ECONOMIC OUTLOOK USA

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SURVEY RESEARCH CENTER
Institute for Social Research
THE UNIVERSITY OF MICHIGAN

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EDITOR'S NOTE

"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 in this new publication leans heavily on direct measurements of expectations, attitudes and plans for both consumers and business firms. It incorporates these forward-looking variables along with the economic and financial variables that have traditionally been used in forecast models. The philosophy of "ECONOMIC OUTLOOK USA" is that a blend of anticipatory and traditional measures provides a richer insight into prospective developments in the economic and social system. These richer insights will produce more consistently reliable forecasts of economic and social change.

The opinions expressed in this publication represent those of individual authors, and do not necessarily reflect the views of either the Survey Research Center or of Outlook Associates. The editor, as a matter of policy, makes no attempt to reconcile divergent opinions.

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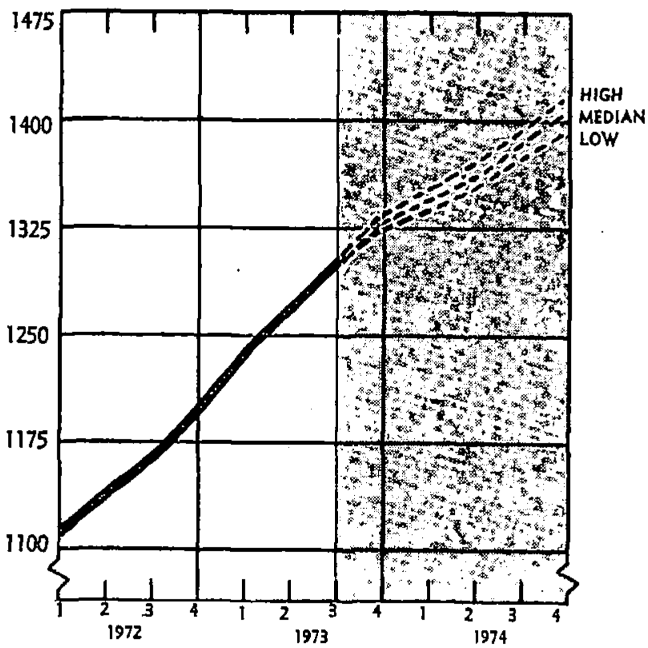
ECONOMIC PROSPECTS

Actual and projected; seasonally adjusted quarterly data at annual rates

GROSS NATIONAL PRODUCT

IN CURRENT DOLLARS: a small rise ahead

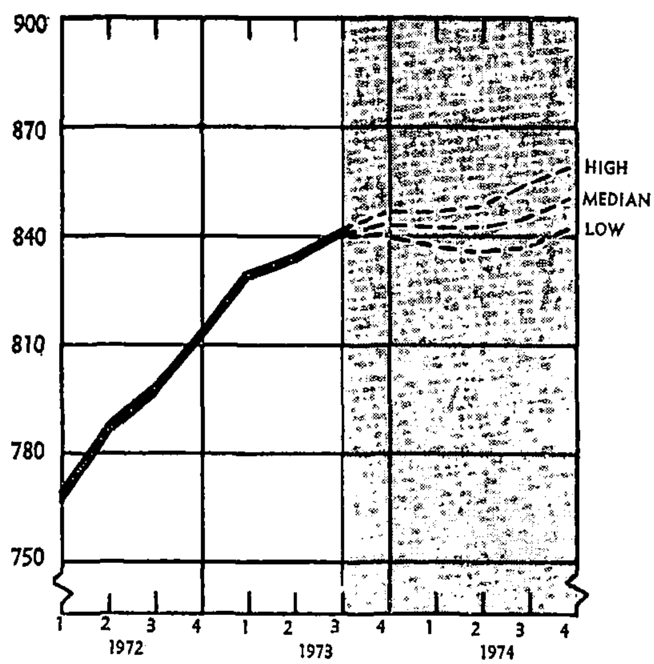
Billions of Dollars ACTUAL PROJECTED



GROSS NATIONAL PRODUCT

IN CONSTANT 1958 DOLLARS: mostly flat

Billions of Dollars ACTUAL PROJECTED



THE OUTLOOK FOR THE ECONOMY

The Consensus Forecast: No Cause for Panic

Henry C. Wallich
Professor of Economics, Yale University

The consensus forecast of a group of 55 leading forecasters, made after the outbreak of the oil crisis, anticipates more inflation, but no recession in 1974. The forecasters see a plateau in economic activity in the first half of the year followed by a slow resumption of economic growth in the second half. Inflation is expected to hit an annual rate of 6 percent during the first half but to slow down to about 4½ percent by the end of the year.

A Powerful Instrument

The composite forecast yielding these predictions is one of the most powerful forecasting instruments currently available for the American economy.* It derives its effectiveness from the large number of professional forecasts that enter into it. Every three months, as the GNP data for the past quarter are published by the Department of Commerce, these forecasters update their latest estimate. The individual predictions are put together to show the median of the group — the value separating the upper from the lower half — and the top and bottom 25 percent. Contrary to a widespread belief, most of these economists agree quite closely. The spread between the upper and lower quartile is rarely wide.

The composite forecast gains in reliability by the great diversity of forecasters and forecasting techniques. Because the views of a large body of men do not shift readily, the protection against extreme error that derives from the number of forecasters and variety of methods is purchased at some cost in terms of quick response. But the composite stands up well in comparison with smaller samples of individual forecasts. A survey of some well known forecasters recently published in *Business Week* arrives at a very similar conclusion for the rate of economic growth during 1974 — 1.6 percent real growth for the *Business Week* group against 1.1 percent for the composite forecast. A detailed study made by Stephen McNees for the Federal Reserve Bank of Boston shows that the composite forecast ranks in the middle of the

* These forecasts are obtained from a panel of forecasters who supply data every quarter to the American Statistical Association (ASA). The forecasts are analyzed for the ASA by the National Bureau of Economic Research (NBER). The panel is referred to as the ASA-NBER Forecasters Panel.

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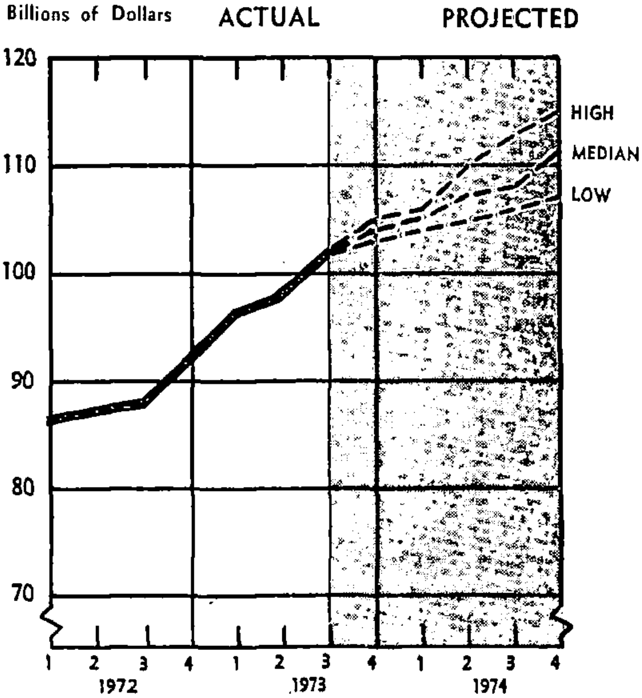
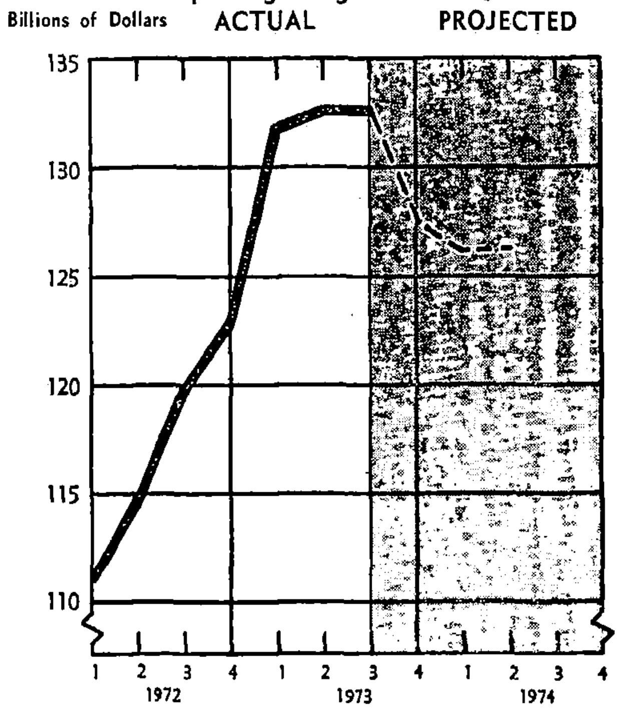
BUSINESS CAPITAL OUTLAYS

