Consumer Behavior and the Saving Concept

An uncertainty that clouds most forecasts is the marked change in consumer spending-saving behavior. Since the early 1950s, consumers have saved slightly more than 6 percent from their disposable income. During the period of rapid inflation between 1965 and 1975, consumers stepped up their rate of personal saving to about 7 percent of income after taxes.

Consumers have responded much differently to inflation in recent years than in the past. Since 1977, and especially since late 1979, the saving rate trended downward, falling to 3.4 percent by year-end 1979, the lowest since the early 1950s. Reasons for this departure from historical averages are not clear. It is also unclear whether the sharp decline in the saving rate is an aberration or a new norm based upon widespread expectations of continued high rates of inflation. The premature forecasts of a recession in 1979 were based largely on the expectation that consumers would step up saving from income, simply because recent rates of personal saving have been low by historical standards. Instead, consumers cut back saving in late 1979, and preliminary information for early 1980 does not yet suggest a resumption of more normal spending-saving patterns.

Some of the problems inherent in interpreting saving behavior are due to the difficulty in measuring personal saving. There are two commonly used concepts of saving, one that is prepared by the U.S. Department of Commerce and the other prepared by the Board of Governors of the Federal Reserve System. John Gorman, assistant chief of the National Income Division of the U.S. Department of Commerce, told the Fourth District economists that both concepts are conceptually similar and both have the defect of being derived from residual computations.[2] The saving rate concept in the national income and product accounts is measured as the residual between disposable income and total consumer outlays. Income not recorded as being spent on goods and services, interest payments, and remittances abroad is assigned to the saving estimate. The saving concept in the flow of funds is a net worth concept that attempts to measure the changes in acquisition of assets less liabilities during a given period. Here, too, allocation of much of the assets and liabilities to the household sector is based on residual calculations. Neither concept attempts to measure changes in the value of assets held by households, which in recent times have been an important support for consumer spending. Gorman also explained that, while there are no conceptual differences between the two measures, differences in estimates are sometimes significant. In the fourth quarter of 1979, for example, the flow of funds concept of saving showed an increase in personal saving, while the national income account concept showed a decrease. Also, the level and rate of personal saving according to the flow of funds measure are considerably higher than the national income measure. Despite divergences between these two measures, both have shown a declining trend since 1977. While Gorman viewed this trend as disturbing, he cautioned that the quality of the data has deteriorated in recent years. Furthermore, unreported income may be understating the level and rate of personal saving. On the product side of national income accounts, for example, income can be understated by as much as ½ of 1 percent. Similarly, income can be understated because of underreporting.

2. Although these two concepts are measured differently, they may be considered conceptually similar because personal saving may include financial assets, such as cash and deposits, as well as physical assets, such as net acquisition of real property.

Nevertheless, economists have generally tended to accept published data that show a historically low saving rate as a signal of consumer behavior. It is uncertain when or whether the saving rate will revert to historical averages. The median forecast of Fourth District round-table economists incorporates a saving-rate assumption of about 3.5 percent in the first half of 1980, 4 percent in the third quarter, and 4.5 percent in the fourth quarter. Some, however, expect that consumers will promptly begin to save more from their income and spend less in the first half in response to heightened uncertainties and growing reluctance to rely on saving substitutes to maintain spending. An economist commented that consumers have indeed cut back on real spending for the past several quarters, trying simply to maintain their past standards of living; consumers are unlikely to commit themselves to purchases of long-term assets, at least until real income improves.

Defense Spending

Another economic uncertainty discussed by the round-table economists concerns the rearmament program. Some economists have incorporated higher defense spending into their outlooks for 1980 and 1981 than that proposed by the administration. Increased defense spending was expected to moderate the recession in 1980. Despite the administration's proposed boost in military spending, the military budget for fiscal year (FY) 1980 and FY 1981—relative to GNP or to total federal expenditures—is virtually unchanged from 1970. Congress, therefore, may accelerate defense spending beyond that proposed by the administration in the January 1980 budget.

