

FORECASTS 1975

Will the "Year of the Hare" Outrun the Hounds?

The process of economic forecasting is usually misunderstood and often maligned by the public at large. Each year the Federal Reserve Bank of Richmond compiles various forecasts of the economy's performance for the coming year. These forecasts, published by leading business and academic economists, are not really attempts to foresee the future. Professional forecasters can only evaluate the implications of current trends, and—given certain assumptions about future events—extend these trends into the future. If unforeseen events occur, the "prediction" does not come about, and, unfortunately for the forecasters, the one certainty in forecasting is the unforeseen events *always* occur. The economic forecast of the 1974 economy could not have incorporated the effect of a Presidential resignation. Even astrologers missed on that one. Nor could the economist have been expected to foresee another relatively poor crop year, skyrocketing sugar prices, and the full extent of the liquidity crises both here and abroad.

There is a legitimate area for debate about forecasting performances if the forecasters seemed to miss the implications of development that were in existence when they made their forecasts. For example, the 1973 forecasts underestimated the rate of increase of prices in 1974 by a large margin. Viewing 1974 from hindsight, the inflationary trend, which was well entrenched by the time that the forecasters made their forecasts, might have been expected to worsen considerably. In late 1973 and January 1974, however, when the forecasts were published, the economy was slowing; and forecasters expected this slowing to affect the rate of price increase much more than it did. Thus, debate about their price predictions should revolve around the question of whether they were justified in expecting a slowing in prices based upon their knowledge at the time.

Last year the forecasters underestimated the actual GNP total for 1974 by only \$2.4 billion. They were considerably off target, however, for real GNP, or GNP measured in constant 1958 dollars. The estimate was for a rise in the aggregate of 1.2 percent; instead, it fell approximately 2.1 percent.

This year the principal forecasting problems have been whether the economy will recover in 1975, and if so, when and by how much? The forecasters were not able to take account of the President's economic package. Nevertheless, the consensus that was reached is that recovery can be expected in the second half of the year. Some of the reasons that have been advanced to explain the second half upturn have been:

- 1) A reduction in the rate of inflation,
- 2) A decline in the price of oil,
- 3) Recovery in productivity,
- 4) Recovery in automobile sales,
- 5) A rebound in housing starts, and
- 6) The inventory correction ending by midyear.

The reduction in the rate of inflation is expected to have a favorable impact upon the financial sector of the economy, leading to lower interest rates and generally easier credit conditions. Also, it is expected to stop the deterioration in real spendable earnings for consumers. As employers have already begun to lay off hitherto unproductive workers, output per man-hour should improve substantially, leading to more slowing in price pressures. Automobile sales are expected to recover by midyear, if only because of the aging of the current stock. Housing starts are expected to begin their recovery in the spring, because of easier credit conditions and improving real incomes for consumers.

Many forecasters view the current sharp downturn as an inventory correction. Fueled by the boom, many industries, not only automobile and related, but also consumer durables in general—textiles, apparel, and furniture—and housing saw increases in their inventories in 1974 as their unit sales fell off. The forecasters think that these excess inventories will have been worked off by the middle of next year, and firms will cautiously begin to rebuild their stocks.

The consensus of our forecasters is that current dollar GNP will increase 8.3 percent in 1975. Price increases, however, are expected to account for the entire gain, so real GNP is expected to remain approximately the same as it was in 1974. The con-

sensus has the unemployment rate averaging 7.3 percent for the year, an increase of approximately 1.7 percentage points from the 1974 average.

The consensus of our quarterly forecasters also shows recovery in the second half. Gross national product measured in 1958 dollars is projected to decline in the first quarter by \$1 billion, increase in the second by \$3 billion, followed by increases of \$7 billion in the third and \$9 billion in the fourth.