Surprisingly strong



CONSUMER DURABLE OUTLAYS

"OUTLOOK" expects growing weakness



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four econometric models that the Bank thought it interesting to compare.

Computer Models and Other Methods

The big computer models provide a very rigorous examination of the economy and its outlook. They can do this because the past history of the economy is programmed into them. But since the future cannot be expected to work exactly like the past, most of the big models nevertheless involve some adjustments made by the individual forecaster. The forecaster must also make assumptions as to certain future events, such as the Federal budget and Federal Reserve policy. This, in addition to differences in structure, ensures that no two models will ever yield exactly the same results.

Many of the 55 forecasters employ a GNP model generated by judgmental methods. While less rigorous, the exercise of putting together such a model nevertheless imposes discipline on the forecaster. No variable in a GNP table can be changed without changing at least one other variable, like in a double entry bookkeeping system. Guesswork is quickly revealed by inconsistencies.

The Consensus Forecast here presented does not show the awesome multiplicity of numbers typical of com-

(Continued on page 3)

ACTUAL AND PROJECTED ECONOMIC INDICATORS

seasonally adjusted

ECONOMIC INDICATOR	Quarterly Data												Annual Data		
	ACTUAL							PROJECTED							
	1972				1973				1974				Actual	Projected	
	1st	2nd	3rd	4th	1st	2nd	3rd	4th	1st	2nd	3rd	4th	1972	1973	1974
1. GROSS NATIONAL PRODUCT (annual rate, billion $)	1,113	1,142	1,167	1,199	1,243	1,272	1,305	1,329	1,347	1,366	1,388	1,412	1,155	1,287	1,378
2. GNP IMPLICIT PRICE DEFLATOR (1958=100)	144.9	145.4	146.2	147.6	149.8	152.5	155.1	157.5	159.8	161.8	163.9	165.7	146.1	153.7	162.8
3. GNP IN CONSTANT DOLLARS (annual rate, billion 1958 $)	768	786	797	812	829	834	841	844	843	844	847	852	791	837	847
4. INDUSTRIAL PRODUCTION (1967=100)	110	114	116	120	123	125	127	128	127	126	126	128	115	126	127
5. UNEMPLOYMENT RATE (percent)	5.8	5.7	5.6	5.3	5.0	4.9	4.8	4.8	5.1	5.5	5.7	5.8	5.6	4.9	5.5
6. CORPORATE PROFITS AFTER TAXES (annual rate, billion $)	52.2	53.4	55.6	60.3	66.9	72.6	71.5	70.6	68.3	66.0	67.3	68.4	55.4	70.2	67.5
7. EXPENDITURES FOR NEW PLANT and EQUIPMENT (annual rate, billion $)	86.8	87.1	87.7	91.9	96.2	97.8	101.9	103.7	105.5	107.5	108.0	110.9	88.4	99.9	108.0
8. NEW PRIVATE HOUSING UNITS STARTED (annual rate, million units)	2.43	2.28	2.37	2.40	2.40	2.22	2.02	1.66	1.57	1.60	1.69	1.80	2.36	2.08	1.67
9. CHANGE IN BUSINESS INVENTORIES (annual rate, billion $)	1.7	5.5	8.7	8.2	4.6	4.5	4.7	7.4	7.4	7.1	6.0	6.0	6.0	5.3	6.6
10. CONSUMER DURABLE EXPENDITURES (annual rate, billion $)	111.5	115.1	120.2	122.9	132.2	132.8	132.8	131.2	130.4	129.9	131.4	133.6	117.4	132.2	131.3
11. NATIONAL DEFENSE PURCHASES (annual rate, billion $)	76.5	76.6	71.9	72.4	74.3	74.2	74.2	74.9	76.0	77.0	77.8	78.7	74.4	74.4	77.4

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

(Continued from page 2)

puter models. The 11 series presented have been selected because they are frequently demanded by "consumers" of forecasts. Several of them are of a kind particularly likely to generate cyclical fluctuations.

Reliability

How reliable are economic forecasts? When a man sits down at a restaurant table and orders his appetizer and entree, the management, from well-established experience, does not expect him to know what, if anything, he will want for desert. With future demand so hard to forecast even for short periods and by the buyer himself, it is not surprising that economists are sometimes wrong about demand several quarters away. They have been off the track particularly at turning points of the cycle. The long term trend of the economy is easier to evaluate, because this trend has been fairly stable. Yet both business and government, each for their particular planning and budgeting needs, are condemned to forecast by design or default.

At the present time, the usual hazards of forecasts have been increased by the oil shortage, and the composite forecast reflects the forecasters' concern over the consequences of the embargo. Many of the forecasters hedged their bets by making specific assumptions about when the oil embargo would be lifted, 25 of them placing this hypothetical event in the first half of 1974. Rationing and controls are explicitly assumed by eight respondents, substantial gasoline tax increases by five. Because of the uncertainties about both the duration and effect of the embargo, one would expect the spread between the optimists and the pessimists to widen, especially as they look toward the end of 1974. This however has not been the case. The spread between the upper and the lower 25 percent has remained at approximately 2 percent as it was in the previous forecast, made in August 1973. Many forecasters probably felt increasingly unsure about their numbers but saw no way of assessing the impact of the embargo beyond reducing the overall level of their forecast.

The Oil Situation

In the early days of the oil discussion, much of the attention focused on the likely response of demand to a higher price or a higher tax on oil products. Meanwhile, more and in large part favorable information has appeared concerning supplies. In the light of the data available at the beginning of the year, a relatively more favorable evaluation of the outlook might have been made by the forecasters.

Forecasters typically see two effects of oil shortages. One takes the form of interruptions of production, if and to the extent that inputs become inadequate. The other takes the form of a shortfall of demand, as consumers buy fewer large automobiles, fewer homes located in distant suburbs, and cut vacation expenditures and the like. Forecasters then must estimate how consumers will reallocate the unspent funds — to saving, to alternative forms of consumption, or both. Different answers will lead to different forecasts.

Growth in 1974

The forecasters have responded to all these uncertainties by reducing their expected rate of real growth to 1.1 percent, from 2.6 percent (not shown in Table 1) in their previous forecast dating back to August. It is of some interest to note that those who were more pessimistic in the previous round (the lower 25 percent) cut their forecast by less than the median. Apparently even the pessimists do not see the economy sliding very far.

Going from quarter to quarter in 1974, the forecasters see the main impact of contractive forces in the first quarter, with continuous improvement during the rest of the year to a growth rate of about 2.5 percent at the end. This would still be below the long term growth rate of the economy, which has averaged 4 percent or a little better. Only the pessimists see two quarters of continuing decline, while the optimists (upper 25 percent) see no quarterly decline at all. In a questionnaire not shown here the group estimated the chances of a decline during the first half at about 50:50, during the second half as roughly four to one against.

