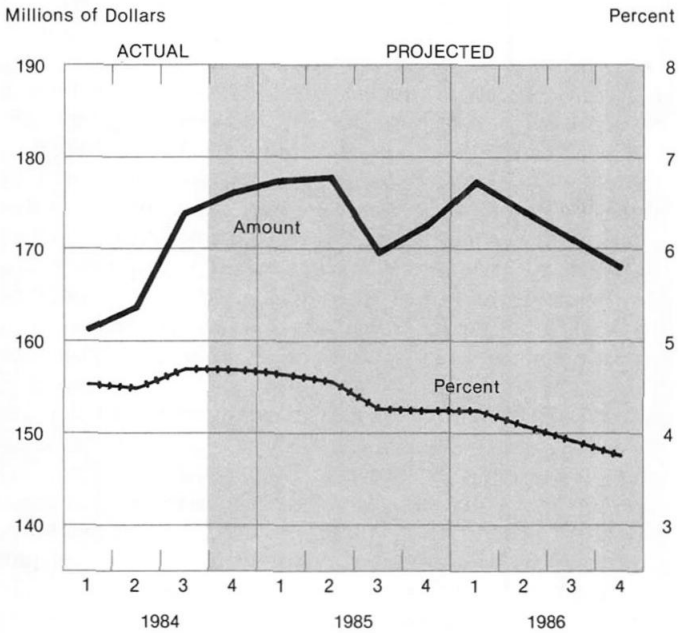
Although not shown in the charts, the path of net exports in the Control Forecast is worth mentioning. The combination of a depreciating dollar, more modest U.S. growth, and somewhat faster growth abroad produces a slow improvement in our real net export position over the next two years. In the closing quarter of this year our real net export deficit is estimated to be about $25 billion in 1972 prices, a year from now it is forecast to be just slightly improved at $22 billion, and in the closing quarter of 1986 the deficit is forecast to be down to $15 billion. The real adjustment over this period is not estimated to be sufficiently rapid, however, to turn around the current dollar imbalance in net exports, though the *rate* of deterioration declines dramatically compared with that of the past year. From 1983:4 to 1984:4 our net export deficit in current dollars is estimated to have risen by $63 billion—up from $30 billion to $93 billion; from 1984:4 to 1985:4 we are forecasting a further increase of $22 billion to bring the deficit to $115 billion, and from 1985:4 to 1986:4 an increase of $11 billion to bring the deficit to $126 billion. It would appear from the quarterly pattern that the deficit would be just about poised to begin to decline in nominal terms two years from now.

Chart 6 shows the pattern of the federal deficit implicit in our Control Forecast, both in absolute and in relative terms. Despite the continued growth of the economy over the next two years "those lines"—i.e., federal spending and receipts—neither meet nor, really, even begin to converge. By our calculations, the deficit—under current tax laws and likely spending programs—remains at a rate insignificantly different from $170 billion throughout the next two years, even with substantial economic growth and reasonably stable interest rates. This does, of course, imply a steady decline in the deficit as a percent of GNP—from 4.7 percent currently to 3.7 percent at the end of 1986. There is a proper sense, therefore, in which the Control Forecast—which involves no new budget actions—implies that the deficit problem will become less serious over the next few years. That is not quite the whole story, however. Despite the shrinkage of the deficit as a share of GNP, federal interest payments continue to absorb a growing percentage of total federal receipts in the Control Forecast. And this aspect of the burden of the federal debt could worsen after fiscal '86, with interest rates remaining relatively high and tax indexation continuing, in effect, to provide annual tax cuts. And, if this is not already complicated enough, it has to be pointed out that the Control Forecast presents a kind of best-case view of the deficit problem, in a sense to be explained in the following section.

The Hidden Assumption in the Control Forecast

In our discussion of federal budget input assumptions, we noted that the Control Forecast contains no legislative actions to reduce the deficit beyond the provisions already present in the Deficit Reduction Act passed in the summer of 1984. Those who maintain that continued high deficits aren't much of a problem might be tempted to read the Control Forecast as evidence in support of such a position. Such an inference would be far too facile. In fact, the Control Forecast—if taken literally—has to be viewed as presuming *both* that no action is taken to reduce the deficit *and*

CHART 6. Federal Government Deficit (NIPA Basis): Amount and Percent of GNP



Sources: Actual data, U.S. Department of Commerce; projected data, RSQE Forecast.

TABLE 3. Selected Economic Indicators as Forecast by RSQE

Seasonally adjusted

ECONOMIC INDICATORS	Quarterly Data										Annual Data			
	ACT.	PROJECTED									PROJECTED			
													% Changes	
	84:3	84:4	85:1	85:2	85:3	85:4	86:1	86:2	86:3	86:4	1985	1986	84-85	85-86
GROSS NATIONAL PRODUCT	3,701	3,758	3,827	3,902	3,986	4,078	4,179	4,276	4,377	4,480	3,948	4,328	7.74	9.62
PERSONAL CONSUMPTION EXPENDITURES	2,359	2,413	2,464	2,514	2,567	2,624	2,685	2,745	2,807	2,871	2,542	2,777	8.41	9.22
DURABLE GOODS	317.3	322.9	330.3	336.9	345.8	353.6	362.0	370.0	378.2	385.8	341.7	374.0	7.46	9.47
AUTOMOBILES and PARTS	150.8	153.7	158.2	161.6	167.1	171.1	175.5	179.9	184.2	188.0	164.5	181.9	8.84	10.58
FURNITURE and H.H. EQUIPMENT	115.1	116.9	119.0	121.2	123.7	126.3	129.1	131.6	134.3	136.9	122.5	133.0	6.18	8.54
OTHER DURABLES	51.4	52.3	53.2	54.2	55.1	56.2	57.4	58.5	59.7	60.9	54.7	59.1	6.29	8.21
NONDURABLE GOODS	863.1	883.6	900.0	915.7	931.8	950.6	970.8	990.5	1,011	1,031	924.5	1,001	7.30	8.26
SERVICES	1,179	1,207	1,234	1,262	1,290	1,320	1,352	1,384	1,418	1,454	1,276	1,402	9.48	9.86
GROSS PRIVATE DOMESTIC INVESTMENT	660.5	657.8	660.3	673.5	693.4	716.0	737.8	757.9	778.4	799.0	685.8	768.3	6.77	12.03
NONRESIDENTIAL	431.5	448.7	462.2	473.7	484.9	496.6	508.2	520.6	533.8	547.4	479.4	527.5	12.81	10.04
RESIDENTIAL STRUCTURES	156.6	155.8	158.6	163.7	171.5	179.5	185.8	190.3	194.7	199.0	168.3	192.5	8.75	14.32
CHANGE in BUSINESS INVENTORIES	72.4	53.4	39.5	36.0	36.9	39.9	43.8	47.0	49.9	52.7	38.1	48.3	–	–
NET EXPORTS	−85.4	−93.0	−97.6	−102	−108	−115	−120	−123	−125	−126	−106	−124	–	–
EXPORTS	375.7	382.6	391.3	400.5	410.8	422.0	434.3	447.7	461.7	476.5	406.1	455.0	9.80	12.04
IMPORTS	461.0	475.6	488.8	502.9	519.1	536.6	554.2	570.9	586.9	602.5	511.9	578.6	15.79	13.04
GOVERNMENT PURCHASES	766.9	780.4	799.6	816.6	833.5	852.5	876.7	896.3	916.0	936.2	825.6	906.3	10.24	9.78
FEDERAL	307.7	310.1	318.0	323.4	328.4	335.2	346.9	353.7	360.4	367.2	326.3	357.1	10.42	9.44
NATIONAL DEFENSE	225.4	229.3	236.3	240.2	244.1	249.7	258.9	264.5	270.1	275.8	242.6	267.3	9.16	10.20
OTHER	82.3	80.8	81.7	83.2	84.3	85.5	88.0	89.2	90.3	91.4	83.7	89.7	14.27	7.23
STATE and LOCAL	459.2	470.3	481.6	493.2	505.1	517.3	529.8	542.6	555.6	569.0	499.3	549.2	10.12	10.00
GROSS NATIONAL PRODUCT DEFLATOR, 1972 = 100	224.4	226.4	228.6	230.8	232.9	235.3	238.2	241.0	244.0	247.1	231.9	242.6	3.80	4.60
REAL GROSS NATIONAL PRODUCT (billions of 1972 dollars)	1,650	1,660	1,674	1,691	1,711	1,733	1,754	1,774	1,794	1,813	1,702	1,784	3.80	4.80
AGGREGATE UNEMPLOYMENT RATE (percent)	7.48	7.41	7.41	7.35	7.22	7.04	6.85	6.69	6.55	6.43	7.25	6.63	–	–
CORPORATE PROFITS plus IVA and CCA	284.6	282.5	283.9	292.1	302.9	315.4	326.7	335.2	343.8	353.4	298.6	339.8	5.17	13.79
3-MONTH TREASURY BILL RATE (%)	10.32	9.48	9.05	8.75	8.75	8.68	8.96	9.09	9.23	9.21	8.81	9.12	–	–
REAL DISPOSABLE INCOME (billions of 1972 dollars)	1,175	1,184	1,194	1,204	1,211	1,223	1,237	1,248	1,258	1,269	1,208	1,253	3.42	3.73
PERSONAL SAVING RATE (percent of disposable income)	6.30	5.89	5.67	5.53	5.20	5.27	5.41	5.36	5.32	5.30	5.42	5.35	–	–

Note: All data are in billions of current dollars unless otherwise indicated.

Sources: Projections by Research Seminar in Quantitative Economics, University of Michigan; actual data from Departments of Commerce and Labor, Board of Governors of the Federal Reserve System.

that the financial markets and the monetary authorites *don't care* that no action has been taken to reduce the deficit. The latter is thus a hidden assumption in the Control Forecast, and it is rather difficult to accept.

