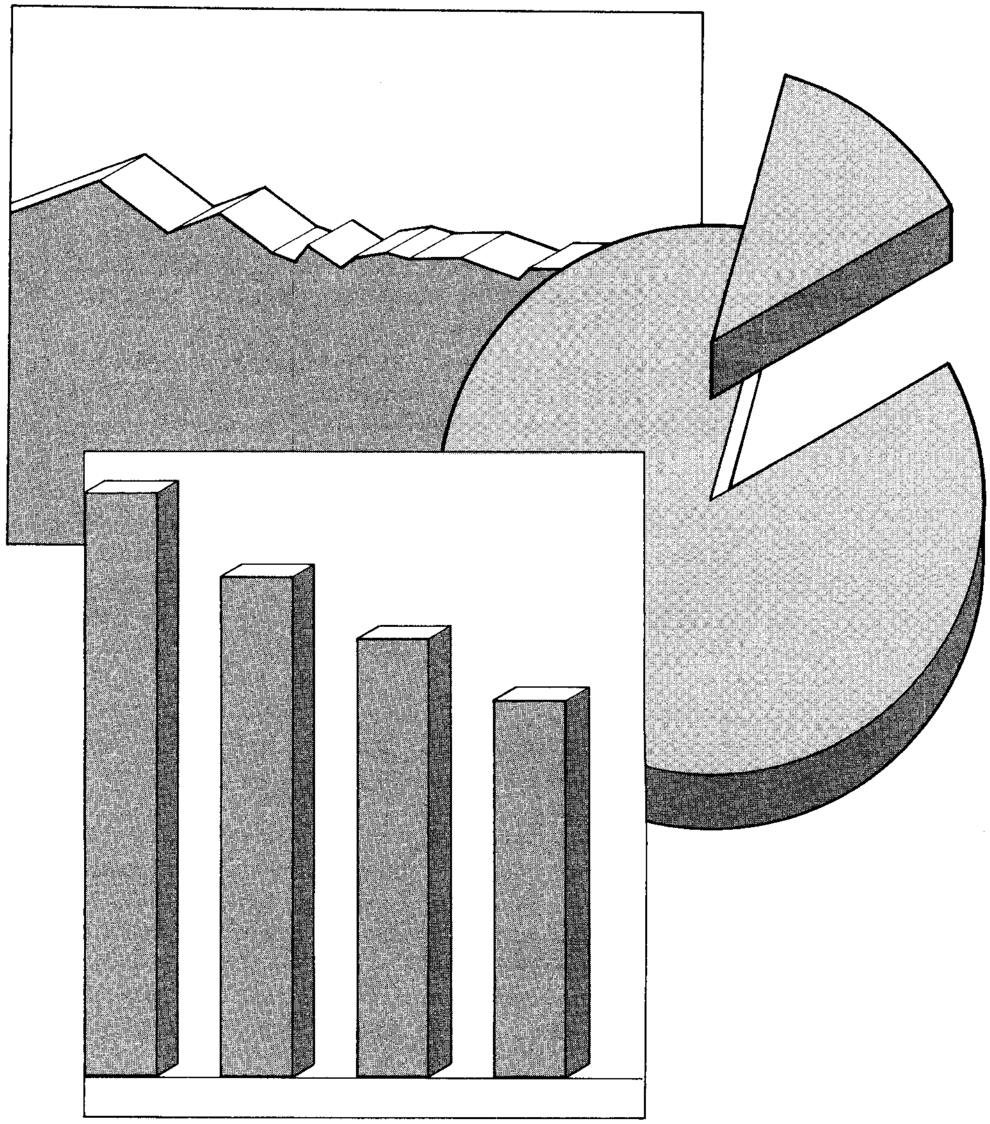
March 1985

First Quarterly Economic Forecast



Prepared by

Cheryl Parish

Senior Staff Economist

Editor, FISCAL AWARENESS SERVICE

PUBLIC SECTOR CONSULTANTS, inc.