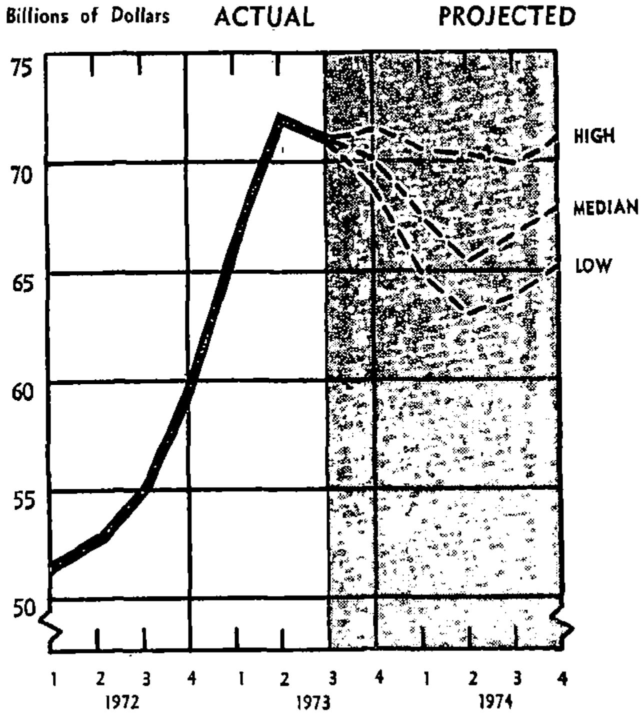
Strength

Looking at particular sectors of the economy, the forecasters see considerable strength in Plant and Equipment Expenditures, which they expect to rise by 8.1 percent over 1973. Presumably this reflects their reaction to widespread capacity shortages and to the prospects for an aggressive search for alternative new sources of energy. In another part of this report, Professor Victor Zarnowitz raises questions about the consistency of this optimistic evaluation of the outlook for capital expenditures.

(Continued on page 4)

CORPORATE PROFITS (AFTER TAXES)

A slight decline — some recovery



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Weak Spots

Weakness is seen by the forecasters to originate principally in Housing and Consumer Durable Expenditures. Housing Starts are expected to fall about 20 percent below 1973, but the decline is seen to bottom out as early as the first quarter, followed by a moderate revival. For consumer durables the forecasters anticipate weakness through the second quarter, with recovery in the second half but a small drop for the year 1974 as a whole nevertheless. The article by F. Thomas Juster, in this publication, gives some of the reasons for expecting this poor performance of consumer durables. Its general conclusions, however, are somewhat more pessimistic than the outlook envisaged by the consensus forecast. The unemployment rate, in the median forecast, will not reach 6 per cent even in the highest (final) quarter. The pessimistic 25 percent do see a 6 percent unemployment rate for the second half.

Price Outlook

Expectations of inflation have gone up sharply. For the year 1974 as a whole, a price rise (GNP deflator) of 5.9 percent is expected, contrasted with 4.6 percent in the previous forecasting round. During the year, however, forecasters expect inflation to come down from a 6 percent rate in the first quarter to 4.4 percent in the final one. The pessimists expect no worse a result for the final quarter, although their inflation rate for the year is somewhat higher.

Inventory Pattern

The slowing down — a "growth recession" envisaged by the forecasters — has one peculiar feature: unlike several post World War II recessions, it is not preceded by a spurt of inventory accumulation. Typically, this has tended to occur as some firms seek to restore stocks that have become depleted during a boom while others find goods backing up on them. In the present juncture, many types of inventories no doubt are being drawn down severely, making accumulation difficult despite the very low inventory/sales ratios prevailing. The forecasters anticipate inventories to rise at a virtually constant rate each quarter. Experience has shown, however, that inventories are notoriously hard to forecast, and estimates are therefore subject to a larger margin of error than most other series.

Profits Well Maintained

Corporate profits, stated after taxes, are expected to drop approximately 4 percent in 1974. Considering the fact that profits typically swing much more widely than GNP, this is indeed a remarkably moderate decline. The optimists even see a minute rise, while the pessimists anticipate nothing more drastic than a fall of 7 percent. All sides see profits rising again by the end of 1974.

Corporate profits in 1973 received a strong boost from inventory profits. On a pretax basis, inventory profits amounted to approximately 14 percent of the total. A return to a better degree of price stability would eliminate much of the inventory component. The forecasters' expectation of only a small drop in profits therefore seems to reflect their expectation of a high rate of inflation for some time longer.

Stock Market

This view of the profit outlook requires some reconciliation with the performance of the stock market in the last months of 1973. A decline of something like 20 percent for the major averages, and much more for many individual stocks, seems out of keeping with a forecast drop of profits of about 4 percent, particularly since a rising trend is expected after midyear. This becomes all the more evident when one considers what a 20% drop in stock market values implies in terms of discounted earnings flows. With a price:earnings ratio of 15, such as used to be common in the market, approximately one half of the value of a stock represents the discounted present value of earnings more than 10 years away. It does not seem likely that anyone could now forecast what the events of 1973 will do to earnings in the middle 1980's and after. Thus, the 20 percent drop in the market should reflect a reduction in earnings expectations for the next 10 years by 40 percent. All this seems to be at odds with the behavior of profits as seen by the forecasters.

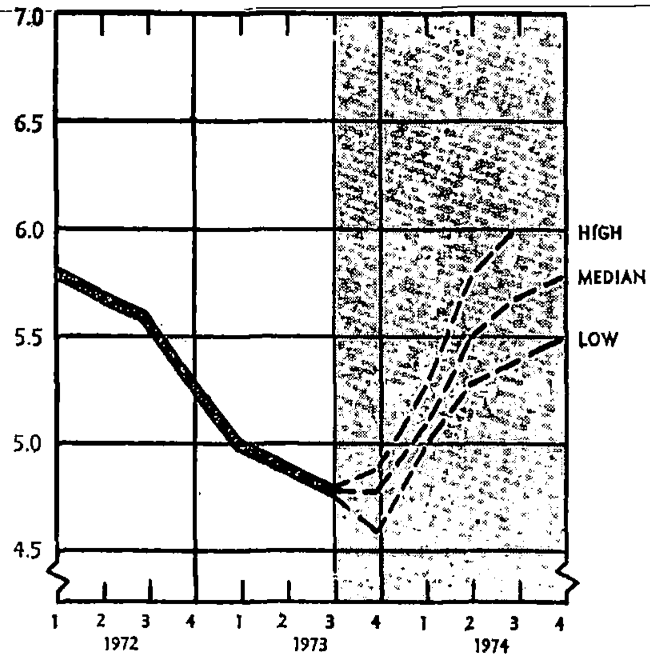
One possible explanation may be the inventory component of total profits. Inventory profits are of poor quality. They are embedded in a higher valued inventory of possibly unchanged real size, are available neither to pay dividends nor to finance capital expenditures, and they generate tax liabilities. One can surmise that the behavior of the stock market in some measure reflects a reaction to the deteriorating quality of profits.

Conclusion

All in all, the consensus forecast displays a considerable degree of confidence in the future, given the circumstances in which it was made. All forecasts today carry a greater degree of uncertainty, owing to the oil situation. They must be interpreted in the light of the assumptions made by the forecasters concerning the outcome of that situation. To the limited extent that it is possible to look into the future today, the forecasters seem to anticipate no crisis of major proportions.

