First Quarterly

Economic Forecast

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The Outlook in Brief

The economy shifted from recession in 1982 to recovery in 1983. Led by major increases in consumer outlays for durable goods such as housing and autos, the nation's gross national product grew by 9.7% in the first quarter. As recovery spread to other sectors of the economy, the pace of consumer spending and economic growth shifted to a lower, more sustainable rate of growth, averaging 4.5% by the fourth quarter of 1983.

As the economy continues to expand during 1984 and businesses use a larger share of their existing capacity, consumer spending will play a less important role in economic growth and business spending will assume a more important role. The money supply and the cost of credit remain the greatest threats to continued expansion, but neither factor is expected to derail the economic locomotive during 1984. The following are highlights of our forecast for 1984 and early 1985:

* Stable interest rates and money supply growth.
* Continued decline in the national and state unemployment rates due to job creation and slowed labor force growth. The national unemployment rate will decline from the 1983 average of 9.6% to 8.1% in 1984 and 7.6% in 1985. Michigan's unemployment rate will fall to 11.6% in 1984 and 9.8% in 1985 from the 14.1% average of 1983.
* Auto sales will continue to increase in both 1984 and 1985. Total U.S. auto sales will rise to 9.9 million units in 1984 and 10.7 million units in 1985. Import restraints will restrict foreign auto sales to approximately 2.4 million units, reducing the import share of the U.S. market to 22% in 1985, down from an average 26% share during 1983.
* Exhaustion of inventories of new houses, combined with continued strong housing demand, will cause housing starts to increase to 1.8 million units in 1984 and 1985, up from the 1.7 million units started in 1983.
* A 5% increase in inflation-adjusted personal income in 1984 and a 4.5% increase in 1985.
* A slight increase in inflation as measured by the consumer price index (CPI) to 4.9% in 1984 and 5.6% in 1985.

Summary of Major Economic Factors

Factor	Projected 1983	Actual 1983	Projected 1984	Projected 1985
U.S. Auto Sales (millions)	9.1	9.2	9.9	10.7
Housing Starts (millions)	1.7	1.7	1.8	1.8
Inflation (U.S. CPI)	3.1%	3.8%	4.9%	5.6%
National Unemployment Rate	9.7%	9.6%	8.1%	7.6%
Michigan Unemployment Rate	14.6%	14.1%	11.6%	9.8%

Leading Economic Indicators

As in all other post-World War II recoveries, the upturn that started in late November 1982 was initiated by increased consumer spending, primarily on autos and housing, and gradually spread through the entire economy. Increased consumer spending depleted business inventories. As manufacturers labored to keep pace with the increased level of consumer demand, production hours increased, manufacturing capacity utilization rose, productivity increased, prices stabilized, business profits started to rise, and workers were recalled or hired. Rising employment levels generated more personal income. As this income was spent on food, clothing, and entertainment, workers in nonmanufacturing industries were called back to work. As these workers spent their income, the previous effects were reinforced, generating even more economic activity.

The index of leading economic indicators consists of eleven indicators and is a barometer of future economic activity. Increases in the index portend continued expansion during the next 12 to 18 month period; decreases indicate a weakening economy which may lapse back into recession. A single month's change in the index is not significant in and of itself and cannot predict either an expansion or an economic contraction. Continued advances in the index provide reassurance of future growth, while a series of decreases offer strong evidence of an impending recession.

This index increased by 0.6% in December 1983, the fifteenth increase during the past 16 months. (The index declined by a revised 0.2% in November 1983.) Changes in the direction of movement of the index are typical of the transition from economic recovery to economic expansion.

Four of the ten available indicators contributed to the December increase in the index. A jump in business and consumer credit use was the primary reason for the rise. Growth in the money supply, a decline in new unemployment compensation claims, and slower supplier deliveries, indicating an inability to keep pace with growth in new orders, also helped boost the index.

The remaining six indicators registered declines, offsetting a portion of the positive contribution of the preceding four factors. The six indicators making a negative contribution to the index included a decline in business starts and small reductions in the length of the average workweek, the number of manufacturers orders for goods and materials, stock prices, new building permits, and new contracts for plant and equipment.

Interest Rates

Interest rates remained stable during 1983 and are not likely to change significantly from 1984 through 1985. The prime rate, which is the interest rate reserved for banks' most credit-worthy business borrowers, started 1983 at 11.5% but declined to 11% in April and has remained there ever since.

