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U.S. ECONOMIC OUTLOOK

[By Paul MacAvoy, Member, Council of Economic Advisors]

Under Secretary Campbell suggested that there may be differences in forecasts here today. According to my calculation there are 450 economists in this room, so that there are now 900 different points of view. I would like myself to contribute at least six points of view on where the American economy is going in the coming year. Before doing so, however, let me mention a first point of controversy on where we now are. It is not altogether clear that three economists would be able to arrive at a consensus on the present state of the American economy. In the statistical materials now available, it appears that the United States economy grew at an 11.2 percent seasonally adjusted annual rate in the third quarter of this year, a much higher rate than 99 percent of the economists had forecast would occur. It is also much higher than anyone in the White House believed or dared hope would occur. The question arises, naturally, given this growth spurt whether there were statistical or other aberrations which might have caused it.

In fact, there were a number of important statistical quirks and events of a non-recurring nature in the third quarter. The statistical have to do with the use of obsolete 1958 price deflaters to measure real growth in the United States. As you know, the procedure is to estimate growth rates in current dollar terms and then deflate them to obtain the real growth rate. Using a 1958 deflater with a very low value created, given the nominal dollar value, a very high estimate for real growth. The reason this is controversial is that there has been an important shift in the composition of output toward items with low 1958 price deflaters which cause the given increase in spending to be associated with higher measured real growth than if more current deflaters had been used. Hence, when the benchmark revisions are completed and real GNP is measured in 1972 rather than 1958 dollars, the rate of real growth this past quarter may be found to have been only around 9 percent rather than the preliminary indication of 11 percent. So that when various forecasters extol to you the recent performance, be very cautious.

The 9 percent to 11 percent rate is substantial, as large as in the first few months of past recoveries from recessions. Why it has occurred is important. Final sales grew by 4½ percent from the second to the third quarter, about the same as from the first to the second quarter. The remainder of the 9 percentage point increase in real GNP is due to the shift from sharply increasing to decreasing rates of inventory decumulation. Corporations have been reducing their inventories but rather than decrease them at 8 or 9 or 10 percent they were decreasing them only at 2 or 3 percent which meant that production was being increased.

We believe that roughly half of the inventory correction has already been completed and the remaining half is likely to be completed before the middle of 1976. Thus, if there is to be sustained recovery, it must be carried along by greater strength in final sales of goods and services. Our expectation is that final sales will grow by more than 5 percent from the fourth quarter of 1975 to the fourth quarter of 1976.

There is real strength in final consumption goods, in the sale of goods and services, to final consumers, for two principal reasons. The first has to do with inflation. The purchase of goods and services by consumers is strongly related to their expectations as to price changes in the future. It appears from the behavior of the last two or three years that if there is a widely held forecast that we are in for a period of rapid inflation, then consumers cut back on their purchases in order to add to their savings. Their primary concern is that the value of their savings remains roughly constant, so that dollar savings have to increase, and the savings rate itself may have to increase, in order to maintain the value of such balances. Our expectation is that inflation rates will be much lower in the coming one to two years than in the past, and when consumers are made aware of this, they will maintain high levels of consumption rather than savings and this is an important source of stimulus for the economy.

Let us pause for a moment on this forecast of prices. It is based in part on recent rates of inflation. Inflation has been decelerating in the last few months. Increases in both wholesale and consumer prices have averaged between 6 and 8 percent since September of last year while they were more than twice as high the year before. There is reason to believe that these rates may stay at the lower end of this range in coming months. For one thing, as you know very well, food prices which rose by 7.8 percent from September to September '74 to '75, are likely to increase by less of an annual rate at least until the middle of next year. Furthermore, the price of energy products in the CPI consisting of gasoline and motor oil, fuel oil, and coal will not rise by the 11 percent hike registered over the last 12 months. This assumes that we will have gradual decontrol of old oil over the 40 months now found in the conferees bill reported out last Friday, rather than the much more rapid decontrol assumed by instant elimination of the given price control now in effect. Given these two primary considerations of a slowing down in the rate of increase in prices of food and energy, we see consumer price increases tending toward 5 to 6 percent. With prices of producer durables rising less rapidly, therefore, we expect the GNP deflater to increase only by 5 to 6 percent except, of course, in the final quarter of the year.[1]

The second reason why we believe that final sales will grow by more than 5 percent in real terms lies in the continued rapid rise in disposable real income. Since the first quarter of this year real income has increased at an average annual rate of 6.7 percent with over 2 percentage points of this rise being due to the non-refund features of the '75 tax cut. Even though we expect this rate of growth to decline to about 5 percent in '76 largely on account of the slow rise in transfer

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[1] You had better watch this. In the final quarter, the deflater rises by around 1 percent more at an annual rate on account of Government pay increases which go into effect each October. So the Federal pay system hits you the last quarter of each year and the blow is reasonably great.

payments, such growth—coupled with small reductions in the saving rate—is sufficient to project more than a 5 percent rise in personal consumption expenditures.