This article attempts to convey the general tone and pattern of some 50 forecasts received by the Research Department of this Bank. Not all of them are comprehensive forecasts, and some incorporate estimates of future behavior of only a few key economic indicators. The consensus of the annual forecasts differs from the consensus drawn from the quarterly forecasts, since different forecasters were applying their skills. Since there were varying assumptions in the individual forecasts regarding events in 1975, the general tone and pattern may not necessarily be based upon the more accurate assumptions, but only the most prevalent.

This Bank publishes also a Business Forecasts booklet, which is a compilation of representative business forecasts with names and details of the various estimates. No summary article can begin to be as informative as the actual forecasts themselves, so serious readers are urged to look at the individual forecasts in more detail in *Business Forecasts 1975*.

The views and opinions set forth in this article are those of the various forecasters. No agreement or endorsement by this Bank is implied.

1974 FORECASTS IN PERSPECTIVE

The consensus forecast for 1974 GNP, published in last year's March/April ECONOMIC REVIEW called for an increase of 7.6 percent over 1973. The forecasts for increases in GNP ranged from a low of 5.6 percent to a high of 9.3 percent. Using the revised 1973 GNP figure of \$1,294.9 billion, the consensus forecast for 1974 GNP would have been \$1,393.3 billion and the range, from \$1,367.4 billion to \$1,415.3 billion. Increasing prices were predicted to account for most of the 7.6 percent gain in GNP. GNP measured in constant dollars, or real GNP, was expected to rise by only 1.2 percent.

Latest estimates by the Department of Commerce indicate a 1974 current dollar GNP total of \$1,395.7 billion, which is only \$2.4 billion higher than the consensus forecast of business and academic economists. Historically speaking, this forecast was very

close to the mark. However, the forecasters were far away from the target on real GNP. Instead of increasing 1.2 percent as they predicted, the constant dollar measure of output is currently estimated to have fallen by 2.1 percent. Consistent with their performance in past years, the forecasters made their mistake in underestimating the rate of price increase. The implicit deflator, which is the price index for items included in the GNP, was forecast to increase 6.4 percent during 1974; in fact, it increased 10.2 percent. The large underestimate of price increases is understandable, for double digit inflation has been, at least until recently, almost unthinkable. But the forecasters, nevertheless, worsened their already poor performance in predicting price changes.

The consensus of quarter-by-quarter forecasts for 1974 was for current dollar GNP to rise by approximately \$19.8 billion in the first quarter, \$19.0 billion in the second quarter, \$24.5 billion in the third quarter, and \$28.1 billion in the fourth. The realized increases came to \$14.8 billion, \$25.0 billion, \$32.5 billion, and \$7.7 billion for the four quarters, respectively. The quarterly projections for real GNP were for changes of -\$0.9 billion, -\$0.5 billion, +\$4.0 billion, and +\$5.6 billion. For the four 1974 quarters, however, GNP in constant dollars actually fell by \$15.2 billion, \$3.4 billion, \$4.0 billion, and \$19.2 billion, respectively. Thus, the consensus path forecasted for the economy in 1974 turned out to be inaccurate. The recovery that was forecast for the

RESULTS FOR 1974 AND TYPICAL FORECAST FOR 1975

	Unit or Base	Preliminary Forecast		Percentage Change	
		1974	1975*	1973/1974	1974/1975
Gross national product	\$ billions	1,396.7	1,511.5	7.9	8.3
Personal consumption expenditures	\$ billions	877.0	963.1	9.2	9.8
Durables	\$ billions	127.8	134.9	-1.5	5.3
Nondurables	\$ billions	380.2	414.4	12.8	9.1
Services	\$ billions	369.1	410.8	9.7	11.2
Gross private domestic investment	\$ billions	208.9	211.2	-0.3	1.4
Business fixed	\$ billions	149.6	161.2	9.2	8.2
Residential structures	\$ billions	46.0	43.8	-19.2	-4.3
Change in business inventories	\$ billions	13.4	3.0	—	—
Government purchases	\$ billions	308.8	341.8	11.5	10.9
Net exports	\$ billions	2.0	-5.0	—	—
Gross national product (1958 dollars)	\$ billions	821.1	816.3	-2.0	-0.6
Plant and equipment expenditures	\$ billions	112.17	125.6	12.5	12.0
Corporate profits before taxes	\$ billions	140.9	127.3	18.4	-9.7
Private housing starts	millions	1.39	1.52	-32.2	9.6
Automobile sales	millions	8.87	8.45	-21.9	-5.5
Rate of unemployment	percent	5.6	7.3	—	—
Industrial production index	1967=100	124.3	123.9	-0.8	-0.3
Wholesale price index	1967=100	160.2	179.4	18.9	12.0
Consumer price index	1967=100	147.8	161.8	11.0	9.5
Implicit price deflator	1958=100	170.2	185.5	10.2	9.1