If the 99th Congress fails to take any significant fiscal action to reduce the deficit, we would expect that to result in a far different set of financial and credit market conditions than is contained in the Control Forecast. It is our view that current conditions in the financial sector of the economy are already based on the presumption that the new Congress will follow up on the downpayment put in place by the Deficit Reduction Act. If it were to become clear in the early months of 1985 that such a presumption is unfounded, expectations about future financial conditions would be changed dramatically and adversely. In all likelihood, interest rates would begin to move up sharply long before much of the scenario in our Control Forecast will have unfolded. In that event, the 3 to 4 percent growth rates being forecast for the early quarters of 1985 could well be the peak to be attained before sharply rising interest rates produce a recession in such sectors as residential construction, capital formation, and the purchase of automobiles and other big-ticket consumer durables. Indeed, sharply rising interest rates could also reverse the turnaround in our real net export position, implying yet another source of drag on domestic production and employment.

That is an all-too-familiar scenario, we've experienced it on more than one recent occasion, and there is nothing to recommend it. We believe that the memory of such occasions is all too vivid in the halls of Congress, and that—with the proper packaging—a serious revenue enhancement program will even gain the support of the White House.

How, then, do we interpret the Control Forecast? We envision 1985 as the year in which a major set of tax reform actions begin to work their way through the Congress. There is considerable agreement that the current federal tax struc-

ture is too cumbersome, too inefficient, too unfair, too full of loopholes and abuses—the president is perhaps the leading political spokesman supporting this perception. It also raises too little revenue in comparison with the likely course of federal spending for the foreseeable future. All of these problems can be addressed simultaneously: a major revision of the tax code priced out to phase in higher revenue levels over time.

We would not expect any of this to become effective in 1985 but to begin to be phased in during 1986 as various parts of the package become law. This is the scenario which justifies the relatively calm credit markets implicit in our Control Forecast. The only difference is that our forecast contains none of the tax reform/tax increase legislation which we would expect to begin to phase in during 1986. The economic impact during 1986, however, is likely to be quite small. Purely for illustrative purposes, however, we have made an Alternate Forecast to suggest the kinds of impacts which might be expected from a combination of policies similar to some which appear already to be under tentative discussion.

An Illustrative Deficit-Reduction Package: The Tax Side

Among the tax changes which seem currently to be receiving some attention are:

- the closing of certain tax loopholes, which will broaden the base on which revenue is collected even with existing tax rates,
- a modified indexation of the tax system so that tax brackets are less than fully adjusted for inflation,
- a value-added tax, or VAT, to place part of the tax burden directly on consumption.

For purposes of an alternative calculation, we assume each of the above three tax changes is put into effect to raise additional revenue. Although we have included no other tax changes at the same time, the result in the short run would be little different if these revenue-raising measures were accompanied by a change in the nation's basic tax structure, as long as its total revenue yield were no different than under current law. The specifics of our illustrative tax package are:

- base-broadening which raises $10 billion at annual rate at current income levels,
- an indexation floor of 2 percent so that tax brackets are adjusted to reflect only the excess of inflation over 2 percent per year, and
- a one percent value-added tax on a base that amounts to half of personal consumption expenditures (i.e., certain categories of expenditure such as food and medical care are not subject to the tax). At current expenditure levels this would yield about $12 billion in annual revenue.

Our calculations pertain to a scheme in which all three tax changes are put into effect simultaneously, and we evaluate their effects at the end of four and eight calendar quarters. It is important to note that we have made no offsetting changes in other assumptions at the same time. Specifically, for example, we have not allowed for any changes in monetary policy; the discount rate and growth of the monetary base remain exactly as in the Control Forecast. The results are summarized in Table 4.

The first result to note is that the application of a package of tax increases reduces the level of economic activity. Obviously, this could be counteracted by an accompanying shift toward an easier monetary policy, but we have not allowed for any such change. Two years after the imposition of the tax package, real GNP would have been reduced relative to the Control by more than $12 billion—nearly three-fourths of one percent—and the unemployment rate would be nearly one-fourth of one percentage point higher than in the Control Run.

A good deal of the burden of this tax package hits the consumer sector, both because of the direct tax increases and because the value-added tax pushes up the effective level of consumer prices. Thus, after two years consumer prices are, on the average, nearly three-fourths of one percent higher than they would otherwise be, while real disposable income is 1.6 percent lower than otherwise. The tax package in question tilts the composition of GNP away from consumption.

Interest rates are very slightly lower, but the reason for this is a bit complicated. The simple part is that the deficit has been reduced. The complicated part has to do with two offsetting effects. First, the level of economic activity is lower so that real credit demands are reduced, which should lower interest rates. At the same time, however, with no change in the growth of nominal reserves and a higher price level, real reserves in the banking system grow more slowly, which offsets at least part of the effect of the economic slowdown on interest rates. The net effect is the very small drop in interest rates shown in Table 4.

Finally, of course, a major impact of the tax package is its effect on the deficit, which is down by almost $23 billion at annual rate after one year and by $30 billion after two years.

The real message of this calculation is that a significant shift in the level and slope of the deficit path can be established with only small real effects on the economy. Such a program would provide for a permanent, gradual decline in the deficit and should therefore justify long-term expectations which are consistent with a stable credit environment.

TABLE 4. Economic Effects of Three Revenue Enhancements: Base – Broadening ($10 billion), Indexation Floor (2%), and VAT (1% on half of consumption.)[1]

Indicator	Economic Effects After[2] 4 Quarters	8 Quarters
Real GNP:		
Change in Level (billions of '72 $)	−7.8	−12.5
Percent Difference	−0.5	−0.7
Level of Unemployment Rate (percent)	+0.15	+0.23
Consumption Deflator (percent difference)	+0.6	+0.7
Real Disposable Income (percent difference)	−1.2	−1.6
Treasury Bill Rate (difference in percentage points)	−0.06	−0.08
Federal Deficit (billions of current $)	−22.9	−30.3

[1]The exact tax package is defined in the text.
[2]All economic effects are calculated as Alternate minus (or relative to) Control.

The Surprises of 1983-84 and Scenarios for 1985-86

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A Much Underestimated Expansion

By the last quarter of 1982 the longest slump since the Great Depression of the 1940s had spread through the industrial world causing record unemployment in defiance of many observers who foretold its earlier demise. Yet most forecasters at that time rightly insisted that recovery in the U.S. was imminent, as reported in this space (OUTLOOK, Autumn 1982, pp. 75-77). Subsequent data show that the upturn did start before the year-end as predicted. Indeed, it soon turned out that the recovery was much stronger than had been expected. The median forecasts from the November 1982 ASA-NBER survey were very accurate on the percentage change in current-dollar GNP for 1982-83 but they substantially underpredicted real growth and overpredicted inflation, and the same applies to the simultaneous forecasts for 1982:4-1983:4 (Table 1, columns 1-4). Directionally these predictions were correct, with but two exceptions (lines 5 and 9). One can identify a few real successes in 1982-83 for variables that are difficult to predict (lines 10 and 11). But some very large errors occurred in the forecasts of the rates of growth in industrial production, housing starts, business investment, and profits. The declines in net exports were greatly underestimated.

Forecasters again scored on the average very well with regard to nominal GNP changes during 1984, while aiming too low on real growth and too high on inflation (columns 5-8). Although qualitatively similar, numerically their predictions for the second year were in most cases considerably better than those for the first year. In particular, the results for industrial production, the unemployment rate, and real consumption expenditures were reasonably satisfactory. In contrast, forecasts of such variables as corporate profits, housing starts, real outlays on business plant and equipment, and net exports continued to collect large errors. The table shows one directional error for 1983-84 and one for 1983:4-1984:4 (lines 11 and 7, respectively).

Sources of Error

Evidently few economists were sufficiently optimistic when looking a year ahead to a recovery in 1983 and again a year ahead to a continued expansion in 1984. Why? First, the unexpected sequence of two traumatic recessions in 1980 and 1981-82 left some discouraging scars. It seemed that the high interest rates (which were on the whole fairly well anticipated) would, in combination with the slowly but increasingly recognized disinflation, hinder the recovery in business investment and consumer durables. But the economy adjusted to the higher levels of the real rates, while remaining sensitive to large rises in them in the short run. The power of lagged effects of large net tax cuts, on both the demand and the supply side, appears to have been greatly underestimated. Wages and prices increased much less and corporate profits and cash flows much more than expected. Real spending on housing and durable goods turned up early during the 1982 recession and gathered speed as the recovery progressed in 1983. Real outlays on producers' durable

TABLE 1. Annual and Year-Ahead Forecasts for 1983 and 1984: Predicted vs. Actual Changes

Series	1982-83		1982:4-1983:4		1983-84		1983:4-1984:4	
	P (1)	A (2)	P (3)	A (4)	P (5)	A (6)	P (7)	A (8)
1. GNP in current dollars[1]	7.9	7.7	9.4	10.4	10.1	10.8	9.4	9.4
2. GNP in constant dollars[1]	2.4	3.7	3.5	6.4	5.2	6.8	4.3	5.6
3. Implicit price deflator[1]	5.3	3.8	5.6	3.8	4.8	3.8	3.5	5.4
4. Index of industrial production[1]	2.9	6.5	6.6	14.9	9.1	10.7	5.3	6.3
5. Unemployment rate[2]	−0.2	0.1	−0.8	−2.1	−1.4	−2.1	−0.8	−1.3
6. Corporate profits after taxes[1]	10.4	21.6	18.4	40.0	24.2	15.1*	15.0	2.1*
7. New private housing starts[1]	30.1	60.4	27.0	33.9	1.2	4.1	4.2	−8.2
8. Consumption expenditures in constant dollars[1]	2.6	4.8	3.4	5.7	4.2	5.3	3.5	4.2
9. Nonresid. fixed investment, constant dollars[1]	−3.7	2.5	1.9	14.2	8.5	20.0	6.9	16.6
10. Change in bus. inventories, constant dollars[3]	7.8	6.8	8.0	31.8	13.3	27.8	8.3	7.0
11. Treasury bill rate (3 months)[4]	−2.5	−2.1	0.4	1.0	0.2	−0.9	0.0	0.2
12. Net exports in constant dollars[3]	−1.8	−17.8	−0.8	−22.1	−6.0	−28.1	−0.2	−17.2

P – predicted; A – actual.