I might add at this point that this assumption is another of these political assumptions that are so crucial in making this forecast. The price forecast depends critically on energy policy, on the decontrol program, now within hours of passage by Congress. The forecast as to consumer's disposable incomes depends critically on the tax reductions which are not within hours of passage but which will be hammered out by Congress and the Administration in the next month. If the President's program were put into effect, there would be stronger additional increases in real disposable income which would have a strengthening affect on consumer expenditures in the next two quarters. After that, because it's coupled with a reduction in Government outlays in expenditures by the Federal Government in fiscal year '77, then it would follow there would be a slightly depressing affect in the middle and latter part of next year. You had better watch the newspapers closely to determine how these tax reductions actually occur, because they will offset the phasing of your final forecasts.

Overall, the view of consumer expenditures which I am giving you, is rather optimistic. Consumption in the C+I+G definition of GNP is the strongest element of the three.

There are forecasts of I, which is investment and G which is Government. G is easiest to take care of and the most depressing. G is government expenditures at the state, local, and national level. The New York Times and the other newspapers strongly suggest that things are not going well in New York City and that this may very well spread to other large metropolitan and state regions. We had already forecast before the New York spectacular that there would be a low rate of growth of state and local Government expenditures, partly because voters are increasingly resistant to the growth of local and state government programs. The government purchases of goods and services in our forecast will grow only by two to three percent in real terms and that is the outside end of our forecast.

The more optimistic element is in business fixed investment, the I element. Business fixed investment is showing greater strength than in comparable stages of past recoveries. Instead of reaching a bottom two-quarters after the trough in the reference cycle, BFI this time has risen in the first quarter of general recovery. The rise had something to do with rather special conditions—most prominently, with a surge in the producer durable component of sales of automobiles to final consumers. As automobile sales begin to move ahead, then the investment of automotive and automotive supplying corporations has increased rather rapidly. Nonetheless, there is some evidence that business fixed investment is turning up generally. The Federal Reserve's industrial production index for business equipment has risen by over 2 percent since June. Non-defense orders in the capital goods industries have increased, even if unevenly, since March. The seesaw pattern of these orders received in the primary's metal sectors contributed to some recent instability there, but the outlook here is reasonably strong. With the majority of new investment now devoted to modernization, the growth in equipment purchases should be especially strong during the middle and latter part of next year while investments in structures will show little or no strength until the middle of next year.

Looking at investment as a whole, we expect around a 10 percent growth from the fourth quarter of this year to the fourth of next year. This contrasts with most other forecasts. For example, the OECD forecast calls for only 5½ percent growth over this component. I want to warn you of this and to note that to forecast accurately business fixed investment is to possess a high skill. Most differences among forecasters lie in this area and we are on the optimistic side.

Given I+G, the elements of strength in this outlook should combine to hold the rise in unit labor costs below 5 percent for the coming four quarters. With the average total cost of production falling in relation to prices, profits should grow at relatively high rates to be more specific, we anticipate that the profit share will reach a cyclical high of over 11 percent of national income by the end of 1976 (the profit share has been less than 10 percent in every year since 1969).

With profits strong, with competition keen on account of available capacity, there is no reason for product prices to rise more than roughly 5 to 5½ percent. At the same time the greatly enlarged cash flow and lower effective tax rates should make non-financial corporations increasingly inclined to invest in anticipation of rapidly growing demand. In this way, we see the elements of our forecast hanging together reasonably credibly.

Overall, we are looking for a growth rate in real GNP in the range of 6 to 7 percent for the coming four quarters. This is a strong or optimistic or idealistic or incredible forecast depending on how you want to add up your adjectives. But let me leave you not with euphoria—rather, with a sentence or two of caution. The parts of the forecast that concerns me are the rate of inflation and the rate of growth of investment. Inflation if more serious will be a product of significant demand changes or reduced supplies of food and energy. These will be addressed in a number of other sessions this week, and in Congress, so that there is little more for me to caution you on. Investment is driven by psychological and economic forces; thus forecasting it is a perilous but challenging profession. If you cannot do it well, then let me urge you to do it often.