KNAPP'S CENTRE • 300 S. WASHINGTON SQUARE • SUITE 401 • LANSING, MI 48933 • (517) 484-4954

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Economic Overview

The economic recovery matured in 1984, settling down to lower but more sustainable rates of growth. There was a temporary pause during the second half of 1984, but the economy has since shown renewed signs of vitality. Consumer confidence remains high, and business investment spending is strong; inflation has once again settled to levels below 5%, and employment has improved, contributing to growth in personal income.

Prospects for 1985 and 1986 appear equally promising, although the federal budget deficit and a growing trade gap threaten the longevity of the current expansion. The following are highlights of our forecast for 1985 and 1986:

* Both interest rates and money supply growth will remain stable.
* State and national rates of unemployment will continue to drop, due primarily to job creation. The national unemployment rate will decline from 7.2% in 1985 to 6.9% in 1986; Michigan's unemployment rate will drop to 10.4% in 1985 and 9.9% in 1986.
* Inflation-adjusted personal income will increase 5.1% nationally during 1985 and 3.0% in 1986. In Michigan, inflation-adjusted personal income will grow by 5.7% this year and 3.2% next.
* Auto sales will rise to 10.8 million units in 1985 but drop to 10.5 million units in 1986.
* Housing demand will remain strong, but activity will shift from basic no-frills houses to more luxurious single-family homes. Housing starts will decline modestly in both 1985 and 1986, reaching 1.65 million units this year and only 1.60 million units next year.
* Consumer prices will display continued restraint, rising nationally by 3.5% in 1985 and 4.0% in 1986. The Detroit Consumer Price Index will grow by 3.0% in this year but increase by 3.8% in 1986.

SUMMARY OF MAJOR ECONOMIC FACTORS

Factor	Projected 1984	Actual 1984	Projected 1985	Projected 1986
U.S. Auto Sales (millions)	10.4	10.4	10.8	10.5
U.S. Housing Starts (millions)	1.80	1.75	1.65	1.60
Inflation — U.S. CPI (%)	4.0	4.1	3.5	4.0
Unemployment — U.S. (%)	7.6	7.8	7.2	6.9
Personal Income — U.S. (%)	5.6	5.3	5.1	3.0
Inflation — Detroit CPI (%)	3.6	3.5	3.0	3.8
Unemployment — Michigan (%)	11.2	11.6	10.4	9.9
Personal Income — Michigan (%)	5.6	6.7	5.7	3.2

Leading Economic Indicators

Designed to predict the course of the economy over the next 12 to 18 months, the monthly Index of Leading Economic Indicators is a composite of twelve measures of the economy. As is typical of this advanced stage of the business cycle, the index since August 1984 has vascillated between positive and negative changes. As a rule, three successive declines in the index signal the possible onset of a recession within the next year or so. A series of consecutive increases in the index suggest the onset of a period of strong economic growth, while a mixture of increases and decreases indicate that business activity is in the process of stabilizing.

In January, the index of leading indicators rose by 1.7% after falling by 0.5% in December and rising 0.5% in November. The January increase was the largest monthly increase in the index since March 1983, and more than compensated for declines chalked up during the second half of 1984. Eight of the eleven available indicators contributed to the January advance: orders for consumer goods, stock prices, the money supply, business and consumer borrowing, business formation, building permits, delays in vendor deliveries, and declines in new claims for unemployment benefits. Components that reduced the overall gain in the index included declines in orders for plant and equipment, producer prices, and the length of the average work week. The twelfth factor, corporate profits, is not available until several weeks after the other eleven indicators.

Most of these factors are related to the goods-producing sector of the economy, but the service sector now employs 75% of the nonfarm work force. It may consequently be misleading to focus so narrowly on factors measuring manufacturing activity. Given the rising proportion of the goods markets that has been captured by imports, fluctuations in the leading indicator index may provide a misleading impression of the strength of business activity. However, lacking a better measure, this index continues to serve as the most viable gauge of economic vitality.

Unless the advance in the index is sharply revised downward when additional information becomes available, the January increase suggests that the economy is regaining momentum following a slowdown in the fourth quarter of 1984. The pattern of changes in the index over the past several months indicates the economy should continue to expand throughout all of 1985 and well into 1986.

