Second Quarterly

ECONOMIC FORECAST 1983

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The Outlook in Brief

The index of leading economic indicators increased during 7 of the past 8 months. Upturns in the index generally precede the onset of economic recovery by 4 to 6 months. The steady upward progression of the index indicates the current recession, if not already concluded, is in its very last stages. The fact that the aggregate increase in the index over the past 8 months was only 5.3%, compared with 8-month gains of 10.7% in previous recessions, offers further evidence that this recovery will be long and slow-paced. We look for appreciable improvement in the state and U.S. economies during the second quarter of 1983. The following are highlights of our forecast for 1983:

1. A continued easing of interest rates.

2. An increase in the unemployment rate as the recession winds down and the economy recovers. The national unemployment rate will increase to an average 10.3% from 9.7% in calendar 1982, while Michigan's unemployment will decline to 15.2% from 15.4% during 1982.

3. An increase in U.S. auto sales from the 7.9 million unit level of calendar 1982 to 8.6 million units in 1983.

4. Recovery of Michigan housing starts to 16,000 units, up from the abnormally low level of 13,000 units in 1982.

5. A 2% increase in inflation-adjusted personal income.

6. A slight increase, from 4.6% in 1982 to 6% in 1983, in the rate of inflation.

Interest Rates

Interest rates have fallen continuously since July when the prime interest rate was still 16%. The prime rate is presently 11.0% and further reductions are anticipated for the near future. Other rates have floated downward with declines in the prime. Long-term Treasury securities averaged 13.85% on July 2, but had fallen to 10.48% by January 7, 1983. Mortgage rates have followed a similar course and currently range between 13.0% to 13.5%, down from 17.0% one year ago.

Declining interest rates have been made possible by rapid expansion in the rate of growth of the nation's basic money supply. The Federal Reserve Board (Fed) targeted the growth range for M1 (currency plus demand deposits held by the nonbank public) at 4.5-5.5% for calendar 1982. However, faced with a stagnant economy, a stillborn recovery in August, and with inflation in retreat, the Fed in October decided to focus less attention on monetary aggregates and more on basic economic conditions. The result has been a tripling of money supply growth to a 14.5% annual rate by late December.

Although this rate of growth is not sustainable for extended periods of time, recent structural changes in the money supply prevent the Fed from tightly controlling the money supply even if it wanted to. Creation of the super-NOW and bank money market funds has broadened the category of demand deposits and altered the way people manage their financial resources. With a more loosely defined money supply, the Fed can further accelerate the growth rate or do anything else it pleases and still remain insulated from substantive criticism of its policies since it will be virtually impossible to determine an appropriate base by which to gauge its performance.

These factors mark the end of the Fed's three-year experiment with monetarism. The Fed now has little choice but to suspend targets for M1 and to weigh economic trends and interest rates more heavily in setting credit policy. Fed policy since 1980 has been characterized by extreme volatility, but general economic trends have been relatively stable. Consequently, this change should help restore order to the financial markets and smooth out interest rates. As uncertainty about the path of interest rates diminishes, long-term rates should continue to decline, thereby facilitating economic recovery.

A couple of factors will limit the extent to which interest rates decline. Financing of the national debt consumes a major portion of available credit. Despite the pending $200 billion level of the 1983 deficit, weak business and consumer demand for credit has prevented development of excess demand for credit which would otherwise bid up interest rates. High long-term interest rates during this recession forced businesses into short-term financing of debt, altering the ratio of short- to long-term debt. Given the historically high level of excess capacity, businesses are unlikely to quickly resume capitalization plans which would require long-term borrowing. As the economy recovers and demand increases and prices stabilize, firms will first use their increased receipts to eliminate much of their short-term debt, thereby reducing credit demand. However, as the recovery gains momentum this year and into 1984, businesses will require additional credit to finance inventories and capital acquisition, and consumers will increase installment debt to finance increased purchases. As interest rates rise, the federal government can draw on the assets of the Treasury to ensure access to credit markets regardless of the level of interest rates, but the private sector has no similar resource. Consequently, in any competition between the public and private sectors for limited credit, the private sector is bound to lose. If credit becomes too expensive for consumers and businesses to finance their purchases, the recovery will collapse.

Assuming the government checks its credit consumption, other factors will still maintain high interest rates on consumer loans. The super-NOW and money market accounts are attracting additional loanable funds to banks and saving and loan associations but at a cost considerably higher than funds currently obtained from savings and NOW accounts. The higher cost of obtaining funds will be reflected in interest rates on consumer loans. As a result, interest rates for mortgages, auto loans, and other types of consumer credit will decline more slowly than other interest rates, remaining well in the double-digit range long after other rates have declined below 10%.

Unemployment

The unemployment rate is the ratio of people aged 16 years and over actively seeking employment to workers in the noninstitutional civilian labor force; this labor force, in turn, is the sum of employed people plus actively searching unemployed people. If the size of the labor force remains constant, an increase in the number of job losers increases the unemployment rate, and this is the interpretation commonly attributed to a reported increase in the unemployment rate. However, the unemployment rate may also increase, even as the total number of employed workers increases, if the labor force expands more rapidly than new employment. Conversely, the unemployment rate may decline even without additional employment if the labor force contracts, as would happen, for example, if discouraged workers discontinued their job search efforts and subsequently dropped out of the labor force. Nationally, the number of discouraged workers stood at 1.8 million in December, the highest level since recordkeeping started in 1967.

