Consumer Behavior and the Saving Concept

An uncertainty that clouds most forecasts is the marked change in consumer spending-saving behavior. Since the early 1960s, consumers have saved slightly more than 6 percent from their disposable income. During the period of rapid inflation between 1966 and 1975, consumers stopped saving 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 saving patterns.

Some of the problems inherent in interpreting saving behavior are due to the difficulty in measuring personal 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.3 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 personal saving. The saving rate in the flow of funds is a net worth concept that attempts to measure the 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 concept is considerably higher than the national income measure. Despite divergences between these two measures, both have shown a declining trend since 1977. Moreover, it was noted that the lags are substantially longer. Lags appear to be much longer than 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 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 4.5 percent in real terms, rather than the 3 percent increase proposed by the administration.

Defense Spending

Another economic uncertainty discussed by the round-table economists concerns the rearmament program. Some economists have incorporated higher defense spending into their forecasts 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 1979. 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 modest levels 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 backlogs. 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 4.5 percent in real terms, rather than the 3 percent increase proposed by the administration.

The views contained herein are not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.
A rapid chain of events since late January has led to steeper declines in key economic indicators for 1980. Among these developments are the stronger than expected pace of economic activity at the beginning of the year, the acceleration in consumer price increases, and the sizable deficits for fiscal years 1980 and 1981. The perception of domestic financial markets that fiscal policies are incompatible with an anti-inflation objective has crippled investment in the first three quarters of 1979 and into the first quarter of 1980, leading to weak business activity and further reductions in labor force participation.

The round-table forecast of recession last November was already uncertain at the beginning 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. Thereafter, the recession was more evident 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 fallen, and overbuilders have reduced their home-building plans. The Federal Reserve Bank of Cleveland's economists suggested that housing starts would continue downward for the 7.5-year 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 on money market certificates effective March 1, 1980. There is some doubt, moreover, about the willingness of some thrift institutions to issue six-month 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 housing appears to be weakened. In recent years, investors perceived rates of return from real estate to be as high as 10 percent. If housing starts were cut by 10 percent, the resulting higher interest rates would further weaken mortgage markets. Investors are uncertain that their implications for economic activity will be as severe as anticipated. The more severe recession scenario also assumes a smaller decline in the rate of personal saving toward historical levels. Therefore, curtailment in consumer spending, as well as in residential construction, was seen as having cumulative downward effects elsewhere in the economy.

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 the 30-year low in the fourth quarter of 1979. The sharp run up in interest rates 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 on money market certificates effective March 1, 1980. There is some doubt, moreover, about the willingness of some thrift institutions to issue six-month 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 housing appears to be weakened. In recent years, investors perceived rates of return from real estate to be as high as 10 percent. If housing starts were cut by 10 percent, the resulting higher interest rates would further weaken mortgage markets. Investors are uncertain that their implications for economic activity will be as severe as anticipated. The more severe recession scenario also assumes a smaller decline in the rate of personal saving toward historical levels. Therefore, curtailment in consumer spending, as well as in residential construction, was seen as having cumulative downward effects elsewhere in the economy.

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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.

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