UNEMPLOYMENT RATE (seasonally adjusted)

Going up again



Growing Weakness In The Consumer Sector

F. Thomas Juster
Survey Research Center, The University of Michigan

Background

1973 has been a traumatic year for the American consumer. The first part of the year witnessed an extraordinary boom in the consumption sector, centered in durable goods and especially in automobiles, and fueled by a combination of sharply rising prices leading to anticipatory buying, strong gains in disposable income, and exceptionally heavy tax refunds stemming from the overwithholding of 1972 income taxes. The middle of the year was characterized by some hesitancy in consumer demand, partly due to the uncertainty generated by the behavior of prices, partly the natural aftermath of the unsustainably rapid growth in the early part of the year. Phase 3½ and 4 followed shortly thereafter, resulting in another shortlived surge in consumer demand. The last part of the year has been characterized by the renewal and even acceleration of price inflation, continued rapid growth in money income but relatively sluggish growth in real income, and a growing concern over energy supplies, energy prices and expected cutbacks in employment.

Expectations and Attitudes

In large part as a consequence of the above events, consumer expectations and attitudes changed drastically during 1973. The mood of consumers was relatively buoyant in late 1972: output had been expanding in the aftermath of the Phase 1 and Phase 2 control programs, real incomes were rising rapidly, prices seemed to be under control and expectations about the business outlook and personal finances were more favorable than they had been in some time. But starting late in 1972 and continuing throughout 1973, consumer pessimism about business, about their own personal financial situation, and about price changes reached landslide proportions as documented in the article by Jay Schmiedeskamp in this publication.

Changes in Real Income

Moreover, the financial circumstances of many consumers changed adversely during 1973, despite the fact that unemployment rates declined throughout the year and that growth in aggregate income was maintained at an apparently satisfactory rate. Growth in *real income per family* virtually came to a halt. The relevant numbers are striking, and not widely recognized: aggregate money income grew at just under a 10% per year rate during the first 9 months of 1973; price changes absorbed the lion's share of that increase, but the growth in real income (money income deflated for price changes) was at a rate of 3.2% per year — less than trend but still reasonably satisfactory However, because the number of households grew at almost the same rate, the average growth in real per family income over the first 9 months of 1973 was almost exactly zero, leaving the average family no better off at the end than at the beginning of the year.

(Continued on page 6)

CONSUMER DURABLE GOODS SPENDING & CONSUMER SAVING

seasonally adjusted quarterly data at annual rates

	ACTUAL							PROJECTED		
	1972				1973				1974	
	1st	2nd	3rd	4th	1st	2nd	3rd	4th	1st	2nd
Consumer Durables (billion $)	111.5	115.1	120.2	122.9	132.2	132.8	132.8	127.5	126.2	126.3
Autos & Parts	49.4	51.2	55.0	55.7	60.5	59.7	59.2	52.0	50.0	49.6
New Autos	36.6	38.1	41.8	41.2	45.1	44.6	44.5	37.9	35.9	35.5
Auto Parts	12.8	13.1	13.2	14.5	15.4	15.1	14.7	14.1	14.1	14.1
Appliances & Furniture	46.6	47.3	48.6	50.0	53.7	54.4	55.0	56.5	57.1	57.4
Other Durables	15.4	16.6	16.6	17.3	18.0	18.6	18.6	19.0	19.2	19.2
Unit Sales of Autos (millions)	10.3	10.7	11.4	11.3	12.5	12.2	11.7	9.9	9.3	9.2
Saving Rate (percent)	6.8	5.8	5.7	6.6	5.9	5.9	5.7	7.6	7.9	8.7

Sources: Past expenditures from "Survey of Current Business", Department of Commerce. Projected data are estimates by author.

(Continued from page 5)

Finally, the extraordinary price gyrations that accompanied 1973 mean that more families than usual had experiences that were different from "the average" for the economy as a whole. If real income growth per family was close to zero during 1973, most families with a bigger than average share of food in their total budget must have experienced real income declines, since food prices rose much more than other prices. More generally, a large number of families must have experienced declines in real income during 1973. In a society long accustomed to a norm of significant positive growth, that experience must have been unsettling and accounts in some part for the extreme pessimism evidenced by the consumer survey findings.

Price Changes and Price Expectations

In the consumer section, the most striking development during 1973 was on the price side. The typical consumer reaction to rising prices has been to retrench on spending and increase saving, probably because inflation and the fear of inflation generate uncertainty and caution. There are, however, occasions when the opposite effect occurs — rising prices bring expanded purchases in an attempt to buy ahead of the anticipated price increases. Ordinarily, this phenomenon is shortlived, and represents only a displacement of purchases in time — transitory strength followed by transitory weakness.

In recent U. S. history, the only two periods when the anticipatory buying phenomenon has been clearly marked was in 1950-51 during the Korean War, and during 1973. Since there is evidence that anticipatory buying has now largely abated, a decline in consumer demand during the fourth quarter of 1973 and into the first half of 1974 is clearly implied.

An additional feature of inflationary expectations during 1973 has been the marked increase in *variability* in expected price changes. Not only have people come to expect higher rates of price inflation, but there seems to be much more uncertainty as to what the extent of the price rise will be. That uncertainty appears to add an additional dimension of pessimism to the present situation.

The Energy Crisis

Virtually all of the data discussed in this report were obtained prior to the oil embargo, restrictions on highway speed limits, the specter of gasoline rationing, etc. The impact of all these changes on consumer behavior is bound to be substantial in many expenditure categories, but the overall impact on total spending and saving is much less obvious. At the aggregate level, the energy crisis might well mean substantially higher unemployment than is now being projected. Certainly, the energy crisis piled on top of the existing weakness in the consumption sector contains the possibility of producing the sharpest decline in real consumption since the 1950's.

Looking below the aggregates, it is easier to see areas where the energy crisis will result in lower expenditures than to find ones where expenditures are likely to be increased: Americans are clearly going to travel less, use fewer motel services and gasoline, buy fewer and smaller cars, do less skiing and other kinds of vacationing, eat less food away from home, etc. But one cannot infer that consumer expenditures are going to be cut by the sum of such a list, since money not spent on travel and outdoor recreation is not necessarily going to end up not being spent at all. Forecasting in the face of this kind of uncertainty is virtually hopeless: one can speculate, but that is about the limit of what can be done.

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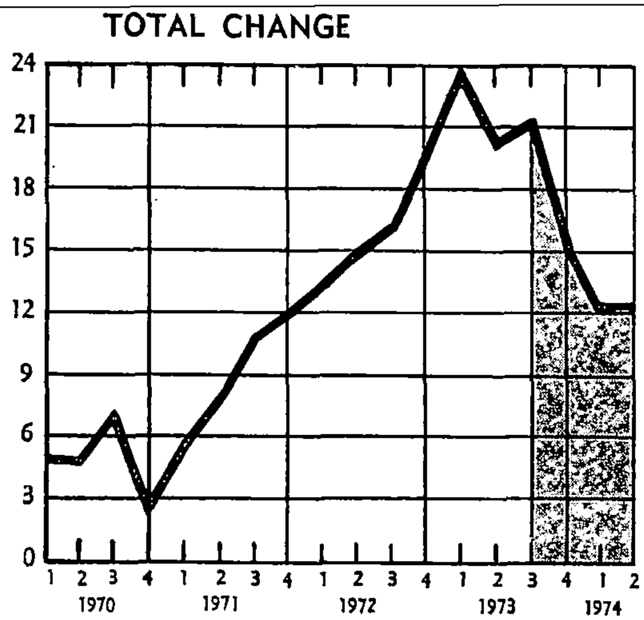
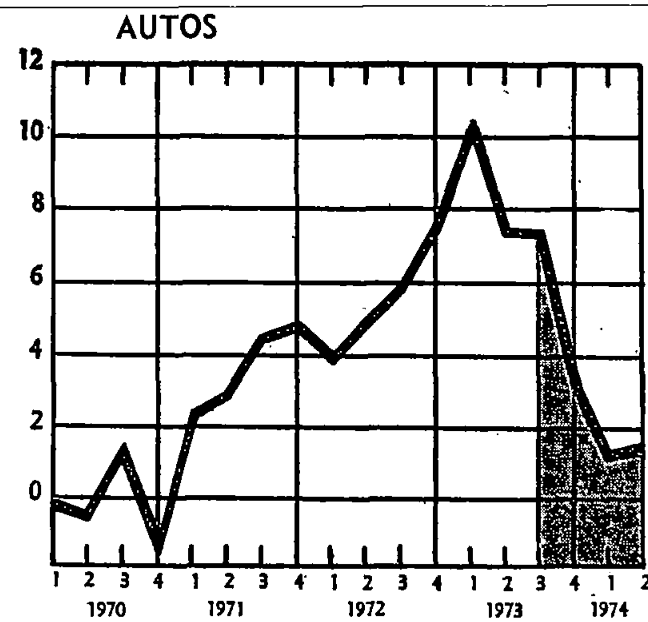
NET CHANGE IN CONSUMER CREDIT OUTSTANDING

Seasonally Adjusted Quarterly Data At Annual Rates, in Billions of Dollars





Sources: Actual Data: Federal Reserve Bulletin. Projections by theauthor.

