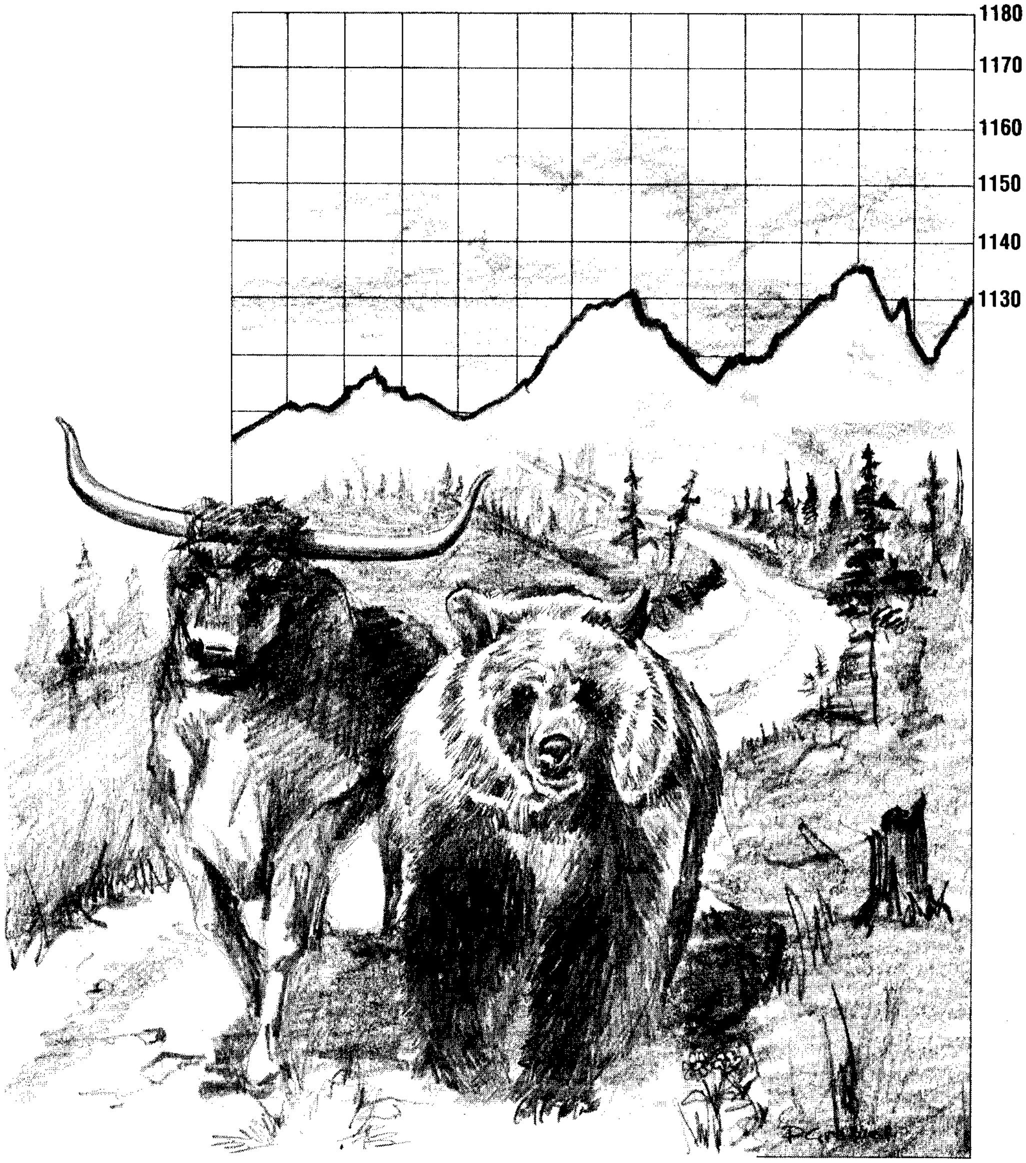
Second Quarterly Economic Forecast

April 1984



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- Monthly newsletters which treat topics of special interest and fiscal importance such as school aid funding, transportation, and funding of state-managed public employee retirement systems. On a quarterly basis the newsletter assesses the condition of the state's budget, including a discussion of the strengths and weaknesses of the governor's proposed budget and the one subsequently enacted by the legislature. Significant line-item vetoes are discussed and evaluated.