Interest Rates

Most of the decline in interest rates during this business cycle has already occurred. Despite some weakness in the economy in the second half of 1984, figures for 1985 indicate that the economy is growing at a reasonable, steady rate and does not require the additional stimulus of either a decline in interest rates or an increase in the money supply. Interest rates are likely to remain virtually unchanged through 1986.

There are a variety of factors working to keep interest rates where they are. If interest rates were to fall, business and consumer demand for loans would increase, depleting an already small pool of funds available to borrowers. At the same time, lower rates would make U.S. financial instruments less attractive, prompting investors to seek other options that provide greater monetary rewards. If investment funds were shifted into other assets or invested outside the United States, the number of dollars available to domestic borrowers would be further reduced. If credit supplies were to become insufficient to accommodate loan demand, interest rates would rise again, rationing the scarce credit resources among those able to produce the greatest economic gain from use of the funds. Any decline in interest rates would therefore be temporary.

Conversely, if interest rates were to rise appreciably, economic growth would be choked off. The dollar would acquire an even higher rate of currency exchange, encouraging greater quantities of imported goods to enter the U.S. market. With comparatively low rates of inflation, consumers would have no incentive to avoid future price increases by accelerating their purchases. If they were to borrow to buy, they would incur high interest charges. Without this incentive to beat price increases, higher interest rates would discourage purchases, and consumer expenditures would decline. With softer consumer demand and a greater proportion of that demand being met by foreign goods, U.S. manufacturers would incur excess manufacturing capacity and have little reason to borrow to expand output or upgrade facilities.

Moreover, a number of U.S. banks have major dollar-denominated loans to developing third-world countries. As interest rates and the value of the dollar rise, the cost to these third-world countries of merely paying the interest on their debt rises. If protectionist measures were imposed on the U.S. market to prevent foreign nations from capturing a larger share of the market and displacing U.S. goods, these nations would be left with few remaining alternatives to acquire the dollars needed to stay current on their debt. They would have little choice but to default. Since U.S. banks have insufficient reserves to cover huge foreign debts, a massive default could jeopardize the entire U.S. banking system, causing commerce to grind to a halt.

The most obvious way of avoiding either of the two horns of the dilemma -- overstimulating the economy by artificially slashing interest rates or curtailing economic growth by allowing interest rates to skyrocket -- is to reduce the federal deficit and, consequently, the federal government's demand for credit. If funds available for lending could be channeled from servicing the national debt to supporting business and consumer activities, interest rates could fall while still maintaining a balance between credit demand and supply. If interest rates then fell to reflect reduced demand for credit, the exchange value of the dollar would decline, effectively increasing the price of foreign goods on the U.S. market and enabling domestic manufacturers to recapture some of their lost market share.

This prospect, however, is contingent on the federal government's ability to slash its budget deficit. Some progress has been made; social security benefits and defense spending have finally become grist for discussions on deficit reduction. The economic projections that follow assume that Congress will meet its target of bringing the 1986 federal budget deficit in at $50 billion under the projected 1985 deficit.

Unemployment

Unemployment rates have dropped significantly over the past year. Nationally, the unemployment rate for February 1985 stood at 7.2% compared to 7.7% in February 1984. Michigan's unemployment rate in February 1985 was 9.2% compared to 11.4% only 12 months earlier. For the entire year, unemployment nationally averaged 7.8%; for Michigan, the corresponding rate was 11.6%.

As noted in the last forecast, a major share of the gains in employment has come in the service industries. Service jobs account for about 75% of all nonfarm employment but have provided more than 80% of the job growth during the past year. Improvements in manufacturing employment have been somewhat uneven. The strong dollar has encouraged the flow of imported goods into the United States, and price-conscious consumers are buying a wide range of high quality, comparatively inexpensive foreign-made goods instead of similar U.S.-manufactured goods. Consequently, while consumer confidence remains high and retail sales fairly brisk, this has not translated into corresponding gains for manufacturing sales or employment. In February alone, nationwide employment in manufacturing fell by 82,000. Employment patterns in Michigan have mirrored those of the nation.

To achieve a reduction in the rate of unemployment, the economy must generate enough new jobs to keep pace with the number of new workers entering the labor force as well as to accommodate those who are out of work. During the early stages of recovery from the 1980-82 recession, many unemployed workers were called back to work, causing relatively large and quick declines in the state and national unemployment rates. Most of the laid-off workers who will be recalled already have been recalled, however, making further declines in the unemployment rate depend on the number of new jobs generated by a growing economy.