(Continued from page 6)

A plausible speculation, given the extreme pessimism that now pervades the household sector, is that enforced reductions in certain kinds of expenditures are more likely than usual to result in higher saving than in increased expenditures for other goods and services. In an atmosphere where pessimism and uncertainty are the dominant characteristics, the urge to add to liquid balances and to reduce debt is likely to be stronger than the urge to acquire different kinds of products to replace the ones that must be foregone. A possibly important influence in the opposite direction is illustrated by food and gasoline: if prices rise sharply and people buy only slightly lower quantities, outlays on these items would rise rather than fall; even though outlays fall for other items, the net result may not be much if any reduction in total spending.

The Outlook

Developments during 1973 have generally followed the classical pattern that predates recessions or growth retardations. In the consumer sector, the primary impact so far has been on housing: from a first quarter level slightly in excess of 2.4 million, housing starts declined to just over 2 million by the third quarter and were barely over 1.5 million at the beginning of the fourth quarter. The decline in housing activity was in part the natural aftermath of a long (3 year) boom that started at the beginning of 1970 and reached record proportions. But the extent of the decline has clearly been affected by a number of adverse circumstances, including rising housing prices, lower rates of growth in consumer real income, and deepening consumer pessimism about both the short- and long-term economic outlook.

After housing, the next consumer sector to feel the impact of rising pessimism is usually automobiles. The survey data have been suggesting serious prospective weakness in automobiles since early 1973; that weakness began to appear in the third quarter, and more substantially, in the fourth quarter. And the present energy crisis has added significantly to the prospective weakness in auto sales.

Projected Expenditures for Automobiles

From the peak level of roughly 12.5 million sales in the first quarter of 1973, auto sales have declined to about 11.7 million in the third quarter and are projected to be under 10 million during the fourth quarter. Some further decline during the first part of 1974 seems likely; the net result is a relatively weak 1974 automobile year. The decline in automobile sales is basically attributable to a sharp rise in consumer pessimism, and to some degree, to a substantially slower growth rate of consumer real income. While both of these factors have been operating throughout 1973, their effect has been counteracted during the first part of the year by anticipatory purchasing of cars in expectation both of higher vehicle prices and less satisfactory vehicle performance for the 1974 model year cars. The projections have been adjusted downward in an attempt to reflect the energy situation.

Expenditures for Household Durables and Appliances

Household durables and appliances are projected to rise throughout the end of 1973 and into the first part of 1974, although in real terms either rough constancy

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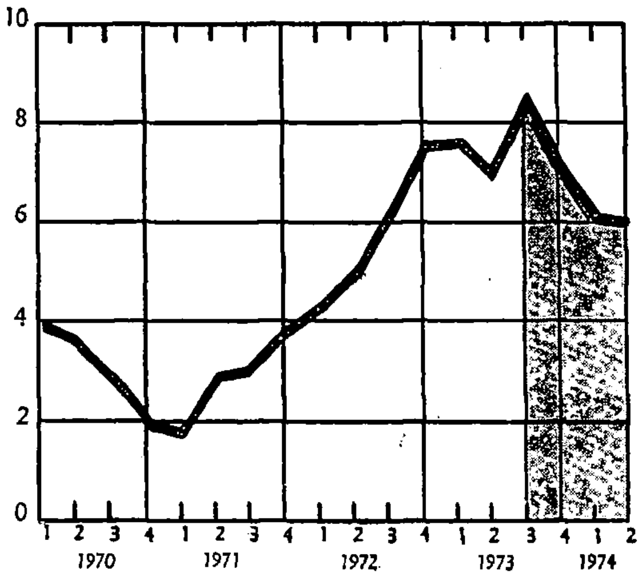
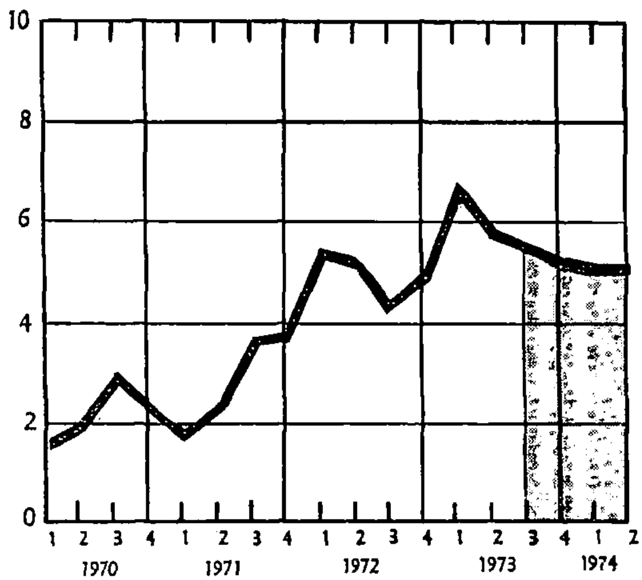
OTHER CONSUMER GOODS



PERSONAL LOANS*



* Includes home improvement loans

(Continued from page 7)

or a decline is implied by the slow growth in current dollar expenditures. The principal reasons for the sluggish growth in this category are a projected rise in the unemployment rate and a marked decline in housing starts; the latter has a major impact on purchases of durables and appliances. In addition, the projections have been *increased* somewhat on the grounds that reduced vehicle outlays due to the energy situation will have a favorable impact on expenditures for non-auto durables.

Consumer Credit

From peak levels of roughly $24 billion in the first quarter, consumer installment credit change has declined slowly to about a $21 billion third quarter level. The effect of projected declines for durable goods expenditures, increased pessimism generally, higher expected price inflation, and greater expected variability in price inflation are all to reduce growth in credit very substantially during the next three quarters. The fourth quarter growth in credit is expected to be only about $15 billion, and credit growth is anticipated to decline further to about $12 billion by the middle of 1974. This is a very large swing, and is due principally to the anticipated decline in automobile credit.

Consumer Savings

The personal saving rate has shown marked ups and downs during the past several years. From a peak level of over 8.6%, the ratio of saving to income declined to under 6% for the second and third quarters of 1973. But if the projections for durables and installment credit change described above are anywhere near the mark, the personal saving rate is due for a sharp rise during the fourth quarter of this year and the first half of next year. The projected quarterly pattern is very erratic, largely because of the way that higher Social Security taxes and benefits impact on saving behavior. The rise in the personal saving rate is due in large part to the impact of price changes on saving. Both the average expected price change and the variability of expected price change have risen dramatically during 1973, and these measures have a delayed effect on the personal saving rate. Thus we expect a rise in the saving rate to just under the 8% level by the fourth quarter of 1973, and a continuation at about that level during the first part of 1974.