[1]Percent changes. [2]Differences, percent of labor force. [3]Differences, billions of 1972 dollars. [4]Differences, percentage points.

SOURCES: Median forecasts from the ASA-NBER November 1982 survey (columns 1 and 3) and from the November 1983 survey (columns 5 and 7.) Actual values from the December 1984 issue of *Business Conditions Digest* and more recent releases for 1984:4 and 1984.

*Inferred from the most recent data and forecasts (actual values for 1984:4 not yet available).

equipment, spurred on by these developments and an especially favorable tax treatment, rose promptly and steeply, exceeding the forecasts by large margins.

The dollar was widely expected to weaken, which would bring on more inflation than the Fed would be likely to tolerate. Instead, the dollar rose to record levels and stayed high, helping to keep inflation relatively low. The growth rates of M1 and M2 declined, but real money balances rose fast late in 1982 and steadily thereafter. The income velocity of money, having dropped at a surprising pace during the recession, stabilized and increased moderately. The large declines in exchange rates for foreign currencies, resulting in record low import prices, generated a great expansion of imports and a continuing weakness of exports of goods and services. This hurt badly many primary producers in manufacturing, mining, and farming. At the same time, however, sectors superior to or shielded from foreign competition prospered and expanded rapidly, notably the information-related "high tech," sophisticated distribution, and other service industries. Prices of services remained relatively strong, but those of sensitive materials have been weak for a long time and actually declining since early 1984 (in large part reflecting the movements of exchange rates). In the past, such developments would betoken a recession, but now the changed structure of the U.S. economy is such as to restrict the hardships to some industries, occupations, and regions. The expansion is still hindered thereby but no longer stopped in its tracks.

Finally, the persistence of huge Federal budget deficits proved to be a long-term, not an immediate problem. In the short run, their effect was the usual one of making fiscal policy on balance definitely stimulative. True, the explosion of government borrowing helped to keep interest rates high, but the inflow of foreign capital, continually attracted by high and apparently safe returns on dollar investments, mitigated the results.

It is easier to forecast annual than quarterly changes, just as it is easier to hit larger and more slowly moving targets. The survey averages of November 1983 predicted an even growth during 1984; but actual output soared in the first quarter, grew less but still strongly in the second, quite weakly in the third, and just about as predicted in the last quarter (Table 2). Thus errors of over-, then underprediction resulted, extending to real consumption and industrial production. The declines in the unemployment rate and rises in plant-and-equipment investment were rather consistently underestimated; the downturns in corporate profits and housing starts were missed. The quarterly forecasts of the volatile movements in inventory investment and net exports generated large random errors.

Of course, in subsequent surveys closer to the target quarters the forecasters were on the average able to improve their predictions of most of these short-term changes. But the unanticipated sharp decline of growth in 1984:3 led many to lower their forecasts for the next quarter, which proved wrong in the light of data now available.

Mixed Signals from Indicators . . .

While the estimate of the annual rate of growth in real GNP for 1984:3 was reduced from 1.9 percent to 1.6 percent, that for 1984:4 was raised from 2.8 percent to 3.9 percent. The implicit price deflator rose 2.3 percent in 1984:4, less than in 1984 as a whole (3.8 percent). The favorable end-of-year news is still subject to revisions.

Most of the recent readings on monthly coincident indicators have been positive, too. The composite index of the four main series in this category gained 0.8 percent in November and 0.9 percent in December, reflecting some moderate rises (industrial production) and some rather handsome ones (nonfarm employment). However, the unemployment rate rose from 7.1 percent of the civilian labor force in November to 7.2 percent in December and 7.4 percent in January. Unless output growth reaccelerates above the average rates of the second half of 1984, unemployment rates will not go down.

The downward trends in interest rates, which began in July-August as the economy weakened, were helped along more recently by easier Federal Reserve policies and have continued through the day of this writing. In the last week of January, the Treasury bill rate stood at 7.7 percent, the Federal funds rate at 8.1 percent, and the average prime rate

TABLE 2. Quarterly Forecasts for 1984: Predicted vs. Actual Changes

Series	1983:4-1984:1		1984:1-1984:2		1984:2-1984:3		1984:3-1984:4	
	P (1)	A (2)	P (3)	A (4)	P (5)	A (6)	P (7)	A (8)
1. GNP in current dollars[1]	2.3	3.5	2.2	2.6	2.3	1.4	2.3	1.6
2. GNP in constant dollars[1]	1.1	2.4	1.1	1.7	1.1	0.4	1.0	1.0
3. Implicit price deflator[1]	1.4	1.1	1.3	0.8	1.3	1.0	1.3	0.6
4. Index of industrial production[1]	1.3	2.7	1.3	2.1	1.6	1.5	0.9	−0.2
5. Unemployment rate[2]	−0.3	−0.6	−0.1	−0.4	−0.2	0.0	−0.2	−0.3
6. Corporate profits after taxes[1]	3.5	6.7	3.9	−0.3	3.7	−7.3	3.1	1.6*
7. New private housing starts[1]	2.4	15.9	0.6	−3.7	2.9	−12.2	−1.4	−6.3
8. Consumption expenditures in constant dollars[1]	0.9	1.1	0.8	1.9	0.9	0.1	0.9	1.0
9. Nonresid. fixed investment, constant dollars[1]	1.4	4.8	2.1	5.0	1.7	3.7	1.6	2.7
10. Change in bus. inventories, constant dollars[3]	−0.1	24.4	2.4	−11.3	0.0	9.7	1.1	−16.4
11. Treasury bill rate (3 months)[4]	−0.2	0.3	0.0	0.7	0.1	0.5	0.1	−1.4
12. Net exports in constant dollars[3]	−1.0	−10.3	0.4	−3.1	−0.4	−15.6	0.8	11.8

For notes and sources, see Table 1.

TABLE 3. Average Forecasts from Surveys of December 1984-February 1985, Ten Aggregate Variables, Quarterly and Annual, 1984-1986

Date of Forecast	Quarterly Forecasts Targets					Annual Forecast Targets		
	1985:1 (1)	1985:2 (2)	1985:3 (3)	1985:4 (4)	1986:1 (5)	1984 (6)	1985 (7)	1986 (8)
	Gross National Product in 1972 Dollars (% change, annual rate)							
December 1984	3.2	3.8	3.5	2.9		6.7	3.2	
January 1985	3.3	4.2	3.8	3.1	2.4	6.7	3.4	2.8
February 1985	4.1	4.3	4.0	3.4	2.5		3.9	3.0
	GNP Implicit Price Deflator (% change, annual rate)							
December 1984	4.4	4.2	3.9	5.8		3.8	4.2	
January 1985	4.3	4.2	4.4	4.9	5.1	3.9	3.8	4.9
February 1985	3.9	3.7	4.0	4.4	4.6		3.6	4.6
	Rate of Unemployment (% of civilian labor force)							
December 1984	7.3	7.2	7.2	7.2		7.5	7.2	
January 1985	7.3	7.2	7.1	7.0	7.0	7.5	7.1	7.1
February 1985	7.2	7.0	6.9	6.8	6.9		7.0	6.9
	Corporate Profits After Taxes (% change, annual rate)							
December 1984	10.6	17.1	11.7	2.6		13.5	2.4	
January 1985	11.8	18.4	14.8	4.3	0.2	14.2	3.9	5.3
February 1985	15.2	20.5	12.2	5.5	1.0		4.4	5.8
	Industrial Production Index (% change, annual rate)							
December 1984	4.1	4.4	4.0	2.8		11.1	4.0	
January 1985	4.4	4.6	4.7	3.4	2.5	10.1	3.8	3.0
February 1985	5.9	5.8	4.9	3.6	2.5		4.0	4.1
	New Housing Starts (% change, annual rate)							
December 1984	13.6	8.4	− 2.5	− 3.2		4.2	− 6.0	
January 1985	29.1	17.2	0.2	− 3.4	− 7.3	4.7	− 3.3	− 2.7
February 1985	30.7	23.3	5.3	− 3.8	− 2.9		− 0.9	1.2
	Treasury Bill Rate, 3 Months (percent)							
December 1984	8.6	9.0	9.3	9.5		9.6	9.1	
January 1985	8.2	8.6	8.9	9.1	9.2	9.6	8.7	9.1
February 1985	7.9	8.2	8.6	8.8	8.8		8.4	8.7
	Nonresidential Fixed Investment in 1972 Dollars (% change, annual rate)							
December 1984	8.4	7.4	6.6	5.6		19.9	9.4	
January 1985	8.2	7.0	6.4	6.0	5.4	19.9	9.3	4.9
February 1985	7.7	7.0	6.8	6.6	4.9		9.6	5.4
	Change in Business Inventories, 1972 Dollars ($ billion)							
December 1984	18.3	18.0	18.2	17.9		25.9	18.2	
January 1985	18.3	18.6	18.9	18.8	16.9	25.9	18.7	15.3
February 1985	15.5	17.0	18.0	18.3	16.7		17.2	16.9
	Net Exports of Goods and Services, 1972 Dollars ($ billion)							
December 1984	−26.9	−27.4	−27.4	−26.8		−18.0	−27.2	
January 1985	−23.6	−24.2	−24.4	−24.2	−24.1	−17.5	−24.1	−22.5
February 1985	−18.5	−20.5	−22.0	−22.1	−21.5		−20.7	−19.9

SOURCE: *Economic Forecasts: A Worldwide Survey*, Elsevier Science Publishers (North-Holland), Volume 1, No. 6, December 1984; Volume 2, No. 1, January 1985; worksheet tabulations for Volume 2, No. 2, February 1985.