Overall, however, the Fourth District economists do not expect much acceleration in defense spending this year. The median forecast for defense spending shows a 12.3 percent gain between the fourth quarter of 1979 and the fourth quarter of 1980, hardly different from the change in the comparable year-earlier period. Moreover, it was noted that both the relatively small magnitudes of defense spending and the long lags between the budget proposal and the actual economic impact strongly suggest that the 1980 outlook for economic activity would not be affected much by accelerated defense spending. The lags between contract awards and deliveries, for example, are as much as five quarters; for sophisticated equipment the lags are substantially longer. Lags apparently have lengthened because of shortages and bottlenecks. One defense contractor reported that shortages of aluminum forgings have lengthened lead times from 34 to 36 weeks to as many as 74 to 76 weeks; lead times on micro-processor circuits have averaged 18 to 24 months. Moreover, it would be difficult to expand production in the short run because of shortages of skilled and technical workers, especially engineers and scientists; there is also a shortage of suppliers for some types of products, including forgings, castings, and electronic parts and equipment. The defense contractor expected that supplements to the FY 1981 budget would boost real defense spending for FY 1981 by 4 to 4½ percent in real terms, rather than the 3½ percent increase proposed by the administration.

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ECONOMIC COMMENTARY

In this issue:

Reappraising the Economic Outlook for 1980

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Reappraising the Economic Outlook for 1980

Twenty-eight economists met at the Federal Reserve Bank of Cleveland early in March to discuss the economy. This **Economic Commentary** *reviews the appraisal of the economic outlook that emerged from that meeting.*

A rapid chain of events since late January has added uncertainties to an already uncertain economic outlook for 1980. Among these developments are the stronger than expected pace of economic activity at the beginning of the year, the acceleration in consumer and producer prices, and the administration's proposed budget that originally showed sizable deficits for fiscal years 1980 and 1981. The perception in domestic financial markets that fiscal policies are incompatible with an anti-inflation objective has crippled equity and bond markets, and has helped boost short-term interest rates 200 to 400 basis points between mid-February and mid-March. The effects of the rapid run up in interest rates on spending decisions are unknown, as are the effects of the latest set of anti-inflation measures announced in mid-March.

Fourth District Economists Round Table Forecasts

Against this background of rapid economic changes, forecasters have adjusted their economic and financial outlooks for 1980, and further adjustments now seem likely. The Fourth District Economists Round Table met on March 7, 1980, to appraise the economic outlook, while developments described above were still unfolding. Although the round-table economists revised upward their outlook for inflation and output in 1980 from their forecasts at a similar meeting last November, they held to their earlier view that a recession would be under way in early 1980.

The round-table forecast of recession last November was dominated by a view of weakening consumption expenditures, led by an upward shift in consumer saving from a 30-year low in the fourth quarter of 1979. At that meeting the recession was expected to begin in the final quarter of 1979 and to extend into the third quarter of 1980. Measured between peak and trough, a contraction of 2.2 percent was foreseen in real GNP, somewhat less than the average decline of six recessions in the post-World War II period.

Economists at the March 1980 round table still expected a recession in 1980, but one that would be milder than anticipated last November. Real GNP is now expected to decline about 1 percent between peak and trough, the same as the relatively mild recessions in 1960–1961 and 1969–1970.[1] All but a few of the round-table economists expected a recession to last about three quarters. The issues that divided the economists concerned the timing and depth of the recession. Of the 28 economists who attended the round table, 15 forecast a slight decline in real GNP in the first quarter of 1980; most of the remaining economists forecast a recession that would get under way in the second quarter. The median round-table forecast showed annual rates of decline in real GNP of 0.2 percent in the first quarter, 2.8 percent in the second, and 1.6 percent in the third (see table 1). The beginning of an upturn in business activity was foreseen in the final quarter of the year, followed by a 2.5 percent annual rate of expansion in real GNP in the first quarter of 1981. Expectations of a milder recession stemmed largely from a belief that consumer spending would not be as weak as expected last November.

Nowhere is the recession more evident than in residential construction, which has been weakening in recent months. Housing starts have been declining since early 1978. From March 1979 until September 1979, new housing starts ranged between an annual rate of 1.8 to 1.9 million units. In February 1980, housing starts fell to an annual rate of 1.3 million units; housing starts plummeted further in March to an annual rate of 1.0 million units. Sales of new and used houses have slumped, leading to a softening in home-purchase prices. One of the Fourth District economists suggested that housing starts would continue to decline during the balance of 1980. Several reasons were given to support this view. The sharp run up in interest rates affects both mortgage lenders and buyers. Thrift institutions could find it increasingly difficult to attract and hold deposits, especially since the ceiling rate of 12 percent was established for the 2½-year money-market certificate effective March 1, 1980. There is some doubt, moreover, about the willingness of some thrift institutions to issue six-month savings certificates because of severely squeezed profit margins. Demand for mortgage loans at 13 percent was said to be soft, and at 15 to 17 percent demand would weaken even more. Moreover, investment psychology in relation to housing appears to have weakened. In recent years investors perceived rates of return from housing in a range of 20 to 30 percent, but softness in house prices and the inability to sell homes have reduced the expected return. In addition, yields on competing financial instruments were 15 percent or more.