Two forces that would normally help pull interest rates down are the low rate of price inflation and a large foreign trade deficit. However, these forces have been offset by a spiraling federal budget deficit and attendant federal borrowing requirements. The federal government ended its 1983 fiscal year with a $195.35 billion budget deficit, reducing the pool of domestic funds available for new private investment to 1.8% of gross national product (GNP). During the 1970s 6.3% of GNP was available for new investment. Since the government is comparatively insensitive to the cost of credit, it can acquire all the credit it needs by simply paying whatever interest rate is necessary to eliminate competing business and consumer demand. Loanable funds not used by the government are then rationed by the market, through the interest rate, between businesses and consumers. Until 1981, interest rates usually exceeded the rate of inflation by about 3 percentage points. The inflation and interest rates now differ by more than 7 percentage points. This is, in part, a measure of the rationing effect the dozen-digit federal deficit has had on the credit market.

Credit demand should increase in 1984 as businesses rebuild inventories and invest in new plant and equipment. If consumers continue to outspend their increases in personal income, their demand for credit will increase also. When these demands are coupled with those of the federal government resulting from its anticipated budget deficits of over $200 billion annually through 1988, U.S. interest rates would be expected to rise.

Despite these pressures, there are a variety of reasons to believe that interest rates will not change much in 1984. Rising interest rates could stymie the expansion or throw the economy back into recession, a situation politicians are particularly anxious to avoid during the 1984 election year. Second, another recession in the U.S. might be exported, via the financial markets, to other nations, perhaps creating a situation of worldwide economic depression which would last upwards of a decade. Third, reviving business profitability has generated an internally held pool of assets businesses can use to finance inventories or expansion without tapping the credit market. Fourth, state and local units of governments have improved their financial condition during the past year and are reducing their borrowing from the credit market, making those funds available to other borrowers. Finally, as more people return to work and earn income, a portion of their earnings will be placed into saving accounts, thereby increasing the pool of funds available for lending.

However, as the business cycle continues and the expansion begins to slow, mounting federal budget deficits and rising business and consumer credit demand will exact an increasingly heavy burden on the economy. The borrowing needs of the federal government could create excess demand for credit and push up interest rates. Economic activity would taper off because consumers could not afford the high cost of credit and would begin to forgo purchases requiring financing. Without an expanding pool of customers, businesses would have little reason to upgrade their production capacities. Moreover, the high rates of return on investments in the financial markets would increasingly exceed the rate of return on physical investments, causing orders for goods and materials and contracts for new plant and equipment to decline. If this occurred, the economy would fall back into recession in a fairly short period of time.

Unemployment

The large decline in unemployment was one of the most impressive gains scored during the 1983 recovery period. The national unemployment rate declined from 10.4% in January 1983 to 8.0% in January 1984. Michigan's unemployment rate declined from 15.5% to 11.5% in the corresponding 12-month period.

Unemployment will continue to fall throughout 1984 and 1985, although not nearly so spectacularly. Unemployment nationwide will average 8.1% in 1984, declining to 7.6% in 1985. Michigan's unemployment rate will average 11.6% in 1984 before declining to 9.8% in 1985.

Despite this improvement, unemployment will remain comparatively high in manufacturing industries, particularly in automotive manufacting. Auto sales have improved significantly over recession levels. Many auto parts and assembly plants are operating with enough overtime hours to require the addition of a second or third shift of workers, but this is not occurring. There are two overriding reasons for this situation: (1) The fixed costs of labor, i.e., health, life, and disability insurance coverage costs associated with hiring additional employees still exceed the savings which would result from reducing overtime hours and (2) the consistent vetoing by union members of cuts in overtime pay. As a result, unless and until the manufacturers are paying more for overtime than it would cost to add more production employees, an inordinate number of laid-off manufacturing employees will remain out-of-work awaiting recall. In contrast to employment in the automotive and related sectors, employment in health care and specialized service occupations will continue to grow rapidly, thereby helping to hold down the overall unemployment rate.

In addition, a major portion of the unemployment decline will stem from a slowdown in the growth of the labor force. (The labor force is the pool of people aged 16 to 64 who are either employed or who are unemployed but actively seeking employment.) During the seven previous economic recoveries following World War II, the labor force grew an average 1.3% during the first year. The largest growth occurred in the 1975-76 recovery period when the labor force expanded by 2.2%. In contrast to this, the labor force grew by only 0.9% from the time this recovery started in late November 1982 to November 1983.

Major reasons for this slowdown in labor force growth include maturation of the baby-boom generation, stabilization of the entry of women into the labor market, and the withdrawal from the labor force of many long-term unemployed adults who have lost hope of reemployment. However, an expanding economy generates new employment opportunities. Since the unemployment rate is the ratio of the unemployed to the total labor force, if job opportunities and employment grow faster than the labor force, unemployment will decline relatively rapidly, as it did in 1983. The discouraged worker effect will further restrain growth of the labor force. As a result, the unemployment rate will continue to decline rapidly, but it will not be matched by a proportionate increase in employment levels.