Summary

The prognosis for the consumer sector is basically pessimistic because of the behavior of the consumer sentiment and price expectation measures. It is made even bleaker by the negligible growth in consumer real per family income during recent quarters, and by the possibility that the energy crisis with its resulting layoffs and reductions in real output will result in substantially increased unemployment during the first part of 1974. Given that prognosis for the consumer sector, it will take considerable strength elsewhere in the economy to avoid a recession, although it is possible that severe weakness in consumption spending can co-exist with buoyancy elsewhere. Thus the net result could be sluggish growth but no recession.

Finally, these projections contain a wider margin of errors than usual for two reasons. First, some of the projections are based on newly developed models and that often tends to result at first in larger forecast errors. Second and most important, future developments depend partly on how the energy crisis evolves and how people react to it. This imparts an important element of speculation to any current forecast. It accounts in part for the fact that the demand projections described above are substantially lower than comparable ones from the ASA-NBER forecasting panel discussed by Henry Wallich.

Consumer Attitudes Still Pessimistic*

Jay Schmiedeskamp
Survey Research Center, The University of Michigan

Developments During the Past Year

The steep slide in consumer confidence which took place during the first nine months of 1973 was arrested in the November survey, reflecting the fact that bad news about price increases was somewhat less intense than it had been earlier in the year. Hence consumers became less pessimistic about inflation and about their personal financial situations. At the same time, however, expectations about business conditions and about the economy remained quite pessimistic and showed little improvement. Attitudes toward the government's economic policies were still very unfavorable in early November.

The decline in the Index from its 1972 third quarter high was more precipitous and carried to a lower level than for any comparable span in the entire postwar period. It remains to be seen whether the improvement shown in the latest survey (a recovery of 3.9 of the 22.2 points lost in the preceding twelve months) represents a turning point in sentiment, or merely the beginning of a low-level plateau as happened in 1970. Because interviewing on the latest survey ended November 20, the findings presumably do not reflect the full impact of the energy crisis, which intensified late in November and in December.

A seemingly unremitting flow of unfavorable developments in 1973 wrought a profound change in consumer attitudes and expectations: rapid price increases especially in food, Watergate, the price freeze followed by shortages and still more rapid inflation, more Watergate, the energy crisis and oil embargo. These events have produced enormous uncertainty among consumers. Many people feel under pressure to try to add to their savings and reserve funds. Fully 63 percent of respondents in the latest survey said that they were not satisfied with their savings or that it was more important than usual for them to try to save. This proportion is up from 54 percent in early September 1973 and 40 percent in late 1972.

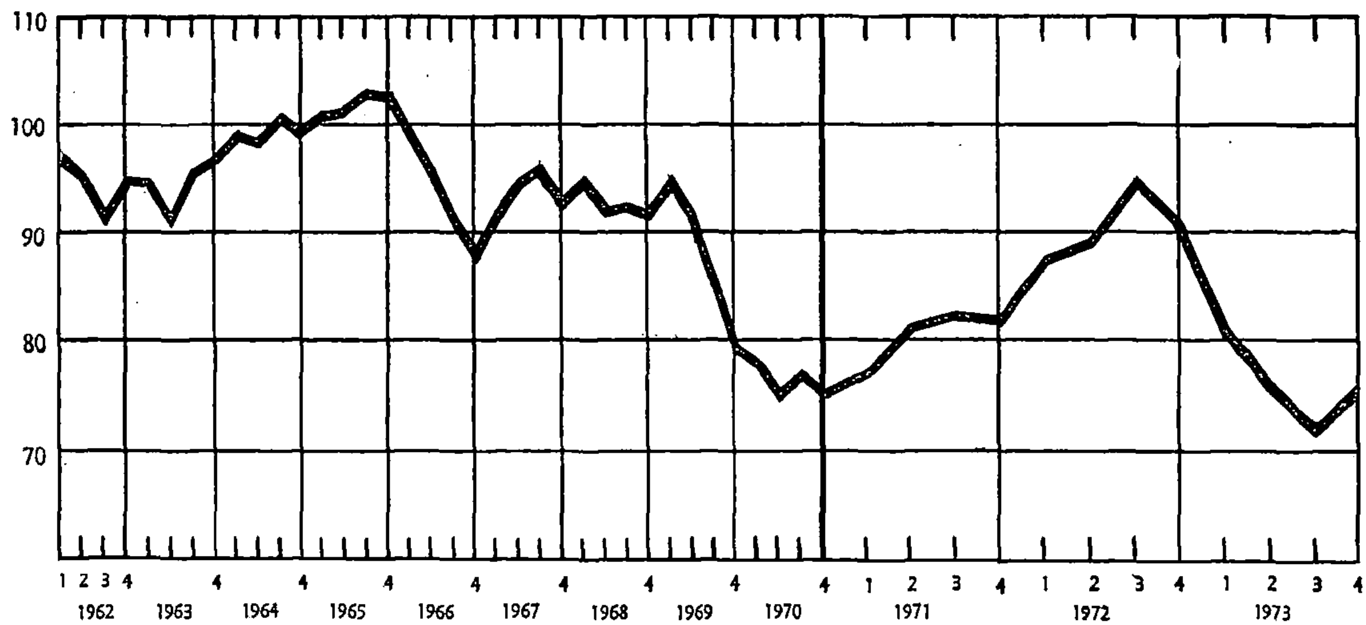
(Continued on page 10)

* The survey data reported here are obtained by personal interviews, or telephone follow-up interviews, from a carefully selected random sample of all U.S. households. Surveys are conducted quarterly (in February-March, May-June, August-September, and October-November) by The Survey Research Center of The University of Michigan.

The Index of Consumer Sentiment is based on responses to five questions that have been asked of U.S. consumers since the early 1950's. The questions concern personal financial changes and expected changes, 1 year and 5 year expectations about business conditions, and buying conditions for household durable goods.

INDEX OF CONSUMER SENTIMENT

February 1966 = 100; seasonally adjusted quarterly data



Source: Survey Research Center, The University of Michigan

(Continued from page 9)

Inflation and the Personal Financial Situation

In one respect the pattern of attitude change this year has been different from previous periods when consumer sentiment declined. Despite greatly increased pessimism about the personal financial situation and about business conditions, opinions about whether now is a good or bad time to buy large household goods have remained relatively favorable this year.

In earlier periods of substantial sentiment decline during the last 20 years, for example in 1969-70, these attitudes toward buying turned downward along with the other components of the Index of Consumer Sentiment; what has made this year different is that fear of *future* inflation (which received powerful stimulus especially in the first and third quarters of 1973) has outweighed consumer resistance to *current* price increases.

In the latest (November 1973) survey, respondents still expressed great resentment of past price increases. Fully 60 percent said that in the last two or three years their income had gone up less than prices, while only 11 percent had the opposite opinion. Nevertheless, the survey findings suggest that inflation was less in the forefront of consumer awareness in November than it had been earlier in the year.

Habituation to bad news (e.g. inflation) is a phenomenon that has been frequently observed in the past; after bad news continues for a while it loses some of its impact on consumer attitudes.

These circumstances explain the recent improvement in attitudes toward the personal financial situation:

	Aug.-Sept. 1972	Nov.-Dec. 1972	Feb.-Mar. 1973	May 1973	Aug.-Sept. 1973	Oct.-Nov. 1973
Reporting optimistic trend	43%	42%	38%	35%	33%	38%
Reporting pessimistic trend	12	16	21	24	30	24
Difference	31%	26%	17%	11%	3%	14%

The extent of the recent improvement, and the persistence of relatively favorable evaluations of buying conditions for household durables, is surprising in the face of continued widespread pessimism about the economy and about the effectiveness of government policies. This divergent pattern of attitudes is unusual and based on past experience quite unlikely to persist.