December 1984: means of 26 individual forecasts; January 1985: means of 30 individual forecasts; February 1985: means of 30 individual forecasts.

at 10.5 percent, down from the summer peaks of 10.5 percent, 11.6 percent, and 13.0 percent, respectively. Since late October, after a pause of about five months, growth in checkable deposits and M1 have resumed at a fair pace but time deposits have flattened.

The retardation of 1984:3 was preceded by downturns in the leading index and inventory investment as well as several months of rising interest rates. The weakness was caused in large part by a decline in real consumption expenditures, particularly on durables. But in 1984:4 these consumer outlays turned up again and recorded large gains. Consumer confidence, though weakened, remained relatively high. Business investment in plant and equipment continued moving up, albeit at a reduced pace. At present, however, some data relating to future domestic production and investment give cause for concern.

The signals from these and some other leading indicators are mixed, pointing to uncertain prospects. According to the Commerce survey taken earlier in the fall, businesses planned to increase their total spending on capital goods by

6.8 percent in the year 1985 compared with 1984, after adjustment for projected inflation. But constant-dollar contracts and orders for plant and equipment have followed a mild and irregular downward drift for several months now. So have new orders for consumer goods and materials in 1972 dollars. These series do not include orders from foreign producers, which have been rising. Sales of automobiles and of existing homes increased strongly in the final months of 1984. But residential construction commitments and expenditures continue to be weak.

The composite index of 12 leading indicators rose to a high of 168.5 (1967 = 100) in May 1984; it then moved down to 163.9 in August, up to 165.2 in September, and again twice down in the last quarter to 164.9 in December. Such oscillations signify a weakness but not a decisive downturn. The January Wall Street rally reflects a new surge of optimism among both the big institutions and small investors. There is an eagerness, often observed in the past, to embrace the good news and downgrade or reject the bad news.

. . . But Most Observers Encouraged, Expect Further Improvements

In late November, the date of the last business outlook survey taken by the American Statistical Association and the National Bureau of Economic Research (the results of which are shown in this OUTLOOK issue), the economy was showing few signs of coming out of the sharp economic slowdown of mid-1984. Nevertheless, most of the 31 respondents predicted real growth of more than 3 percent next year. Chances of a slide into recession were rated by all but a few as low, though generally not negligible. Some rises in the unemployment rate were anticipated but on balance slight declines prevailed. About 60 percent of the survey participants expected that inflation and interest rates will be higher in 1985:4 than in 1984:4. However, the projected changes were on the whole small and the responses to them were not seen as posing a threat to the expansion in the near future.

Table 3 sums up the results of three monthly surveys that are more recent than the last ASA-NBER questionnaire. The source, a new monthly journal *Economic Forecasts: A Worldwide Survey* (North-Holland), provides comprehensive coverage and full detail on individual forecasts, but here only the group averages are used. As in the ASA-NBER survey, judgmental, econometric, and combined forecasts are represented, and the participants include many persons and organizations familiar to the business and financial community.

New and revised data for quarterly, monthly, and shorter periods are being released almost daily: the continuous change creates demand for more frequent forecasts that permit more flexibility of adjustment to the often surprising turn of events. Predictions that are closer to their target period use more up-to-date information and tend to be more accurate. Still another good reason for monitoring monthly forecasts is that they show promptly how expectations vary and change.

Clearly the general outlook improved significantly as shown by the evolution of the survey forecasts published in December 1984 and January and February 1985. All average forecasts of rates of growth in real GNP and industrial production are higher now than they were one and two months ago. The same is true of most predictions of corporate profits. The forecasts of unemployment rates have been revised downward; so have those of inflation (IPD) and interest (Treasury bill) rates.

These changes, however, are on the whole not large. There is little anticipation that the exuberance of early 1984 is coming back. Real growth is expected to be moderate through the summer, at or slightly above 4 percent annual rates, then to decline again to near 3 percent and lower late in 1985 and 1986. This is attributable to upward drifts in inflation and interest rates, a downturn in housing, a weakening of investment in plant and equipment and business inventories, and continuing large trade deficits.

Also, there is still much uncertainty about the outlook, and the dispersion among the individual forecasters is substantial. The predominant moderately optimistic scenario is not without its risks and rivals. Worries about the high federal budget deficits are widespread. If Congress fails to take any effective action on the problem, then, according to some forecasts, interest rates may move up sharply late this year and in 1986. The strong dollar and high imports, too, would continue to hurt large sectors of U.S. economy. The result would be a recession, perhaps only late next year.

Another possibility is that large cuts in government spending are enacted, and perhaps the effective tax burden is also raised. Interest rates should then decline, but some analysts think that this would occur only with considerable lags. In the meantime, the economy would be pushed into a slowdown or recession.

Finally, there are some who foresee stronger and more sustained growth, less actual and expected inflation, more moderation of wages, and lower deficits and interest rates as a result. This highly optimistic scenario, however, is evidently given a low probability by all but a very few forecasters.

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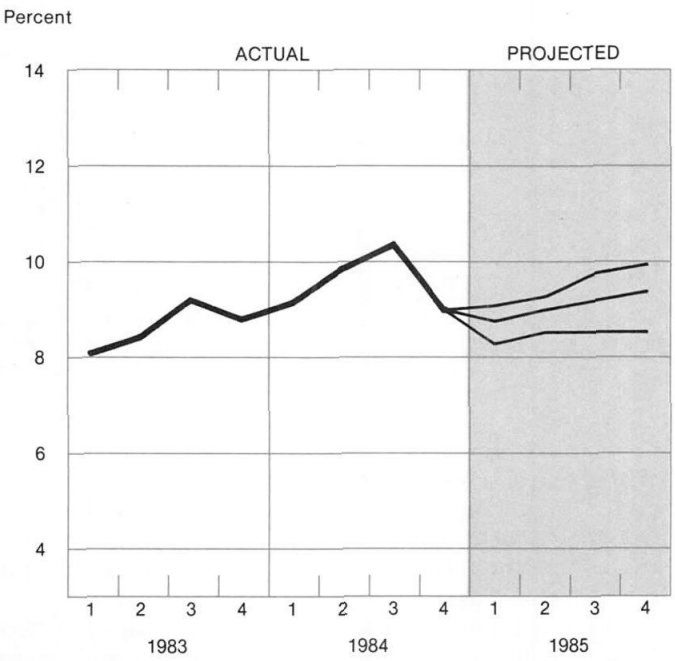
3-MONTH TREASURY BILL RATE



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.

A Recession Narrowly Averted?

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Can Economists Forecast?

No less an authority than the President of the United States has been quoted as declaring that there is not an economist in the world who can accurately forecast long-term budget data. He might even have had in mind a truncated version of this pronunciamento—namely, that economists can't forecast. He would, of course, be right. As for the budget, the Budget Message transmitted in January 1979 projected for fiscal year 1984—in the five-year lookahead required by law—outlays of $674 billion, receipts of $780 billion, and a surplus of $106 billion. Things did not, as the whole world knows, turn out that way. The bottom-line figure was, of course, in red ink to the tune of $175 billion.

There are two problems about citing this as evidence that "economists" cannot forecast budget data or forecast more generally. One is that political actions in any five-year span keep altering the budget path. What "the economists" project, and they do it reasonably well, is how the budget would look five years hence if spending and revenue programs were unchanged. More fundamentally, good policy decision-making in government or in business requires making some assumptions about basic underlying trends. The capital budgets of a corporation, or even its operating plan for "next year," imply some assumptions about trends in economic activity. Any board of directors will (or should) insist that these assumptions be made explicit, but any board of directors worthy of its responsibilities also knows that these assumptions and plans will require modification as added information becomes available.

And both ends of Pennsylvania Avenue would do well to judge the value of these projections on a more fundamental basis than whether government economists "predict" future budget figures accurately. We have an uncomfortable budget problem today because government took inadequate account of where these earlier decisions were taking the budget for several years ahead. Indeed, a budget process which focuses only on "next year" will be an exercise in futility since spending "next year" will largely be determined by program decisions already made. The President and the Congress can "today" have some but limited influence on the budget path if they focus on the forthcoming fiscal year (FY 1986); they can *control* the direction of that path only by focusing on the several years ahead.

Problems at Year-End 1984

As we moved out of 1984, business analysts were clearly beginning to feel some butterflies about economic prospects, and they were not just being Nervous Nellies. The strength that the economy had displayed earlier in the year seemed to fade after mid-1984, and the news that real "final demand" in the third quarter actually declined was decidedly unsettling. Moreover, other information seemed to corroborate this adverse dog-leg in business conditions. Monthly reports from the National Association of Purchasing Management showed the proportion of the responding firms reporting an increase in new orders exceeding the proportion reporting a decline by 20 to 40 percentage points during the first half of 1984 (Table 1). This net favorable percentage dropped in the third quarter, and in the fourth quarter the proportion reporting a decline in new orders exceeded the proportion reporting an increase—the largest net unfavorable figure coming at the end of the year.