Auto Sales

Total U.S. auto sales increased by 15% in 1983, rising to 9.2 million units from 8.0 million units in 1982. Further growth is projected for 1984 and 1985, but the industry will still fall considerably short of its 1973 sales record of 11.4 million units. Total domestic and foreign automobile sales will increase by 8% in 1984 and 1985, generating sales of 9.9 and 10.7 million units, respectively.

Profits of the automakers will increase considerably more than sales. Soft worldwide demand for petroleum products will guarantee ample supply and prevent increases in petroleum and gasoline prices. This will continue to encourage the shift away from small, fuel-stingy compact and subcompact autos to larger, more luxurious and less fuel-efficient vehicles. Since the profit margin on large autos is greater than on compact and subcompact models, the higher sales volumes of the larger vehicles will provide record profit levels. Strengthening consumer demand and elimination of sales incentives will also fatten automaker profits.

Import restraints will maintain foreign auto sales at approximately 2.4 million units during each of these years, increasing the domestic market share to just under 78% in 1985 from 74% during 1983. However, perpetuation of import restraints will encourage foreign auto manufacturers to shift their product mix to larger, sportier, and more expensive (and profitable) vehicles from their current concentration on small, no-frills subcompacts, thereby "skimming the cream" from the market. If foreign automakers are able to transfer their success and profit margins from the subcompact portion of the auto market to that for midsize and luxury vehicles, they could pose a significant threat to the traditional preeminence of domestic manufacturers in this more lucrative end of the U.S. auto market.

Housing Starts

Housing starts will increase modestly in 1984 despite high mortgage rates. Increased use of graduated payment mortgages, builder buy-downs, and government subsidies will help counteract the effect of high mortgage rates and maintain housing demand.

Housing prices will also increase in 1984. During 1983, builders were still attempting to liquidate stocks of unsold new residential construction. Virtually all of these houses have been sold now. As housing demand remains strong, housing starts will of necessity have to rise above the level of 1983. Housing starts nationwide will increase from the 1.7 million units of 1983 to 1.8 million units in 1984.

Personal Income

Higher employment levels, reduced entitlement program outlays, and modest rates of inflation will contribute to a 5% increase in inflation-adjusted personal income during 1984. As the economy slows in 1985, real personal income will increase by an average of 4.5%.

Inflation

The consumer price index rose a seasonally adjusted 0.3% in December 1983. For the year as a whole, consumer prices edged up 3.8%, the smallest annual rate of increase since 1972. Lower petroleum prices, stable food prices, and low rates of increase in wages were the primary reasons for price restraint.

Some of these factors will continue into 1984. With a worldwide petroleum glut, oil prices cannot rise in 1984. This will hold down the price of petroleum products as well as the prices of many energy-intensive manufactured goods. Retail prices will also remain fairly constant. The recession created new market opportunities for factory retail outlets and their number mushroomed, intensifying competition in retail trade. This prevented full-price retailers from raising their prices to recoup lost profit margins even after the economy improved and consumer demand strengthened. The market cannot sustain all these retailers, making 1984 a year of shakeout. The resulting fierce price competition will hold down inflation and benefit the consumer.

Meat prices will rise slightly in 1984, pulling up the average of all food prices. The miserable weather conditions of 1983 destroyed many fresh vegetable crops and reduced cattle feed stocks. To avoid the resulting higher cost of feed stocks, many cattle producers sold their animals early for slaughter. This abundant meat supply held down meat prices in 1983 but reduced the number of cattle going to market in 1984. As a consequence, the smaller volume of meat supplies during 1984 will contribute to higher food prices.

Labor concessions moderated producer price increases in 1983, indirectly helping to contain consumer prices. However, with economic recovery and renewed business profitability, workers are expecting to regain many of the sacrifices they made during the recession. There are few large labor contracts up for negotiation in 1984, but those that are will undoubtedly incorporate wage gains which outstrip those granted in 1983. Due to the relative paucity of labor contracts up for ratification this year, the overall impact on inflation will be fairly small. However, as more contracts expire in 1985, this will set a higher base for wage rates and, indirectly, for consumer prices. Nationwide, the consumer price index will rise 4.9% in 1984 and 5.6% in 1985.

Summary

The economy will shift from a period of recovery to one of expansion during 1984. Inconsistent federal fiscal and monetary policies will keep interest rates at approximately their current levels even though consumer price inflation will hover around 5% annually. The projected $200 billion federal budget deficits will not pose a significant threat to enduring economic growth during 1984. This growth, conjointly with a slowing of labor force growth, will help reduce unemployment rates while producing relatively modest gains in overall employment levels. Higher employment, reduced entitlement outlays, and inflation restraint will boost inflation-adjusted personal income by 5% in 1984 and 4.5% in 1985. These gains will propel auto sales to 9.9 million units in 1985 and increase housing starts to 1.8 million units.

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