Pessimism About the Economy

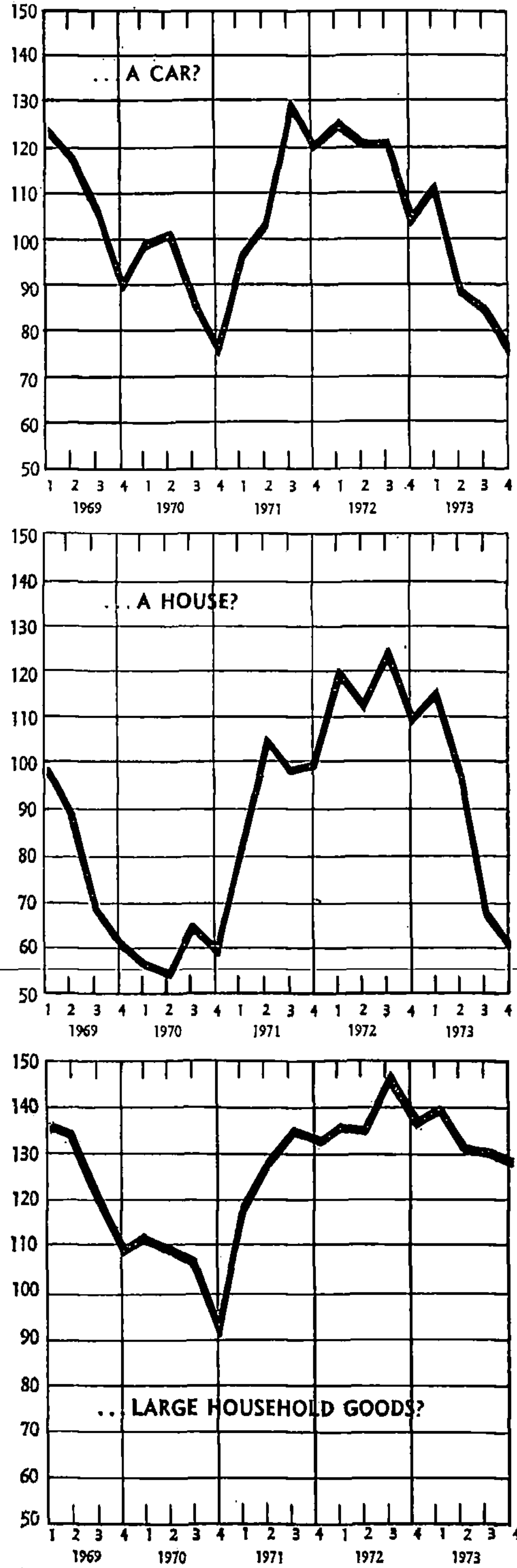
Bad times ahead were expected more often than good times in the latest survey. The majority of respondents (54 percent) expect a recession in the next few years.

	Aug.-Sept. 1972	Nov.-Dec. 1972	Feb.-Mar. 1973	May 1973	Aug.-Sept. 1973	Oct.-Nov. 1973
Expect good times during next 12 months	54%	54%	40%	35%	30%	30%
Expect bad times during next 12 months	15	17	33	44	45	44
Expect good times during next 5 years	32%	31%	19%	20%	19%	20%
Expect bad times during next 5 years	26	31	44	46	47	45

Expectations about the economy have been in a generally pessimistic trend for some time now. Even in late 1972, after a substantial recovery in the economy from the 1969-70 recession, expectations about the economy

(Continued on page 11)

IS THIS A GOOD TIME TO BUY . . .



Source: Survey Research Center, The University of Michigan

(Continued from page 10)
were much less favorable than in earlier years. In late 1965, for example, 71 percent expected good times during the next 12 months and 47 percent good times during the next five years.

Watergate and Lack of Faith in Government

Part of the explanation for the current deep pessimism about the economy is a widespread lack of faith in the government, which has been undergoing a steady erosion since 1966. In 1973, the decline was accelerated, not only by inflation but also by concern over Watergate. In the first 9 months of 1973, economic concerns played the larger role. The proportion saying that the government is doing a poor job in its economic policy rose from 19 percent late in 1972 to 44 percent in early September. Although the latest survey showed little further change in this general opinion, the detailed data suggest that Watergate developments had a significant impact on opinions about the economic outlook.

The Energy Crisis

Some 15 percent of respondents late in October and early in November spontaneously mentioned the energy crisis when explaining their opinion that business may be bad next year. Both the third and fourth quarter survey data indicate that respondents who are concerned about the energy shortage are more likely to be pessimistic about business conditions next year. Even before the oil embargo hit, the majority of consumers expected a recession. Accordingly, any news of layoffs caused by fuel shortages can be expected to reinforce expectations of bad times. In short, the energy crisis not only has direct effects on output and demand (via reduced auto sales, resort travel, etc.), but may also have important indirect effects through contributing to increased pessimism about the economy.

Unfavorable Outlook in Two Major Consumer Industries

Attitudes toward buying cars and houses have become much less favorable since early 1973, and the divergence between these attitudes and those relating to the purchase of large household durables was quite marked in the latest survey. While the proportion saying that now is a "good time" to buy large household durables outnumbered those saying "bad time" by 48 percent vs. 20 percent, opinions about buying conditions for cars (25 percent vs. 48 percent) or houses (24 percent vs. 63 percent) were very much the reverse.

Buying in advance was particularly strong for cars during the first 3 quarters of 1973. Not only do cars have characteristics which make for advance buying due to concern about inflation (a long life, a necessity, and a big-ticket expenditure), but many people also said that one should buy a car before the new models came out with new anti-pollution and safety equipment. To the extent that people accelerated the timing of car purchases for either reason, they will be out of the market in 1974.

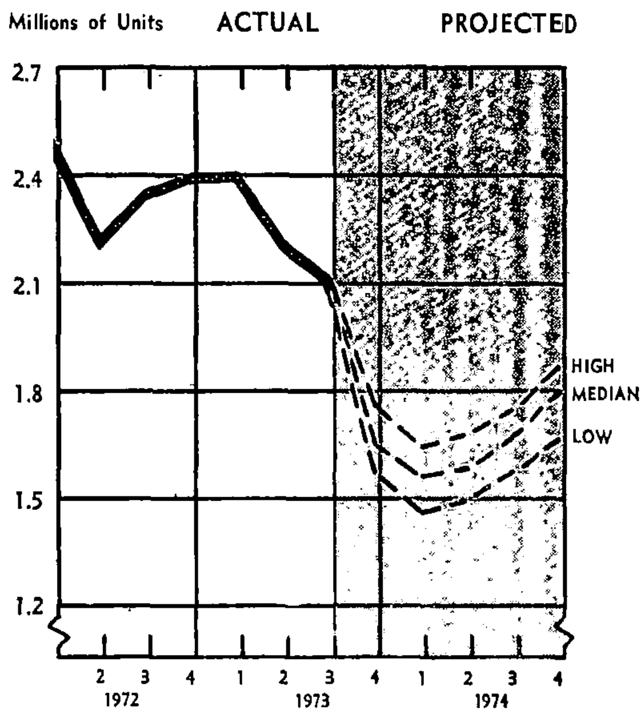
Summary

A significant slowdown in consumer spending, a substantial fall-off in two key consumer industries (housing and cars), and therefore the strong possibility of a recession, were indicated by surveys conducted early this year before the fuel crisis became a problem. The results of the most recent survey, in conjunction with the energy crisis, do nothing to change that prognosis except to strengthen the odds on recession.

If a recession does take place, a crucial question is how long and how deep it might be. On the one hand, the latest survey shows a high proportion of families reporting income gains; assuming that income gains continue frequent, any recession would tend to be relatively short and mild. On the other hand, the pervasive lack of confidence in the government and in its economic policy, together with the widespread opinion that the inflation problem will not be easily solved, has led to great pessimism about the long-run outlook for the economy. These attitudes, which are not easily turned around, have a powerful impact on housing as well as other major spending decisions and the incurrence of installment debt. If these attitudes do not improve, that would tend to make any recession relatively deep and prolonged.