TABLE 1. Net Percent* of Firms Reporting Increases, 1984

Month	Production	New Orders	Inventories
Jan.	+24	+27	+ 3
Feb.	+37	+41	+13
March	+36	+35	+12
April	+38	+40	+18
May	+20	+14	+10
June	+25	+20	+12
July	+ 2	+ 2	+16
August	+ 6	+ 4	0
Sept.	+ 4	− 2	− 7
Oct.	+ 3	− 1	−15
Nov.	+ 2	0	−15
Dec.	− 5	− 5	−14

*Percent reporting an increase less percent reporting a decline.
Source: National Association of Purchasing Management.

There were other indications that the forces for economic expansion might be less monolithic than seemed probable earlier in the year. The two major leading indicator indexes seemed to be on a declining trend after early-year peaks. With average lags, these in the mechanistic sense seemed to be pointing to a peak for business activity generally around the end of this year's first quarter. Since the first quarter has not yet faded into history, we cannot be sure that this peak will not occur, but in the meantime these indicator indexes seem to have changed their minds and started upward again.

Moreover, data for the fourth quarter were generally interpreted to portend more economic strength than was really warranted. While output was rising more rapidly than had been expected, the fact is that over-all demand for output in the U.S. economy was rising at only a one percent per year pace in the final quarter last year (Table 2). This one

TABLE 2. Annual Rates of Increase* in the Demand for Output, 1984

Quarter	Real GNP	Final Demand	Domestic Demand for Output
First	10.0	3.6	12.9
Second	7.1	10.3	7.9
Third	1.6	−1.0	5.4
Fourth	3.9	8.3	1.0

*Percent change computed from data in 1972 prices.
Source: Basic data from the U.S. Department of Commerce.

percent gain in the domestic demand for goods and services here at home translated into a 3.9 percent per year rise in real GNP because there was an unexpected, and possibly temporary, shift in demand from imports to domestically produced stuff. Indeed, imports of goods and services, in real terms, declined at a 27 percent per year rate in the fourth quarter, but it would be imprudent to assume that this is the beginning of a fundamental shift of demand here at home toward domestically produced services and products.

In these early weeks of the year it looks as if 1985 has probably averted by a narrow margin the distinction of launching the ninth recession since World War II or the sixth in the last quarter of a century. At the turn of the year production and employment were expanding at a good rate. Inventories were not overly heavy relative to sales and sales prospects. Consumers were continuing to be prudent in the allocation of their after-tax incomes between spending and saving.

Factors Affecting Continued Expansion

Whether we can keep the expansion going on a sustained and orderly basis will depend on three sets of factors. First, sounding like a broken record though it may, we ought to avoid the zigs and zags of monetary policy with which the economy had to contend once again in 1984. The money stock (M-1) increased at an 8.2 percent per year rate in the first half of last year, but from mid-year to October the trend was flat to slightly downward—only to be followed by a spurt at the turn of the year. The 5.7 percent average rise during the year was appropriate, but swings in this rate during the year were too wide. These swings, particularly the complete cessation of growth after mid-year, had to have exerted an adverse effect on business conditions in the short run, and they thus also were generating demands for more direct political control of the management of the Federal Reserve System. Monetary policy would not then, of course, be managed better (indeed, worse), so it is important to remove this source of that pressure also.

Second, the expansion must move cautiously from here on, because the one development that would start the beginning of its obituary would be to reactivate a rising trend in the rate of inflation—which was disastrous in so many ways during the last decade. Reducing the unemployment rate below present levels can be done, but it requires more careful and patient navigating than was needed during the decline from 10 percent a few years ago to the 7 percent of today. Fortunately, there the performance remains good. The rate of inflation during 1984 was in the 3½ percent per year zone, and hourly earnings (with the influence of changing employment patterns eliminated) were rising at about the same (or slightly lower) average rate. Thus the year ahead of us inherits as an important and favorable legacy a reasonably benign trend in our cost-price level.

Finally, we must make major progress in relieving the distortions imposed on the U.S. economy, and on the world economy also, by the sharp rise in the exchange rate of the U.S. dollar. While the causes of these sharp changes in the exchange rate for the dollar are complex, a major influence clearly has been the large deterioration in the Federal budget (Table 3). The basic problem is that the savings required by the private economy plus the Treasury's borrowing requirements are 10-15 percent more than the volume of savings generated domestically. The market for savings is like the market for corn or semiconductor chips or oil. The price will move to the level where the supplies made available are brought into balance with the amount demanded. In this case the price, rates of interest, here at home must be high enough to attract the foreign savings needed for things to balance out. When a foreigner places funds here, however, he accepts all of the risks of the domestic investor plus the foreign exchange risk that when he wants to take his funds back home a weaker exchange rate for the dollar might mean winding up with fewer francs, or D-marks, or yen. Since these foreign savings come in by the purchase of dollars, the price of the dollar is pushed up. The result is that the real effective exchange rate of the dollar is now about one-third above its 1977-80 level, our net export surplus of manufactured goods of about $5 billion per year at the turn of the decade was an $80 billion deficit last year, and U.S. manufacturing employment last year was 4 percent below that of 1980, though non-manufacturing employment was up 5 percent.

It is essential that this external imbalance be redressed before the rest of the world becomes too comfortably adjusted to what for them is a favorable trade balance with the U.S.—but which for economic and political reasons will not be tolerable here at home for the long run.

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TABLE 3. Factors Associated with U.S. External Trade Deficit

Year	U.S. Export Surplus[1]		Exchange Rate of Dollar[2]	Federal Surplus[3]	Aaa Bond Yields[4]
	Total	Mfg. Gds.			
1977	$ − 39.2	$ 3.6	102.9	$ − 53.6	8.02
1978	− 42.4	− 5.8	98.4	− 59.2	8.73
1979	− 40.4	4.4	98.4	− 40.2	9.63
1980	− 36.4	18.8	102.2	− 73.8	11.94
1981	− 39.7	11.8	112.8	− 78.9	14.17
1982	− 42.7	− 4.3	123.2	−127.9	13.79
1983	− 69.4	−31.0	126.3	−207.8	12.04
1984p	−123.0	−83.0	132.0	−185.3	12.71

[1]In billions, from U.S. Department of Commerce.
[2]Index of real effective exchange rate, from *World Financial Markets*, December 1984 and earlier issues. Data converted to a base of 1977-80 = 100.
[3]In billions, for fiscal years.
[4]Moody's Aaa bond yields, *Economic Indicators*, December 1984, p. 30.
p – preliminary.

Improved Finances Sustain Consumer Optimism

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Changes in Sentiment

In the fourth quarter 1984 survey, the Index of Consumer Sentiment was 95.0, down from 98.9 one quarter earlier, and the cyclical peak of 99.5 recorded in the first quarter of 1984 (see the chart below). Despite this small year-end decline, the average level of consumer confidence recorded during 1984 was higher than in any prior year since the late 1960s.

Most periods of recovery in consumer sentiment mirror past cycles, at least in the structure if not in the extent of change in attitudes. Only infrequently does a new underlying foundation emerge. The current recovery has been accompanied by a shift in the criteria used by consumers to judge the current and expected performance of the economy. Whether this shift in the structure of sentiment endures or is only temporary will depend on subsequent reinforcement. Nonetheless, the older sentiment patterns are now being held in abeyance, the precondition for the emergence of a new belief structure.

From the mid-1950s to the mid-1960s, income and employment trends dominated consumer assessments of the economy. From the mid-1960s through the decade of the 1970s, inflation was the dominant yardstick. By the mid-1980s, interest rates became the most common basis on which assessments were made and the primary source of uncertainty about the future course of the economy. To be sure, the problem of inflation is not viewed by the public as having been resolved, but the remission is expected to continue. Little credence is given to the once common scenario of a stagnant economy and declining living standards. And little credence is given to predictions of uninterrupted growth during the decade ahead. That the economy will experience periods of both growth and recession in the future is not in question. Rather, we have experienced a change in how people assess ongoing economic developments.

When asked about their future financial prospects, three factors have dominated consumer evaluations, at one time or another, during the past several decades: employment prospects, wage trends, and trends in the cost of living. During the past few years, the rate of increase in both wages and prices has moderated to a substantial extent, while unemployment remained at relatively high levels. As a result, job prospects now constitute the most important source of uncertainty about financial prospects for individual families. And because of smaller expected increases in wages and prices, the real burden of future debt repayments, as well as the real return to savings, is now more dependent on trends in market rates of interest. Moreover, this shift from an economy characterized by inflation to one with high and variable interest rates has also influenced purchase timing decisions. Borrowing-in-advance of rising interest rates rather than buying-in-advance of rising prices has emerged as one means of adapting old responses to new situations.

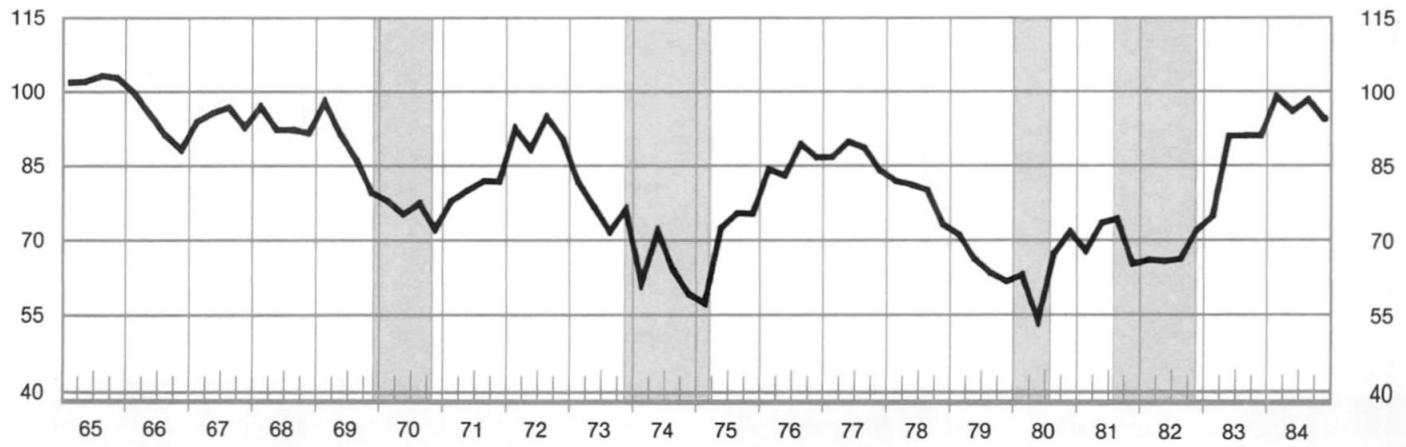
Best Financial Progress in 20 Years

The personal financial situation of American families improved to a greater extent in 1984 than in any other year in the prior two decades. Among all families in the fourth quarter 1984 survey, 44 percent reported that their financial situation had improved, just below the 45 percent recorded in each of the first three quarters of 1984. In comparison, the 1972 and the 1965 peaks were slightly higher, but these favorable levels were only sustained for one quarter – 47 percent in the second quarter of 1972 and 50 percent in the second quarter of 1965.