- Quarterly economic forecasts for Michigan and the U.S.

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- As a service to our subscribers, a tape cassette of the monthly newsletter, quarterly economic forecasts, and monographs will be supplied on request in addition to the printed copy. Busy readers will have the opportunity to listen to FAS information at their convenience on the road, in their homes, or at the office.

The Outlook in Brief

The economy has started the transition from recovery to sustained growth. Last year, consumers paved the way for rapid economic growth by increasing their outlays on autos, housing, and other durable goods faster than they increased their incomes. As businesses worked down their inventories and started gearing up to provide more goods and services, the economy spurted ahead. Business spending on inventory rebuilding and acquisition of new plant and equipment is now starting to assume a more important role in economic activity just as consumers are finally reining in their purchases reducing spending to match increases in their incomes. We look for continued economic growth extending through 1984 and early into 1985.

* Heavy credit demand from all sectors of the economy will nudge interest rates up by another 1.0 to 1.5 percentage points before year-end.

* Unemployment nationwide will decline to an average rate of 7.8% this year and fall to 7.6% next year. Michigan's unemployment rate will drop to an average of 10.7% during 1984 and decline to approximately 9.5% in 1985.

* Auto sales will show improvement in calendar year 1984, rising to 10.2 million units in 1984 and 10.7 million units in 1985.

* Strong housing demand will stimulate 1.8 million housing starts nationwide this year and taper off modestly in 1985, leading to 1.7 million housing starts then.

* Led by continued gains in employment, personal income in Michigan will increase by an inflation-adjusted 5% this year and by 4.5% in 1985.

* Consumer prices will remain moderate this year, averaging only a 4.9% increase, but underlying pressures will edge inflation in consumer prices up by 5.6% during 1985.

Index of Leading Economic Indicators

The index of leading economic indicators provides a rough gauge of future economic growth. Increases in the index suggest the economy will continue to grow for at least the next year or so, while continued decreases in the index generally indicate the economy is experiencing weakness and could fall back into a recession. Recently released figures showed the economy made strong gains during the month of February and indicated that the economy should continue to grow at least through the first half of 1985.

According to the index, consumer demand remained strong in February. Businesses started rebuilding inventories and investment spending increased. Economic performance is continuing to outpace the projections of most major forecasting firms. Of the ten available indicators, five showed improvement: the average number of claims for unemployment insurance declined, new building permits increased, more new businesses were started, the money supply grew, and vendor deliveries slowed, indicating that vendors were unable to keep up with the brisk rate of orders. One indicator, length of the average work-week, remained unchanged. Four indicators registered a decline: new orders for consumer goods and materials, new orders for plant and equipment, stock prices, and prices of raw materials.

$ $ $ $ $ Interest Rates

The path of interest rates remains crucial to the strength and duration of continued economic growth. As the recovery has matured and consumer spending increases have started to taper off, businesses have assumed a more important role in stimulating economic growth and product demand. Higher business profits initially provided firms with sufficient funds to self-finance equipment purchases and construction plans. However, these resources have been spent, and businesses are now starting to turn to the credit markets to finance inventory rebuilding and capital outlay programs. With consumers still very active in the credit markets and the federal government requiring massive quantities of funds to finance its deficit, credit demand from all sectors of the economy has been intensifying.

Interest rates are now starting to rise. On March 19, major banks increased the prime rate (the interest rate charged to their best corporate credit customers) to 11.5% from 11.0%. This was followed on April 5 with a second hike in the prime rate, to 12.0%, and brought the prime rate to its highest level since November 1982. Other rates have also drifted up in response to this increase. On April 6, the Federal Reserve Board (Fed) increased its discount rate, the fee it charges on loans to banks and savings institutions, by ½ point to 9%. Interest charges on auto loans and home mortgages have since edged upward.

Interest rates have been receiving mixed reviews. Early in the recovery many policymakers and economists were warning that high interest rates would make for an anemic recovery. These dire warnings were dismissed when the economy expanded at an extremely rapid rate, but now that interest rates are starting to rise again, these same groups are warning about high interest rates derailing the recovery.