* Figures are constructed from the typical percentage change forecast for 1975.

second half of 1974 did not materialize. In fact, the recession deepened. The rate of price increase, which the forecasters also expected to improve in the second half of the year, also worsened.

The consensus 1974 forecast projected personal consumption expenditures for the year to increase 7.0 percent to \$861.0 billion. Current estimates place personal consumption expenditures much higher, at \$877.1 billion. Gross private domestic investment, on the other hand, forecast to increase 4.8 percent to \$219.4 billion, actually fell 0.4 percent to \$208.3 billion. Thus, 1974 had considerably more current dollar consumption than the forecasters expected and considerably less fixed investment. One of the principal reasons for the overestimate of investment was the forecasters' failure to anticipate the severity of the decline in construction activity in 1974. Residential structures were expected to decline somewhat, from the \$57.2 billion total in 1973 to \$52.1 billion in 1974. Actually residential structures totaled only \$45.8 billion. The seers were relatively accurate in predicting Government expenditures, however, anticipating a 10 percent growth in Government purchases versus an actual increase of 11 percent. Net exports were expected to total \$5 billion, but they actually amounted to only \$1.2 billion.

All-in-all, it would appear that few kudos should be extended to last year's forecasters for their relatively accurate forecast of current dollar GNP, since the forecasts for the components of GNP were so far off target. The GNP estimate came close only because the errors in estimating the components tended to offset one another.

Surprisingly, however, and not consistent with the forecasters' tendency to predict a better performance from the economy in 1974 than the one that actually materialized, they predicted the rate of unemployment quite accurately. The unemployment rate, estimated to average 5.5 percent in 1974, actually averaged 5.6 percent.

In other areas, the 1974 forecasters overestimated the index of industrial production. The index fell 0.9 percent for the year, against a forecast of a 1.1 percent gain. Corporate profits before taxes were predicted to fall slightly to \$122.4 billion, but they actually rose a whopping 14.9 percent to \$140.9 billion in dollar terms. The consumer price index, like the implicit price deflator for GNP, was substantially underestimated. Consumer prices were expected to increase 6.8 percent; they actually rose 9.5 percent.

1975 FORECASTS IN BRIEF

Gross National Product Forecasts for 1975 current dollar GNP center around \$1,511.5 billion. This consensus forecast represents an approximate 8.3 percent yearly gain, which is slightly more than the 7.9 percent increase registered in 1974. Prices, however, are expected to increase by 9.1 percent and thus to account for more than the entire rise in current dollar GNP. GNP measured in constant dollars, or real GNP, is expected to fall in 1975, but only 0.6 percent, compared to a 2 percent fall in 1974. Estimates for increases in current dollar GNP ranged from a low of 6.2 percent to a high of 10.8 percent. The typical quarterly consensus this year indicates that a recovery will begin in the second quarter and pick up steam throughout the year. The typical quarterly estimates indicate that GNP should increase \$26.0 billion in the first quarter of 1975 and \$31.0 billion in the second. The recovery is then expected to accelerate, and the increases in the third and fourth quarters are expected to be \$38.0 billion and \$40.0 billion, respectively.