Fourth District economists expect new-car sales to decline again in 1980. The median forecast of seven economists shows new-car sales at 9.7 million units, compared with the 10.6 million sales in 1979. Sales of small cars, both domestic and imports, are again expected to account for a larger share of total cars at the expense of large and intermediate-sized cars.

Although over one-half of the round-table economists expected the recession to begin in the first quarter, others doubted that a recession would occur before the second or third quarter of 1980. One of the economists pointed out that a shift away from a recession psychology has temporarily spurred economic activity, perhaps best illustrated by a turnabout in inventory policies. Some industries that were depleting inventory in late 1979 are no longer doing so; indeed, they may even be building stocks because of a shift in psychology. At the center of this shift is the steel industry, for which orders picked up early in 1980 but have since fallen. Steel economists, therefore, have upgraded their forecasts for steel shipments for the first half of 1980—a development, however, that might contribute to somewhat greater weakness in production during the second half.

Skepticism over a mild recession scenario was expressed by some economists who believed that high inflation and interest rates would result in a more serious recession than indicated in the median forecast. Expectations of a deeper recession, with a peak to trough decline of perhaps 2.5 percent, were based on a perception that economic policies would tighten in order to control inflation. The resulting higher interest rates would further weaken interest-sensitive markets, such as residential construction. Some economists acknowledged that the high interest rates and inflation of early 1980 have no parallel in previous experience and that their implications for economic activity are uncertain. The more severe recession scenario also assumes an upward shift in the rate of personal saving toward historical relationships. Therefore, curtailment in consumer spending, as well as in residential construction, was seen as having cumulative downward effects elsewhere in the economy.

1. Since the March 7 meeting, several of the economists have revised downward their forecasts of real GNP to show a decline of about 2.5 to 3.0 percent between the fourth quarter of 1979 and the third quarter of 1980.

Table 1 Median Forecasts of Changes in GNP and Related Items[a]

	1979 Actual	1980 Forecast	1979 IVQ	1980 IQ	1980 IIQ	1980 IIIQ	1980 IVQ	1981 IQ
Change in levels, billions of dollars, saar								
Gross national product (GNP)	241.8	215.9	62.9	56.1	34.4	44.0	64.7	77.0
Personal consumption expenditures	159.2	169.9	52.6	45.8	30.0	39.3	39.7	41.0
Gross private domestic investment	35.7	-2.1	-4.8	-1.7	-1.2	-4.3	4.1	15.6
Nonresidential fixed investment	33.5	19.1	2.4	5.8	3.0	1.0	3.5	3.1
Residential construction	6.2	-10.8	0.6	-6.7	-6.4	-4.0	1.7	7.4
Changes in business inventories	-3.8	-14.7	-7.8	-1.3	-0.5	-3.7	0.2	4.9
Net exports	6.1	-3.8	-8.2	12.5	-0.5	1.2	0.0	-0.7
Government purchases	40.8	54.9	23.4	10.4	12.5	12.2	15.4	12.6
Percent changes, annual rates								
GNP, current dollars	11.4	9.1	10.9	9.4	5.6	7.1	10.4	12.1
Implicit price deflator	8.8	9.1	8.6	10.0	9.2	8.8	8.8	9.3
GNP, constant dollars	2.3	-0.2	2.1	-0.2	-2.8	-1.6	0.5	2.5
Industrial production	4.1	-1.8	-0.3	-0.5	-5.8	-5.2	0.7	6.4
Absolute levels								
Unemployment rate, percent	6.0	6.9	5.9	6.3	6.8	7.2	7.5	7.4

a. Median forecasts are based on individual forecasts of the Fourth District Economists Round Table; they do not represent forecasts of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

SOURCE: Fourth District Economists Round Table, Federal Reserve Bank of Cleveland, March 7, 1980.