This charge recently has been countered by other experts who have claimed that high interest rates and a low inflation level are precisely the reason the economy was able to stage such a strong recovery: the high real (inflation-adjusted) rate of return in the U.S. financial markets attracted foreign investment and provided a large pool of funds available for loans. This permitted the credit markets to accommodate the credit demands of consumers, businesses, and the federal government without driving the cost of credit to prohibitively high levels. With inflation starting to increase, the rate of return to foreign investors is declining. These authorities argue that unless interest rates start to rise, thereby offsetting the effects of inflation, foreign investors will withdraw their funds from the U.S. credit markets, sharply reducing the supply of funds available for credit purchases. Unless demand also falls sharply, competition for loans would force up credit prices, which in turn would ration credit. Since most consumers and businesses could not afford the higher financing costs imposed by rising interest rates, purchase activity would plunge, throwing the U.S. economy back into a profound recession. Hence, while some authorities are arguing that high interest rates will kill the recovery, others are arguing that high rates are a prerequisite for continued economic expansion.

Both positions contain a kernel of truth. If demand for credit outstrips the supply, interest rates, which are the price of credit, will rise. In a free and open market, funds will flow to whatever area or activity provides the highest rate of return. However, the rate of return is a relative concept. If the inflation-adjusted rate of return on investment in the United States is currently 8% and it declines to 6%, there will still be no flight from the U.S. financial market if that 6% is at least as good as that available in other financial markets. Moreover, the massive flight-of-funds argument implicitly assumes that foreign investment in the United States is comprised of easily transferable [paper] assets. However, foreign deposits provide only about 8% of all direct and indirect sources of funds to the U.S. credit markets, a level well below the 12% share of 1977-80.

This does not mean that foreign investment has no influence on the U.S. credit market and interest rates, merely that it is not the most urgent factor in the determination of interest rate levels. Of far greater immediate concern is the potential for a credit crunch. If the federal government continues to absorb an ever larger share of available credit funds, businesses and consumers will have to reduce their credit demands and/or confront higher interest rates. Since much of current economic activity depends on ready availability of credit, either of these approaches could slow or curtail future economic growth.

A credit crunch is a very real possibility for 1985. For the remainder of this year, however, we expect monetary growth to remain within Fed guidelines. Interest rates will gradually creep up, with the prime rate reaching 13.0% to 13.5% by year-end, but interest rates will not demonstrate the extreme volatility shown in 1980 and 1981.

Personal Income

Personal income consists of income from wage and salary employment, rental income, interest and dividend earnings, government transfer payments from programs such as Social Security, unemployment compensation and AFDC, and proprietor's income. Personal income has grown strongly during this period of economic expansion, primarily because of gains in employment and, hence, in wage and salary income. Wages have accounted for almost half of the total increase in personal income, with dividend and interest earnings contributing another 10% to 15% share of gains in personal income.

During all of 1983, personal income grew at an average monthly rate of 9.5%. Led mostly by increases in wage and salary earnings, personal income grew at an unusually strong rate of 1.5% in January and by a robust 0.7% rate in February. Since personal income provides the means for consumer spending, these large increases indicate that consumer spending is likely to remain strong throughout 1984. In combination with continued moderation in price inflation, this vigorous growth in personal income is expected to contribute to a 5% increase in inflation-adjusted personal income in Michigan during 1984 and a 4.5% increase in 1985.

Inflation

Consumer prices, as measured by the U.S. consumer price index (CPI), are 4.6% above the level of 12 months ago. Consumer prices rose 0.4% during February, following a 0.6% increase in January. The Detroit CPI, which measures changes in prices in Michigan, showed a larger increase than the national index. Detroit prices were up by 0.5% in February.

Food prices continued to account for a major share of the increase in the price index, reflecting the impact of the severe weather conditions of last year. Household energy costs also rose in February, while clothing prices declined slightly and transportation costs remained unchanged. However, in a break from the relatively modest increases of last year, medical care prices have started to accelerate again.

Consumer and producer prices have shown few immediate signs of regaining their double-digit rates of increase, but there are some signs of underlying price pressure. The prices of raw materials are quite sensitive to increases or reductions in demand, and they are starting to rise more rapidly now than in 1983. Since these raw materials are used in a variety of manufactured goods, increases in the prices of raw materials will begin to be reflected in the prices of finished goods later this year.