When asked to explain how their financial situation had improved, 35 percent of all families reported that their income had increased in the fourth quarter survey, a level that remained largely unchanged throughout 1984. In addition to more favorable trends in nominal incomes, fewer families

INDEX OF CONSUMER SENTIMENT

February 1966 = 100



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

complained about the erosion of the purchasing power of their incomes due to inflation during 1984 than in any prior year since the late 1960s.

American families have viewed prospects for improvement in their financial situation very favorably since the start of 1983. In the fourth quarter 1984 survey, 38 percent of all families expected their financial situation to improve during 1985, just above the 37 percent that expected improvement one year earlier. Just 11 percent of all families in the fourth quarter 1984 survey expected their financial situation to worsen during the year ahead, unchanged from the fourth quarter 1983 reading. On balance, personal financial expectations have remained near cyclical peak levels for nearly two years.

The sustained optimistic outlook for personal finances has not been based on higher income expectations, but rather on the expectation that inflation would continue to remain at low levels. The proportion of families in the fourth quarter 1984 survey that expected income increases of 6% or more was 34 percent, just above the 32 percent recorded one year earlier, but below the 37 percent that was recorded two years earlier. During that same time, the proportion of families that expected an annual rate of inflation of 6% or more fell from 32 percent in late 1982 to 24 percent in the fourth quarter of 1984. As a result, in 1984 families held the most favorable real income expectations during the past ten years.

Given that these favorable financial prospects are based on low rates of inflation and limited income increases, consumers have adopted a somewhat more cautious outlook toward use of savings or debt to finance major purchases. The future burden of debt repayments will not be eased by rapid inflation, nor will the value of accumulated savings erode as quickly as was the case in the late 1970s. Among all families in the fourth quarter survey, 36 percent said that they were willing to use part of their savings in order to make major purchases, down from 42 percent six months earlier, and just above the 35 percent recorded one year earlier. Willingness to incur new debt was reported by 27 percent of all families in the fourth quarter of 1984, down from 29 percent six months earlier, and just above the 25 percent one year earlier.

Becoming Accustomed to Expansion

The majority of consumers have viewed the progress made by the national economy in very favorable terms throughout 1984. Among all families in the fourth quarter survey, 64 percent thought that economic conditions had improved during the past year, just below the 67 percent recorded both one quarter and one year earlier. Although the proportion that reported improved business conditions has declined from the cyclical peak of 71 percent at the start of 1984, at year end it still remained higher than at prior cyclical peak levels.

Given that these very favorable evaluations of the performance of the economy have lasted for nearly two years, it is no surprise that the widespread enthusiasm which greeted the initial phase of recovery has now been transformed into an accustomed awareness. Soon after the recovery first took hold in early 1983, the proportion of families reporting that they had recently heard of favorable economic developments reached an all-time peak of 80 percent. By the end of 1984, only half as many respondents reported hearing of favorable economic developments (41 percent). This decline in perceptions of ongoing developments has been due to both economic and psychological factors.

As the expansion period lengthened, developments that initially commanded widespread recognition and prompted sharp upward revisions in sentiment gradually lost their impact through the process of habituation. As people became accustomed to favorable developments, even the once constant attention given to these developments waned. The rising proportion of families that said they had not heard of any recent economic developments, either favorable or unfavorable, reflects this process of habituation – up from 30 percent in early 1983 to 46 percent by the close of 1984. At the same time, there was no substantial resurgence in perceptions of unfavorable developments; the proportion of families that reported hearing of unfavorable developments only rose from 31 to 38 percent. Although habituation does decrease the public's attention to the continuation of favorable trends, it also acts to insulate current attitudes and expectations from change. Change requires the repeated acquisition of information on *new* developments that cast doubt on the accustomed pattern.

Job Prospects Top Concern

The small overall rise in reports of unfavorable developments at year end was focused on changing job prospects. In the fourth quarter 1984 survey, 14 percent mentioned hearing of news of increases in employment, down from 26 percent at the start of the year, while reports of increases in unemployment rose to 17 percent at year end from 12 percent in the first quarter of 1984.

The negative shift in reports on recent employment trends was accompanied by less favorable job prospects for the year ahead. In the fourth quarter 1984 survey, for the first time in two years, the proportion of families that expected a decline in the aggregate unemployment rate fell below the proportion that expected the unemployment rate to increase. Among all families, 21 percent expected declines in unemployment during the year ahead, compared with 25 percent that expected increases. At the start of 1984, more than twice as many families expected declines rather than increases in unemployment (35 versus 15 percent). Importantly, the majority of families (52 percent) expected the unemployment rate to post neither an overall increase nor decrease during the year ahead, but to remain at its current relatively high level.

Prospects for the Economy: Diminished but Still Favorable

The outlook for the general economy remained largely unchanged at favorable levels during the last nine months of 1984. In the fourth quarter survey, twice as many families expected further improvement rather than reversals in the national economy during the year ahead (33 versus 16 percent). Consumers, however, do not expect the same rapid rate of economic growth for 1985 as they did for 1984 – at the end of 1983, four times as many families expected improved economic conditions (45 versus 10 percent).

Despite the expected slowdown in the pace of economic growth, the majority of families expect good times financially in the economy as a whole to persist in both the near and longer terms. Among all families in the fourth quarter 1984 survey, 59 percent expected the economy to perform well during the next twelve months, just below the 63 percent recorded one quarter earlier and the 61 percent recorded

one year earlier. Economic prospects over the longer term have also remained favorable. In the fourth quarter 1984 survey, 42 percent of all families expected good times financially over the next five years, down from 46 percent one quarter earlier, but above the 39 percent recorded one year earlier. Long-term economic expectations were favorable on balance during the entire year of 1984 – for the first time since the late 1960s.

Confidence in government economic policies to reduce both inflation and unemployment was higher in the fourth quarter 1984 survey than at any prior time during the past decade. Among all families, 33 percent favorably rated government economic policies, unchanged from the third quarter reading and above the 27 percent recorded one year earlier. Unfavorable evaluations of government economic policies were given by 18 percent of all families, down from 21 percent one year earlier.

Interest Rate Declines Encourage Home Buying

Attitudes toward buying conditions for homes improved by a small amount at year-end 1984. Among all families, 53 percent held favorable home-buying attitudes in the fourth quarter survey, up from 50 percent one quarter earlier, but below the 61 percent recorded at the start of 1984. In early 1984, when interest rates were widely expected to increase, favorable home-buying attitudes were supported in part by the appeal of borrowing-in-advance of those increases. Since mid-1984, as interest rate expectations have declined, so has the appeal of borrowing-in-advance, falling to 9 percent at year end from 20 percent six months earlier. The improvement at the close of 1984 was due to more frequent references to the current availability of lower mortgage rates, rising to 30 percent in the fourth quarter from 22 percent in the third quarter of 1984. References to high mortgage rates as a cause for postponement fell to 31 percent in the fourth quarter from 38 percent one quarter earlier, but remained above the 28 percent recorded one year earlier.

How consumers evaluate trends in buying conditions for homes has undergone a fundamental shift during the past several years. The pace and breadth of the housing boom of the late 1970s was propelled by expected future price increases. In that environment, sharp rises in housing prices only reinforced the appeal of advance buying. At that time, purchase timing was dominated by price expectations. At the current time, purchase timing has become more sensitive to trends in interest rates rather than prices. Although reactions to rising interest rates and tight credit conditions have repeatedly caused declines during past cycles, only since 1980 have interest rate declines greatly stimulated favorable buying attitudes, and expected interest rate increases stimulated borrowing-in-advance rationales.

Interest rate expectations, following sharp increases in early 1984, posted significant declines in the second half of the year. Among all families in the fourth quarter 1984 survey, 42 percent expected interest rates to increase, down from 55 percent in the third quarter and 66 percent in the second quarter. The proportion of families that expected interest rates to decline was 24 percent in the fourth quarter, up from 9 percent two quarters earlier. Despite the substantial recent improvement, interest rate expectations remained somewhat less favorable at year-end 1984 than at the close of 1983.

Price Discounts on Durables Attract Buyers

Favorable perceptions of market prices for large household durables have kept buying attitudes at very favorable levels throughout the past year. Among all families in the fourth quarter 1984 survey, 68 percent held favorable attitudes toward buying conditions for durables, between the 71 percent recorded one quarter earlier and the 63 percent recorded one year earlier. In the fourth quarter 1984 survey, the proportion of families that cited the availability of price discounts on household durables was 30 percent, just below the 34 percent recorded one quarter and one year earlier. Unfavorable references to market prices for durables also declined by a marginal amount during the past year – from 16 to 14 percent. On balance, such favorable perceptions of market prices for household durables have not dominated consumer evaluations to this extent in more than 20 years.