Demographic factors favor creation of additional employment in the service sector. As household income rises and more women become employed full time outside the home, service industry employment will show sustained growth. Counteracting this growth will be continued weakness in manufacturing employment. The strong dollar and associated high level of demand for imported goods will constrain employment gains in manufacturing industries.

For these reasons, unemployment rates will not decline as much or as quickly as they did in 1983 and 1984. For Michigan, the unemployment rate will average 10.4% in 1985 and 9.9% in 1986. The U.S. unemployment rate will drop to 7.2% from 7.8% in 1984, then dip to about 6.9% in 1986.

Personal Income

Personal income is income from all sources and is measured after deduction of personal contributions to social security, but before withholding of income taxes and other personal taxes. Personal income during 1984 increased by 9.6%. After adjustment for inflation, this amounted to a net increase of 5.3%. By far the largest share of this increase was attributable to gains in wage and salary income, and reflected improvement nationwide in employment levels. The component of wage and salary income showing the highest rate of growth was wages from service industries; this reflected the dramatic employment gains made in service industries throughout all of 1984.

Growth in personal income in Michigan was even more dramatic than for the nation as a whole. Inflation-adjusted personal income rose by 6.7% in Michigan during 1984, more than one percentage point higher than the national growth rate. This higher Michigan rate was due to substantial improvements in employment levels and to subsequent growth in wage income, largely in the manufacturing and service industries.

With employment expected to grow in Michigan and nationally in 1985 and 1986, personal income will show continued gains, although at somewhat lower rates of increase. For the United States, inflation-adjusted personal income will expand by 5.1% in 1985 before tapering off to 3.0% in 1986, while personal income in Michigan will grow by 5.7% in 1985 and 3.2% in 1986.

Auto Sales

Auto sales in 1984 reached 10.4 million units, the highest level since 1979. Removal in April of the voluntary restraint agreement on auto imports with Japan is likely to have minimal impact on total U.S. auto sales in either 1985 or 1986. Total domestic and imported auto sales will rise to approximately 10.8 million units in 1985 before a slowing economy pushes the sales level back down to 10.5 million units in 1986.

Although the United Auto Workers, Ford Motor Company, and Chrysler Corporation argued against removal of the import restrictions, strong sales levels and record-breaking profits by the U.S. auto industry eliminated justification for continuation of the restraint agreement. Under the restrictions, U.S. sales of Japanese-manufactured autos were artificially capped, enabling auto dealers to raise prices on available units and increasing the profit per unit at the expense of the American consumer. It also allowed U.S. manufacturers to charge higher prices for their cars, comparable in size and features with the Japanese models, because the price competition that would normally prevail in a free and open market had essentially been eliminated.

Elimination of the import restrictions is unlikely to have any immediate effect on U.S. auto sales. First, most Japanese auto plants are running at or near capacity and cannot increase production by any significant amount. Nor do the Japanese have an incentive to do so. Should the supply of Japanese-made autos available in the United States increase substantially, demand could not expand rapidly enough to absorb them, creating excess inventory. This would reduce the per unit profit on each auto sold in the United States.

Second, given the strong protectionist tendencies of major auto-manufacturing states such as Michigan, a large increase in the number and sales of Japanese vehicles in the United States would undoubtedly draw the ire of Congress and lead to charges of unfair competition and of stealing jobs away from American auto workers. This rhetoric might lead to more stringent, formal controls of Japanese auto imports, shutting off a significant share of Japan's market and denying it access to the profits from current sales in the United States. This is undoubtedly a situation Japan would prefer to avoid.

Ironically, most of the increase in Japanese imports is likely to come from General Motors and Chrysler, both of which are attempting to increase the number of vehicles obtained from their Japanese affiliates. If GM obtains all the Isuzus and Chrysler all the Mitsubishis they have requested, auto imports from Japan will increase by 19% above 1984 levels even without allowing for increased shipments from other Japanese makers. The Japanese government would have a difficult time forcing restraint on other auto manufacturers while allowing Isuzu and Mitsubishi to capture a larger market share.