Factories are also starting to operate at over 80% of manufacturing capacity. This is a threshold beyond which prices start to rise and some shortages begin to occur. Finally, a few major labor contracts, most notably for the auto industry, will be opened for negotiation this fall. A major increase in contract costs would not significantly affect the price level this year, but it could build a higher floor under the price level for 1985. We look for consumer prices to increase nationally by approximately 4.9% in 1984 and by 5.6% in 1985.

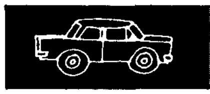
Unemployment

The unemployment rate continues to decline, but is dropping more slowly than it did in the early stages of the recovery. The U.S. unemployment rate was 7.7% in March. Employment gains were offset by an increase in the number of job-seekers. Michigan's unemployment rate of 11.3% in March still exceeded that of the other nine major industrial states. It nonetheless registered a slight improvement over the 11.4% rate of February and was markedly better than the 15.7% unemployment rate of March 1983. Despite the fact that approximately 4,000 more persons sought employment in March than in February, an even greater number obtained employment, thereby causing the unemployment rate to decline. The number of people actually employed rose to 3.9 million, up from 3.8 million in February. As at the national level, most of the employment gains were scored in the retail and service industries.

Different groups have interpreted this employment information differently. Some politicians, nervously mounting reelection campaigns for November, are fearful that the flattening out of employment levels and unemployment reductions portend an impending return to economic recession. The financial markets, on the other hand, greeted the news with some relief; their fear has been that the economy improved too much too soon and that the recovery would soon self-extinguish. A slowing of employment gains would suggest that economic growth was moderating to a more sustainable level of increase. Thus, while both camps agree that employment gains are slowing, they hold radically different views as to the likely impact of that slowdown on the state and U.S. economies.

Much of the slowdown in the rate of decline of unemployment is not directly related to the strength or weakness of the economy per se. During the initial stages of the recovery, the unemployment rate declined quickly because the size of the labor force remained approximately the same. Unemployed workers who had despaired of finding a job did not renew their job search efforts and, hence, were excluded from the unemployment and labor force statistics. New entrants to the labor market were almost balanced out exactly by unemployed workers dropping out of the labor market. With the size of the labor force unchanged, any increases in employment were directly reflected in the unemployment statistics and contributed to large declines in the unemployment rate.

As the economy has shown renewed strength and vigor, many of the discouraged unemployed are now starting to reenter the labor force. Even though employment gains are remaining fairly stable, the unemployment rate is not showing a corresponding reduction. The labor force is larger so that new employment represents a smaller share of the total pool of available labor. Consequently, while the unemployment rate has fallen more sharply than expected over the past six months, unemployment rates will stabilize over the next few months as the labor force continues to grow. Unemployment nationwide will average about 7.8% in 1984 and fall to 7.6% in 1985. Michigan's unemployment rate will drop to 10.7% during 1984 and decline to approximately 9.5% in 1985.



Auto Sales

The auto industry has continued to chalk up impressive sales gains. During the first quarter of 1984, domestic automobile sales surged to 1.995 million units, their highest level in four years and a 36.9% increase over the sales levels achieved during the first quarter of 1983. March sales were up 26% from last year, marking the best sales level for a March since 1979.

Import sales barely managed to keep pace with first quarter sales levels of 1983. This was largely attributable to import restraints on Japanese motor vehicles. March import sales were down 5.8% from 1983. Their share of the U.S. market declined to 21.5%, down sharply from their 26.9% share of a year ago.

At current sales rates, 1984 auto sales would reach approximately 10.3 million units, their best level since 1979. However, the first quarter of the year is typically the strongest sales period. If demand remained as strong as in the first quarter, manufacturers would still have difficulty increasing production over current levels. Most plants are operating at or near capacity: plants operating well below full capacity are those which manufacturer slower-selling compact and subcompact vehicles. Because of import restrictions, foreign auto manufacturers also are unable to take full advantage of this up-surge in auto buying. Consequently, while auto sales are running stronger than initially expected, sales levels are likely to be constrained to approximately 10.2 million units this year and 10.7 million units next.