The figures released for the month of December showed another increase in the unemployment rate. The national unemployment rate increased to 10.8% in December, up from 10.7% in November. For the year as a whole, the unemployment rate averaged 9.7% compared with 7.6% in 1981. Michigan's unemployment rate averaged 15.4% compared with 12.3% in 1981.

In December, the Michigan unemployment rate continued its steady ascent, rising to 17.6% from 17.2% in November. Total Michigan employment increased by 20,000 to 3.58 million people in December. Thus, December's increase in the unemployment rate was attributable to an influx of workers seeking seasonal employment rather than to an increase in the number of job losers. Employment gains were made primarily in retail trade and the automotive industry.

While a number of indications suggest the economy bottomed out in November and is poised for a long-awaited but slow-paced recovery, unemployment is likely to remain high throughout 1983. Uncertain of the strength or duration of a recovery during its initial stages, employers usually increase overtime hours rather than recall workers. Employment does not generally increase until prospects for continued growth in demand are reasonably certain. This is not likely to occur until the second quarter of calendar 1983. As employment prospects improve, a number of discouraged workers are likely to rejoin the labor force, maintaining the unemployment rate despite actual increases in the number of people employed. As a result, the unemployment rate in Michigan is likely to average about 15.2% for 1983, while the national unemployment rate will rise to 10.3%.

Auto Sales

Total auto sales for 1982 reached 7.96 million units, a rate well below the 8.51 million unit level of 1981. This was the weakest industry sales performance since 1961. Domestic sales accounted for 72.3% of sales (5.76 million units) while imports captured the remaining 27.7% (2.20 million units) of U.S. sales.

As stated in our September 1982 forecast, Public Sector Consultants, Inc. anticipates 1983 auto sales will improve modestly to 8.6 million units. Clearance of 1982 models accounted for a majority of new car sales during October and November, but 1983 models provided most of the new car sales during the past 6 weeks. Since it is sales of 1983 models rather than liquidation of 1982 inventories that will eventually translate into increased production and employment, this change offers a basis for modest optimism for 1983 auto sales and tends to substantiate our earlier projection.

The industry has also changed its sales strategy. Throughout this recession, automakers repeatedly offered rebates in an attempt to stimulate sales. As consumers became accustomed to rebates, however, rebates were increasingly necessary simply to maintain sales traffic. The 1983 sales strategy focuses on providing below-market interest rates for dealer-financed sales. This strategy maintains the sale price of the vehicle while reducing the overall cost of financing the purchase, thereby providing a cost break without reducing the price. The prime commercial paper used to finance this program currently costs 8.39%, more than 3 percentage points below the 11.9% at which the dealers are financing sales. This differential is certainly adequate to cover the overhead costs of the program and should enable the automakers to continue their financing program indefinitely until market rates decline sufficiently to eliminate the need for the program.

Housing Starts

High money costs continue to hurt the most interest-sensitive sectors of the domestic economy, most notably residential construction activity and auto sales. Below-market interest rates on dealer-financed auto loans will help mitigate the negative effect of high interest rates on automobile sales, but the housing industry has no such program. However, declining mortgage rates are generating renewed interest in residential construction. Michigan residential building permits should reach 16,000 in 1983, up 23% from the estimated 13,000 issued in 1982 but still far below the 71,000 of 1973. Residential construction permits nationwide should rise to 1.2 million, up from 980,000 in 1982.

December 1982 mortgage rates ranged between 13.0% and 13.5%, down from the 17% level of December 1981. Real estate activity started picking up this fall shortly after mortgage rates started declining. Building permits almost doubled this December over December of 1981, and show signs of gaining momentum during the first and second quarters of 1983. Assuming building permits result in new construction activity, the positive spin-off effects construction has on purchase of durable goods such as appliances and furniture should materialize late this fall.

Personal Income

Inflation-adjusted personal income declined 0.4% in 1982. Higher levels of employment in the second half of 1983 combined with modest gains in wage and salary earnings should result in an annual increase of about 2% during 1983.

Inflation

Inflation averaged 4.6% in 1982, less than half the 10.4% rate of 1981. Inflation is expected to increase slightly in 1983 to 6.0%.

The business failure rate will continue to increase during the initial stages of the recovery, exerting downward pressure on prices via bankruptcy and distress sales. An extraordinarily ample harvest should slow increases in food prices, while a petroleum glut will ensure ample energy supplies and more flexible prices.

Many companies demanded and received employee wage concessions during 1982. As the economy slowly recovers and business prospects improve, employees whose contracts expire this year are likely to demand a premium for the sacrifices they made over the past couple of years. Nonunion employees are unlikely to regain ground lost during the recession, but are also unlikely to tolerate additional concessions. Hence, while nonunion labor costs are not likely to increase in 1983, neither will they decline as they have in the past 18 months. Union wage settlements will not exceed 7%, a rate considerably below the 9-10% rate for prerecession settlements. Productivity gains will cover a major portion of increased labor costs, resulting in only slight increases in product prices.

Summary

We anticipate appreciable improvement in the Michigan and U.S. economies during the second quarter of 1983. The recovery will be slow and weak, marked by stubbornly high unemployment, and will attain perhaps as little as half the level of improvement typified by other postwar recoveries. This slower rate of improvement also increases the possibility that economic gains will extend over a longer period of time and will be more enduring than usual recovery gains.