Favorable car-buying attitudes were held by 55 percent of all families in the fourth quarter 1984 survey, down from 60 percent one quarter earlier and 58 percent one year earlier. Although the fourth quarter 1984 reading of 55 percent was the lowest reading since the first quarter of 1983, it nonetheless remains at a level comparable with the cyclical peak recorded in the late 1970s. A decline in favorable perceptions of market prices for vehicles was the primary reason for the recent erosion. Among all families in the fourth quarter survey, 18 percent referred to the availability of price discounts on new vehicles, the lowest level recorded in more than three years. Although references to price discounts on vehicles has declined, the number of consumers that registered complaints about high vehicle prices had not increased by year end 1984 over the year-earlier level – 14 percent.

Summary Outlook

The small year-end decline in consumer sentiment indicates the transition from the prolonged enthusiasm which accompanied the rapid recovery to the accustomed awareness of the ongoing economic expansion. Even after this small decline, consumer sentiment remained more favorable at year-end 1984 than at the cyclical peak recorded in the late 1970s. Thus far, most of the decline has been concentrated in movement from expectations for continued improvement toward the expectation that economic conditions would remain largely unchanged, rather than toward unfavorable expectations. Even if there are darkening clouds on the horizon, they are viewed as sufficiently distant so as not to cause concern with prospects in the near term.

These data indicate that consumer spending will be maintained at its improved level through late 1985. But unlike the later stages of past expansion periods, when the unrelenting pressure of rising prices promoted advance buying, buying attitudes have become increasingly dependent on the availability of price discounts. As a result, greater resistance to price increases can be expected, as well as an increased focus on comparative price shopping. Buying behavior has thus become more responsive to pricing of individual sellers rather than to aggregate price trends. Instead of inflation, aggregate trends in interest rates are now the primary influence on the timing of major purchases.

February 1985

Actual and Projected Economic Indicators

seasonally adjusted

SERIES FORECAST BY THE ASA-NBER PANEL															
ECONOMIC INDICATOR	Quarterly Data												Annual Data		
	Actual							Projected					Actual		Proj.
	83:2	83:3	83:4	84:1	84:2	84:3	84:4	84:4	85:1	85:2	85:3	85:4	1983	1984	1985
GROSS NATIONAL PRODUCT	3,267	3,347	3,432	3,553	3,645	3,695	3,764	3,761	3,833	3,900	3,978	4,065	3,305	3,664	3,941
GNP IMPLICIT PRICE DEFLATOR (index, 1972 = 100)	214.3	215.9	218.2	220.6	222.4	224.6	226.1	226.6	229.0	231.6	234.2	236.6	215.3	223.4	233.0
CORPORATE PROFITS AFTER TAXES	123.4	142.6	141.1	150.6	150.2	141.7	147.5	145.0	147.2	151.5	155.0	154.0	127.4	147.5	153.0
UNEMPLOYMENT RATE (percent)*	10.17	9.33	8.47	7.87	7.50	7.47	7.20	7.40	7.30	7.20	7.20	7.15	9.58	7.51	7.20
INDUSTRIAL PRODUCTION (index, 1967 = 100)	144.5	151.8	155.5	159.8	163.1	165.6	165.1	166.4	168.0	169.9	171.0	173.0	147.6	163.4	170.1
NEW PRIVATE HOUSING UNITS STARTED (millions)	1.690	1.782	1.699	1.947	1.858	1.663	1.586	1.620	1.655	1.700	1.655	1.660	1.704	1.764	1.660
CONSUMER PRICE INDEX (% change from prior quarter or year)	4.34	4.15	4.43	4.97	3.70	3.58	3.85	4.00	4.05	4.30	4.55	4.65	3.19	4.24	4.30
3-MONTH TREASURY BILL RATE (%)	8.42	9.19	8.79	9.13	9.84	10.34	8.97	9.50	9.25	9.50	9.70	9.90	8.62	9.57	9.53
NEW HIGH-GRADE CORPORATE BOND YIELD (percent)	11.57	12.68	12.76	12.94	14.18	13.72	12.76	12.80	12.70	12.50	12.80	12.90	12.25	13.40	12.80
GNP IN 1972 DOLLARS	1,525	1,550	1,573	1,611	1,639	1,645	1,665	1,660	1,674	1,688	1,702	1,715	1,535	1,640	1,695
PERSONAL CONSUMPTION EXPENDITURES (1972 $)	1,006	1,016	1,032	1,044	1,064	1,066	1,075	1,076	1,086	1,095	1,102	1,111	1,009	1,062	1,098
NONRESIDENTIAL FIXED INVESTMENT (1972 $)	165.3	172.6	184.5	193.3	202.9	209.5	212.7	212.0	216.0	220.0	222.3	224.0	171.0	204.6	220.7
RESIDENTIAL FIXED INVESTMENT (1972 $)	53.4	57.2	57.8	60.6	60.8	60.1	59.3	60.0	59.7	60.0	59.0	59.0	53.7	60.2	59.2
CHANGE IN BUSINESS INVENTORIES (1972 $)	−6.1	0.9	7.2	31.6	20.3	30.6	16.8	22.3	20.5	18.7	19.5	19.5	−3.6	24.8	19.6
NET EXPORTS (1972 $)	13.6	11.9	2.0	−8.3	−11.4	−27.0	−10.2	−23.2	−23.0	−23.0	−22.9	−22.4	12.6	−14.2	−23.0
FEDERAL GOVERNMENT PURCHASES (1972 $)	117.2	115.6	113.0	112.2	123.2	125.0	129.6	128.8	130.0	131.0	133.0	134.1	116.2	122.5	132.0
STATE AND LOCAL GOVERNMENT PURCHASES (1972 $)	175.2	176.4	175.8	177.3	178.9	181.1	181.2	182.9	184.0	185.0	186.0	186.3	175.7	179.6	185.1

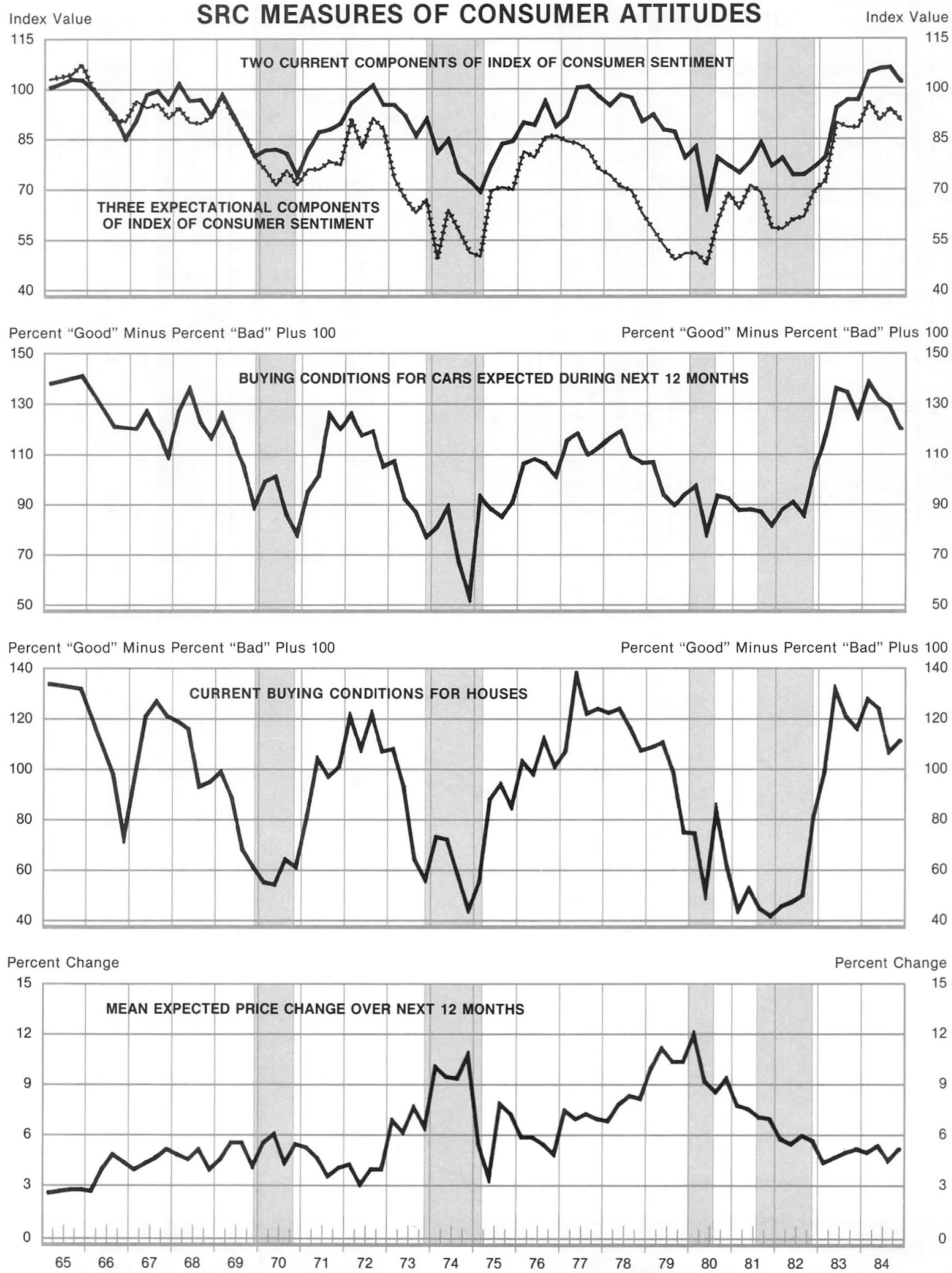
SERIES FROM THE CURRENT-DOLLAR GNP ACCOUNTS															
ECONOMIC INDICATOR	Quarterly Data												Annual Data		
	82:1	82:2	82:3	82:4	83:1	83:2	83:3	83:4	84:1	84:2	84:3	84:4	1982	1983	1984
GROSS NATIONAL PRODUCT	3,026	3,061	3,080	3,110	3,174	3,267	3,347	3,432	3,553	3,645	3,695	3,764	3,069	3,305	3,664
PERSONAL CONSUMPTION EXPENDITURES	1,931	1,961	2,001	2,046	2,070	2,142	2,181	2,230	2,277	2,333	2,361	2,397	1,985	2,156	2,342
GROSS PRIVATE DOMESTIC INVESTMENT	436.2	431.2	415.9	376.2	405.0	449.6	491.9	540.0	623.8	627.0	662.8	634.3	414.9	471.6	637.0
NET EXPORTS	27.7	35.5	6.6	6.3	19.6	−6.5	−16.4	−29.8	−51.5	−58.7	−90.6	−49.2	19.0	−8.3	−62.5
GOVERNMENT PURCHASES	630.9	633.7	656.3	681.0	678.8	682.2	689.8	691.4	704.4	743.7	761.0	781.7	650.5	685.5	747.7
DISPOSABLE PERSONAL INCOME	2,132	2,157	2,196	2,238	2,261	2,303	2,367	2,429	2,502	2,554	2,606	2,648	2,181	2,340	2,578
PERSONAL SAVING RATE (% of disposable income)	6.7	6.3	6.1	5.8	5.7	4.2	5.0	5.3	6.1	5.7	6.3	6.3	6.2	5.0	6.1