NEW PRIVATE HOUSING UNITS STARTED

A sharp drop — and slight recovery



Plant and Equipment Spending Surprisingly Strong

Victor Zarnowitz
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The Relative Strength of Expenditures for Plant and Equipment

Business expenditures for new plant and equipment are predicted to rise each quarter of 1974, according to the average forecast in the December 1973 forecasters' panel conducted by the American Statistical Association (ASA) in conjunction with the National Bureau of Economic Research (NBER). In contrast, consumer capital outlays on housing and durables are seen as declining in the first half of the year ahead, and investment in business inventories is expected to peak out in the first quarter and remain lower in the second half of 1974 than in the first half. In short, of all the GNP expenditure categories that tend to be cyclically volatile, only business expenditures on plant and equipment are regarded by the forecasters as virtually shock-proof in the current situation. Even forecasters predicting a 1974 recession are still counting on a persistent increase in business fixed investment.

This aspect of current forecasts appears to contradict the widely held notion that business investment demand, because of its dependence on expected profitability, is particularly variable and sensitive to uncertainty. And so it may be instructive to ask whether these forecasts are internally consistent and plausible.

Some Historical Relationships

Business capital outlays in current dollars declined in each of the general recessions during the postwar period, except the most recent one in 1970. Measured in constant dollars, business capital outlays contain cyclical declines that match *all* contemporaneous U.S. recessions and also the "minirecession" of 1967. Other data that are related to capital outlays, whether expressed in current or constant dollars, also display changes corresponding to each of the cyclical movements in aggregate economic activity (reference here is to total shipments of machinery and equipment plus business construction expenditures, and to the less comprehensive series on manufacturers' capital outlays).

This evidence of a high degree of conformity between business expenditures on plant and equipment and general economic activity suggests that the former are not likely to continue expanding in the event of a general recession lasting two or three quarters. A sufficiently mild and brief recession combined with a high degree of inflation (like the one in 1970) might be compatible with rising investment in business structures and producers' durable equipment, but probably only for outlays measured in current dollars. At the least, a marked slowdown in the rise of such outlays would be expected to result from a recession of the type observed in the past.

However, the impending setback in economic activity that is so widely anticipated in the current forecasts is supposed to be quite different from the historical phenomena of the business cycle. Its major cause is located in specific supply shortages, not in the deficiency of effective demand. Thus it remains to be seen to what extent past analogies apply. In the meantime, attempts must be made to analyze conditions and prospects that seem to have few if any precedents.

The Energy Crisis and Investment

When the quarterly Commerce Department survey of investment anticipations was released early in December, Government spokesmen for economic policy commented that its projections may be a little too high, since most

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BUSINESS CAPITAL OUTLAYS

Commerce Department Data — seasonally adjusted annual rates in billions of dollars

BUSINESS CAPITAL OUTLAYS	ACTUAL								Actual		Projected
	1972				1973				1972	1973	1974
	1st	2nd	3rd	4th	1st	2nd	3rd	4th			
	Quarter				Quarter				ANNUAL		
Business expenditures for new plant and equipment											
All industries	86.79	87.12	87.67	91.94	96.19	97.76	100.90	104.94	88.44	100.08	112.11
Manufacturing industries	30.09	30.37	30.98	33.64	35.51	36.58	38.81	40.54	31.35	38.00	44.40
Durable goods	15.06	14.77	15.67	16.86	17.88	18.64	19.73	20.94	15.64	19.39	22.61
Nondurable goods	15.02	15.60	15.31	16.78	17.63	17.94	19.08	19.60	15.72	18.61	21.79
Nonmanufacturing industries	56.70	56.75	56.70	58.30	60.68	61.18	62.09	64.40	57.09	62.07	67.71
Public utilities	16.92	16.60	17.01	17.53	18.38	18.08	18.58	21.20	17.00	19.09	22.16
Communication and services	31.81	31.47	31.72	32.84	33.87	34.25	34.48	34.63	31.96	34.27	36.36
Other	7.96	8.68	7.98	7.92	8.44	8.86	9.03	8.51	8.13	8.71	9.19

Sources: Department of Commerce, Bureau of Economic Analysis.

(Continued from page 12)

of the returns were received prior to the Arab oil embargo. Some investment projects would be postponed, but some, notably those in oil exploration and refining, and development of substitutes, would be stimulated; hence the net effect of the crisis was likely to be small, though probably negative.

The Commerce Department predicted a large gain in business capital spending during the first half of 1974: projections were for a rise of 6.9 percent up from the second half of 1973 and a rise of no less than 14 percent above the first half of 1973. Only a short time later, the ASA-NBER roundup of forecasters, already registering strongly the impact of news about the embargo, reduced these estimates greatly.

However, the *annual* Commerce Department survey, conducted in late November and in December, and released early in January 1974, still shows plans for a vigorous increase in business capital spending. Total outlays were expected to rise 12 percent in 1974 from an estimated $100 billion in 1973. Gains of 16 to 17 percent were foreseen by manufacturers, railroads, and public utilities. Only airlines planned to cut their capital spending substantially.

Series on new commitments to invest in plant and equipment (represented by new capital appropriations and selected measures of advance orders and contracts) have so far flattened out somewhat, but as yet show no definite signs of decline. So it is reasonable to expect that expenditures, which lag behind these advance commitment data by sizable intervals and are also smoother, less cyclical, and more trend-dominated, will have no confirmed downturn yet in the next several months, though their rise should be slower and may become rather uncertain. Business capital outlays tend to be bunched at times when the corresponding investment projects are completed, and they are going to be reduced if deliveries or installations on existing projects are delayed because of shortages of energy (or materials, transportation, etc.).

The projected expansion in business spending on plant and equipment becomes more questionable looking to the spring of 1974 and beyond, however, given the conditions envisaged in many current forecasts. This is so because of the earlier declines forecasters anticipate in some factors influencing this type of investment.

The latest Commerce survey does imply that business capital outlays would rise by only 3.8% in the second half of 1974, which is considerably less than the 6.9% increase indicated for the first half. A presumption of prospective weakness by mid-1974 would be strengthened if the advance commitment series begins to show declines earlier in the year.

Output, Capacity Utilization, and Profits

Economic theory predicts that the demand for additions to the capital stock (new investment) will be positively related to the expected demand for output and negatively related to the capital stock already available to produce that output. Closely related to this version of the "accelerator principle" is an alternative formulation which predicts a positive relation between business investment (expressed in constant prices and properly lagged) and the ratio of output to capacity. Typical models of this sort account for other expectational and financial factors that are likely to influence business investment with measures of profits and long-term interest rates.

If the recent forecasts are anywhere near what will happen in the next six months, there should be declines in real GNP and industrial production and rises in the unemployment rate, thus implying a decrease in capacity utilization. Assuming these developments do take place, they would tend to affect new investment commitments adversely (with short lags) and business capital spending (with considerably longer lags.) But here one must be cautious, particularly in the peculiar situation of today, for these influences would probably be much weakened if they were to be widely regarded as transitory and indicative of supply shortages rather than demand weaknesses.

In the composite forecast from the December survey, corporate profits after taxes are seen as already declining, and are predicted to drop by some 3.3 per cent in each of the first two quarters of 1974. In the past, cyclical contractions in profits typically preceded those in business capital outlays, although the 1969-70 developments are an exception as far as the current dollars series are concerned. However, the expected decline in profits is small compared to historical changes in this volatile series. Whether the prospective small decline in profits would have an independent depressing effect on investment is highly uncertain, but the answer may be negative if, as the survey suggests, profits turn up again during the second half of 1974.

INDUSTRIAL PRODUCTION

Level — at best

1967-100; seasonally adjusted quarterly data