Personal consumption expenditures are expected to total \$963.1 billion for 1975, up 9.8 percent from 1974. Forecasters estimate that expenditures for durable goods will increase least rapidly, showing an increase of only 5.3 percent for 1975, but expenditures for nondurables and services will increase 9.1 percent and 11.2 percent, respectively. The slower rate of expansion of durable goods expenditures is expected to stem primarily from a sluggish pickup in purchases of big-ticket items. The increases in nondurables and services expenditures are expected to reflect price increases, in large measure, but to allow for some increases in unit sales.

Government purchases of goods and services are projected to total \$341.8 billion. This estimate represents a 10.9 percent increase over the 1974 total, which is somewhat smaller than the large 11.5 percent gain of the previous year. The 1975 forecasts range from increases of 7.5 to 12.2 percent.

Gross private domestic investment is expected to rise by about 1.4 percent in 1975. This estimate is somewhat higher than the 0.3 percent decline in 1974. Both are considerably slower than the 13.0 percent 1973 pace. Residential construction is expected to decline from the 1974 *average*, but only modestly. Inventory investment, however, is expected to decline by more than \$10 billion. Business fixed investment, the only source of relative strength in the investment sector, is expected to increase 8.2 percent. The forecasters are predicting a recovery

TYPICAL* QUARTERLY FORECAST FOR 1975

Quarter-by-Quarter Changes in Billions of Dollars
Unless Otherwise Noted

	I	II	III	IV
Gross National Product	26.0	31.0	38.0	40.0
Personal Consumption Expenditures	19.0	20.0	22.0	26.0
Gross Private Domestic Investment	-1.0	4.0	9.0	9.0
Net Exports	—	-1.0	-1.0	-1.0
Government Purchases	8.0	8.0	9.0	9.0
Gross National Product (1958 dollars)	-1.0	3.0	7.0	9.0
Implicit Price Deflator†	8.0	7.2	6.6	6.4
Rate of Unemployment (%)	6.8	7.0	7.2	7.3

† Percentage changes at annual rates.

* Median.

for residential construction in the second half of the year, so it seems somewhat surprising at first glance that they are predicting the year's performance to average out as a 4 percent decline. It is important to remember that residential construction at year-end 1974, however, was in considerably worse straits than the *average* 1974 figure would indicate. The forecasters were, as is often the case, less consistent in their investment forecasts than in any other aggregate. The predictions for residential structures range from a 14.9 percent decline to a 10.5 percent increase. Those for business fixed investment range from increases of 3.0 percent to 12.4 percent. And investment in business inventories, which had a consensus of \$3.0 billion, had a range of forecasts from -\$4.3 billion to \$10.5 billion.

Industrial Production The typical forecast for the Federal Reserve index of industrial production (1967=100) is 123.9, a fall of 0.3 percent, which is approximately equal to the 1974 performance. The index of industrial production ended the year, however, at 118.3, so a 1975 average of 123.9 indicates some improvement over that level. Anticipated gains are in the production of heavy machinery, automobiles, and construction related items.

Housing The construction industry is expected to recover somewhat from its dismal 1974 performance. It will remain sluggish, however, compared to 1972 and 1973. Private housing starts, which totaled 2.38 million in 1972, slowed to 2.04 million in 1973 and 1.39 million in 1974, are expected to amount to 1.52 million units in 1975. Considering that housing

starts closed the year at a 1.0 million unit annual rate, 1.52 million units in 1975 is a significant improvement. The recovery is expected to come about mainly because financing is expected to become easier and less costly for home buyers. The easier conditions in the mortgage markets are expected because the slowing economy is supposed to exert downward pressure on interest rates.

Corporate Profits The consensus forecast indicates that this year should be considerably less profitable for corporations than 1974, with pretax corporate profits expected to decline 9.7 percent to \$127.3 billion. Considering their forecasts for a 9.1 percent increase in the price deflator, a decrease in profits of 9.7 percent is a sizable decline.