Housing Starts

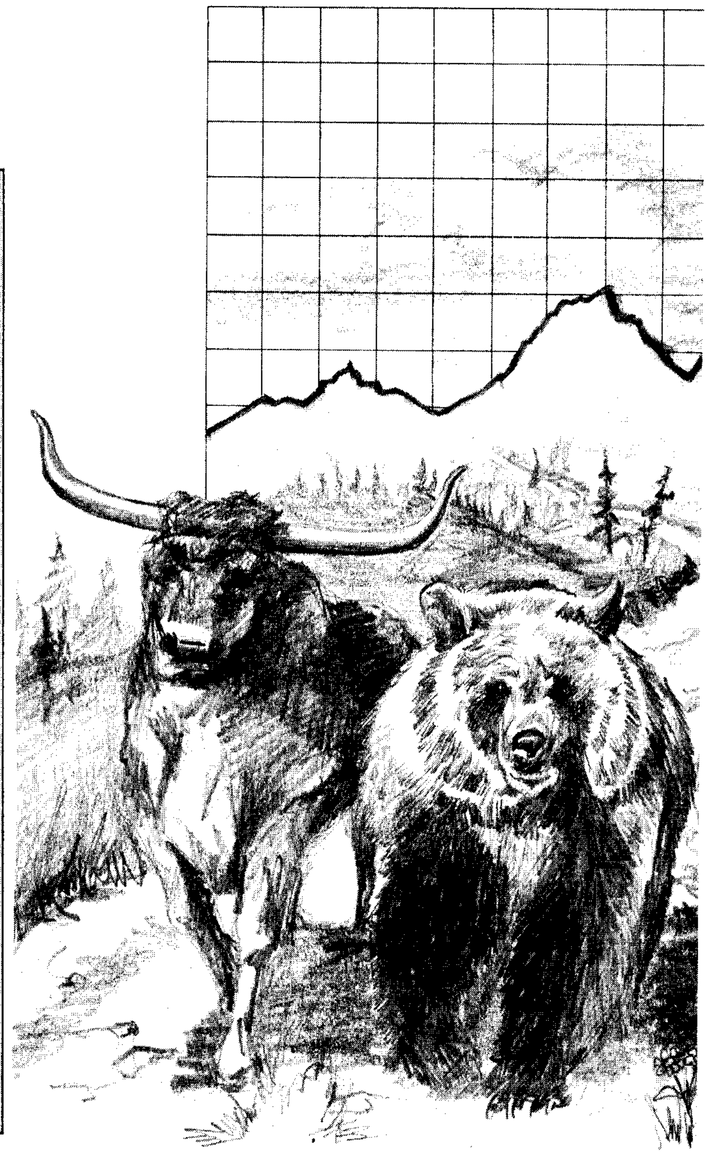
Even though mortgage rates have hovered around 13.5-14.0%, 1984 housing starts and housing sales have remained extremely strong. Housing starts in February surged to an annualized construction rate of 2.2 million units and was the highest level since the 1978 building boom. Housing starts jumped 11.2% in February and followed an increase of 16.7% in January. Apartment construction accounted for a major share of the building activity; private residential housing starts increased only 4.1% from January.

Warmer weather stimulated a portion of these housing starts. Some sections of the country experienced spring weather in February, permitting developers and contractors to start foundation work earlier than usual. Because housing starts and construction activity are seasonally adjusted, the unseasonably warm weather in February distorted the figures on construction activity.

There are also some indications that the strong increases in housing starts and sales have been prompted by recent increases in mortgage and interest rates. Consumers are acting now to lock in the lowest available rates and avoid the financial burden that would be imposed if they secure mortgages at a higher rate later this year. Strength in current housing starts and sales may consequently be coming at the expense of residential construction later this year. Even so, 1984 promises to be a better year for housing construction than the past four or five years have been. We anticipate housing starts nationwide will reach 1.8 million units during 1984 and 1.7 million units in 1985.

Summary

Judging from the available data, the U.S. economy has lost none of the momentum it built up in the final quarter of 1983. Housing starts and auto sales are at their highest levels in five years. Employment and personal income have shown unexpectedly strong gains, inflation is still quite low, and interest rates, although rising, show none of the volatility that marked the economy's slide into recession in 1980. Economic growth will slow during this second quarter, but we still expect strong and steady advances throughout all of 1984. Fears about the federal budget deficit and rising interest rates notwithstanding, there is little reason to believe these factors will pose a serious threat to sustained economic expansion before mid-1985.



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