Over the course of five years or more, expiration of the import restrictions will probably benefit the U.S. auto industry. As increased competition from imports forces domestic prices down, industry wages will stabilize, reducing the pressure for development of more capital-intensive manufacturing processes or relocation of assembly plants to other nations. This would safeguard rather than devastate industry employment levels in the United States. Lower prices will also increase auto sales, benefiting both consumers and manufacturers.

Finally, elimination of the import restrictions should make the domestic auto manufacturing industry less susceptible to the swings of the business cycle. When imports were artificially restricted, demand for foreign cars outstripped supply. Consequently, when the economy softened and demand dropped, supply and demand for foreign cars was realigned. Foreign manufacturers were still able to sell their full quota of autos in the U.S. market, leaving the decline in demand to be borne almost entirely by the domestic industry. As the market opens up and foreign manufacturers have to contend with the same market demand forces as domestic auto manufacturers, subsequent declines in auto demand will be more equally distributed over both domestic and foreign manufacturers, reducing the wild swings in production and employment, sales and profits of U.S. auto makers.

Housing Starts

Last year was a good year for housing construction. Housing starts across the United States reached 1.75 million units in 1984, up from 1.70 million in 1983 and 1.06 million in 1982. While an expanding economy was the major factor in generating the construction level attained in 1983, declining mortgage rates and renewed activity in apartment construction accounted for the 1984 improvement.

Prospects for housing construction are good for 1985 and 1986 although the level of activity will not be as high as it was last year. As mortgage rates have stabilized, there is little advantage for prospective homebuyers to delay construction and purchase in anticipation of even more favorable loan rates. In addition, much of the immediate demand for housing for first-time baby boom homeowners has been met. Most of the recent construction activity has focused on apartment construction and more luxurious single-family homes instead of the basic, no-frills models favored by first-time homeowners.

Consequently, although the dollar value of new construction is likely to rise during 1985 and 1986, the number of housing units represented by these outlays is expected to decline somewhat. For all of 1985, housing starts will reach about 1.65 million units, tapering off to about 1.60 million units in 1986.

Consumer Prices

Consumer prices remained moderate in 1984, registering an increase of only 4.1%. The outlook for price restraint in 1985 and 1986 continues to be excellent. A world oil glut has reduced OPEC's stranglehold on energy prices forcing petroleum prices down. These savings have been passed on to consumers directly through price cuts in gasoline and heating fuel and indirectly through transportation costs for goods.

Comparatively high interest rates, a strong U.S. dollar, and favorable currency rates have reduced the dollar price for imported goods, sparking price competition between U.S. and foreign manufacturers of goods. Even with a growing U.S. economy, this competition will restrict the ability of retailers to mark up prices without sacrificing market shares to imports, ensuring that consumer prices for a wide variety of both durable and soft goods will remain relatively unchanged over the next 15 to 18 months.

In addition, producer prices have shown virtually no change since April 1984. For all of 1984, producer prices rose a mere 1.8%. Since price increases for producer goods such as steel and aluminum, electricity, and business equipment precede price increases for consumer goods that use these processed materials, this flatness in producer prices suggests that the cost of these materials will not soon contribute to major increases in consumer prices. Prices as measured by the U.S. Consumer Price Index will rise by only 3.5% in 1985 and 4.0% in 1986; the Detroit Consumer Price Index will rise by 3.0% and 3.8% for the same periods.

Summary

The Michigan and national economies will continue to expand throughout 1985 and 1986, although at more modest rates of increase than in 1984. National and international financial concerns will prevent significant changes in either interest rates or the money supply, leaving U.S. manufacturers of goods vulnerable to intense competition from foreign suppliers of goods. This competition will constrain hiring in the manufacturing sector, but a growing economy will provide a number of new jobs in other industries, particularly in the service sector.

An improvement in employment coupled with modest rates of inflation will boost personal income, providing the means in 1985 to acquire 10.8 million new cars and build 1.65 million new housing units. Prospects for 1986 are similar, although an unresolved federal budget deficit and rapidly expanding trade gap pose a threat to the duration of this period of economic expansion.