The 18.4 percent increase in 1974 corporate profits, however, resulted in large measure from changes in inventory valuation. In an inflationary period, firms can profit on the value of the inventory held, although the profit is largely illusory because firms must pay the higher price to replace the inventory. Some industry spokesmen have argued that it is not fair for them to be taxed on such inventory gains and, in order to avoid such taxes, have advocated changing to the lifo method of valuing their inventory. This method—last in, first out—causes the inventory valuation to more nearly reflect replacement cost. Many firms in fact have recently adopted lifo, which has the effect of lowering their reported or accounting profits by removing the “illusory” inventory gain. The forecasters took this changeover into account in making their 1975 profit projections, so the predicted profit drop in 1975 is not as large an actual turnaround as it might seem to be from a cursory examination. The most pessimistic forecaster expects a 25.9 percent profit decline; the most optimistic a 9.8 percent decline.

Unemployment Most forecasters are predicting a large increase in the rate of unemployment for 1975. The typical forecast for the year is around 7.3 percent, which is 1.7 percentage points above the 5.6 percent average for 1974. Most of the projections had already been completed before the 7.1 percent figure for December 1974 was announced.

Prices This year the forecast indicates a slight decline in the rate of advance of prices. The implicit GNP deflator, which rose 10.2 percent in 1974, is expected to increase 9.1 percent. The consumer price index is also expected to increase less rapidly, 9.5 percent compared to 11.0 percent in 1974. The wholesale price index, still expected to increase at

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double-digit rates, is expected to rise by 12.0 percent, which is considerably less than the 18.9 percent rate of advance registered in 1974 but still phenomenal.

Net Exports The nation's trade position, which showed a \$2.2 billion surplus in 1974, is expected to be in deficit in 1975 (—\$5 billion). The forecasters, however, were not able to evaluate President Ford's energy package in making their projections. The estimates for net exports ranged between —\$7.8 billion and +\$20 billion.

Quarter-by-Quarter Forecasts Fifteen forecasters made quarter-by-quarter forecasts for 1975. As indicated by the accompanying table, these forecasters generally expected a slow economy in the first half of the year and recovery during the second. To illustrate the diversity of the quarterly estimates, however, the typical forecast for real GNP in the first quarter, a decline of \$0.1 billion, was drawn from forecasts that ranged from a decline of \$10.0 billion to a rise of \$4 billion. Only two of the fifteen forecasters predicted two consecutive quarters of negative growth in real GNP, and only one failed to predict consistently increasing rates of growth throughout the year. By the fourth quarter, they were predicting real growth ranging from \$5 billion

to \$15 billion. The quarterly consensus for the unemployment rate is considerably different from the annual consensus. This divergence results in part from different expectations on the part of the forecasters, but mainly from the fact that the quarterly forecasts are less current and the forecasters were less able to evaluate the November and December 1974 unemployment figures.

Summary According to the majority of forecasters, the economy should begin to recover from its downturn late in the second quarter of the year. Moreover, the rate of price increase should subside throughout the year. Price advances will continue to be high, by historical standards, but double-digit inflation should be behind us, at least at the consumer level. Thus, barring further adverse energy developments and poor crop yields, the stage should be set for a healthy and growing economy in 1976. Thus 1975, which is the "year of the hare" according to the Chinese calendar, is predicted to be milder than 1974, which was the "year of the tiger." Also, it will be characterized by improving, albeit sober, expectations on the part of consumers, investors, managers, and workers.

William E. Cullison

BUSINESS FORECASTS 1975

The Federal Reserve Bank of Richmond is pleased to announce the publication of *Business Forecasts 1975*, a compilation of representative business forecasts with names and details of estimates for the coming year. The booklet is available free of charge from this Bank. Please address requests to Bank and Public Relations, Federal Reserve Bank of Richmond, P. O. Box 27622, Richmond, Virginia 23261.