Note: (1) All data are at annual rates and in billions of current dollars unless otherwise indicated. (2) To facilitate comparison and evaluation of forecasts, both actual data, released in late February, and projected data, released by ASA-NBER in December, are displayed for fourth quarter 1984.

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



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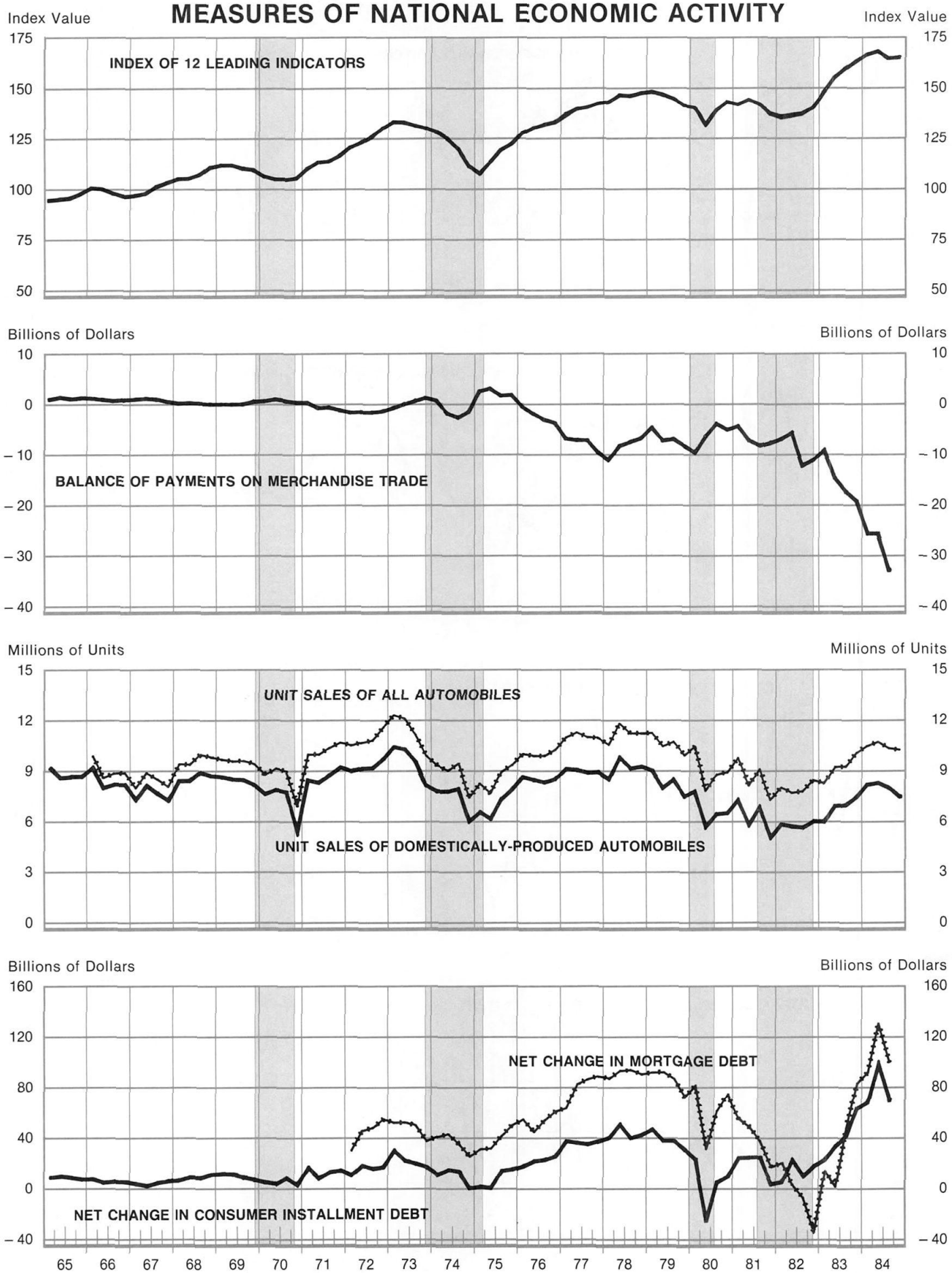

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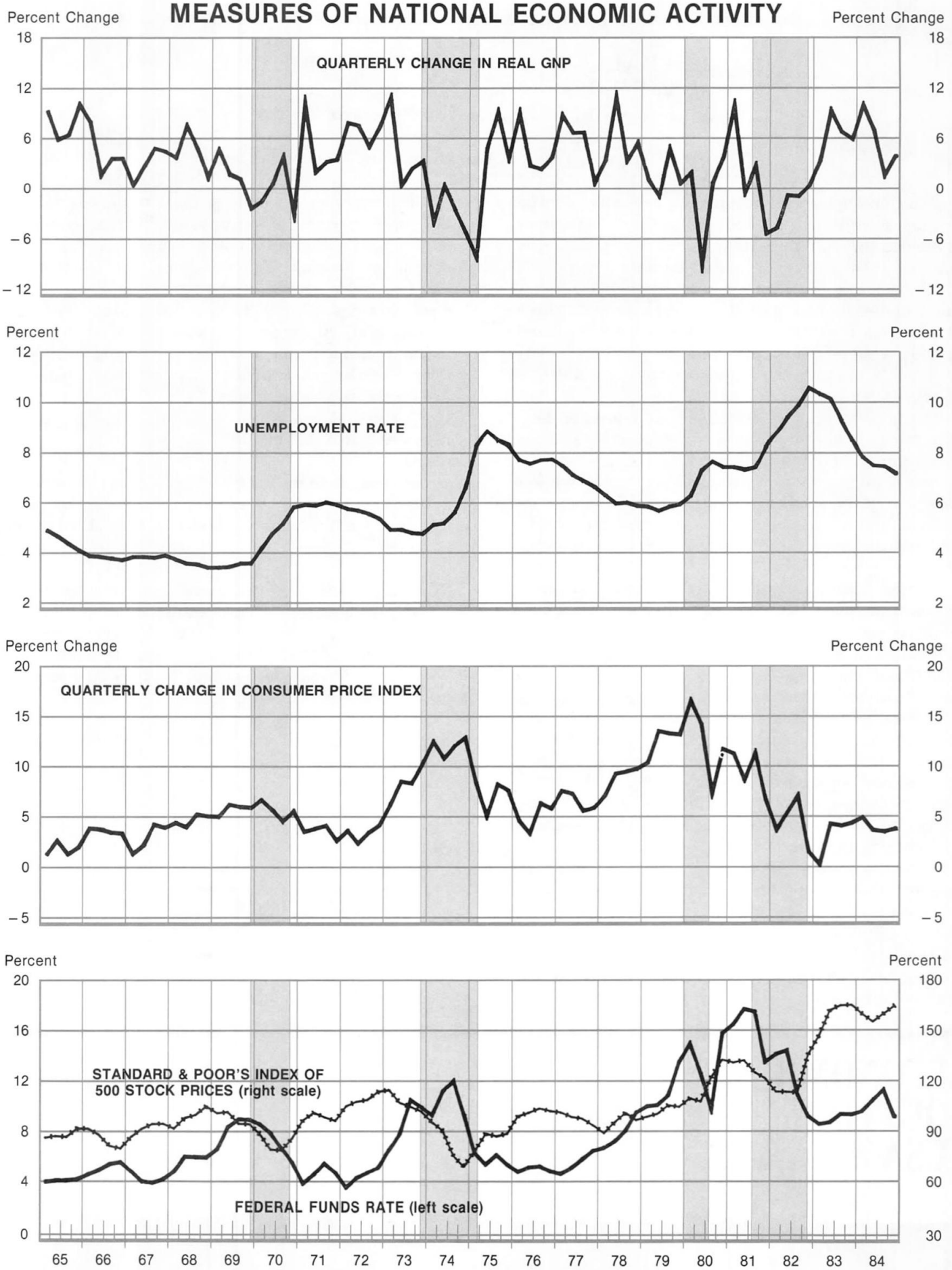
MEASURES OF NATIONAL ECONOMIC ACTIVITY



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