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ECONOMIC FORECAST 1983

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Economic Overview

The economic recovery which started late last year has gradually spread from housing and auto sales to other sectors of the economy. Gains in employment and more moderate rates of inflation will provide consumers with the financial means to demonstrate their growing confidence in the economy. Although the previous two federal income tax rate reductions had a negligible effect on the economy in 1981 and 1982, the third cut slated for July 1983 should provide the economic impetus the other two lacked. Consumers show more optimism about economic prospects than they have in over six years. With consumers less apprehensive about continued employment prospects, most of this third income tax reduction will be spent rather than saved, thereby reinforcing the higher activity levels the economy has displayed over the past seven months. We look for continued economic growth extending through 1984.

* Interest rates will continue to moderate, although heavy federal borrowing demands will prevent major reductions in short- and long-term interest rates.

* Auto sales will show improvement in calendar 1983, rising to 8.9 million units. Auto sales in 1984 will increase to 9.9 million units.

* Lower mortgage rates will stimulate housing starts to 1.7 million units nationwide this year.

* Pulled down by lower energy prices, the Consumer Price Index will register increases of 4.6% in 1983 and 5.5% in 1984.

* Unemployment nationwide will average 9.7% in 1983 and 8.8% in 1984. Michigan's unemployment rate will average 14.6% this year and decline to 12.8% in 1984.

* Inflation-adjusted personal income will increase by 2% in 1983 and 3% in 1984.

Economic Indicators

The economic recovery is now seven months old and shows every sign of accelerating. Gains have been registered in virtually every sector of the economy, from retail sales, housing starts, and auto production to employment, personal income, corporate profits, and interest rates. While the economy was already flashing distress signals six months into the 1981 recovery, increased consumer confidence, combined with lower inflation and significant gains in personal income, has provided the means necessary for sustaining the current recovery.

The most recent report on the government's index of leading economic indicators showed that the index had advanced 1.1% in April following increases of 1.5% in March and 1.4% in February. It was the tenth consecutive monthly increase in the index, and provided evidence that the economy is gaining solidly and will continue to improve over the next twelve to eighteen months.

Components contributing to the increase were the duration of the average workweek, a decline in the number of new claims for unemployment benefits, slower deliveries, increases in contracts and orders for plant and equipment, advances in the stock market, increases in the amount of credit outstanding, more rapid depletion of inventories, higher producer prices, and more orders for consumer goods and materials. During the first quarter of previous recoveries, the index of leading economic indicators increased by an average of 4.7 percentage points. During the first quarter of this recovery (December 1982 to February 1983), it gained 6.2 percentage points.

Other signs of economic strength have reinforced this impression of increasing economic strength. Manufacturing capacity utilization increased from 69.8% in March to 71.1% in April. This compares favorably with the postwar low of 67.6% recorded in the fourth quarter of 1982. Personal income grew 0.8% in April, the largest increase since July 1982. Almost all of the increase was attributable to gains in wage and salary employment. Nonfarm industries provided 258,000 more jobs in April than in March. Additional employment gains were achieved in May. Construction, manufacturing, and services comprised the largest share of the employment increase. Most of the manufacturing employment gains were concentrated in autos, housing, and electrical equipment in response to increased consumer demand in those areas. The workweek also increased from 35.0 hours in April to 35.2 hours in May.

These factors should lead to yet another increase in the index of leading indicators for May. Since this index typically signals changes in the economy sixteen to eighteen months in advance, continued increases provide reassurance that the economic recovery now underway will extend through the remainder of this year and through all of 1984.

Interest Rates

Interest rates remain an area of intense concern for government leaders, the business community, and consumers. Most of the attention has focused on anticipated annual federal budget deficits of $200 billion or more. The fear is that federal borrowing demands will absorb such a large share of the credit market that when business and consumers need to finance inventories and purchases, the supply of credit will be inadequate to meet demand. This would force up the price of credit (i.e., interest rates) in order to ration the available supply of funds among demanders. Rather than pay high interest rates, many people assume that consumers would once again curtail purchases of goods requiring financing. Yet large-ticket items such as autos, housing, furniture, and appliances generally require financing and are the very goods necessary to sustain a recovery. If consumers retrench, the economy would sink back into recession.

Interest rates are higher than they were a decade ago and will probably remain higher. New savings instruments have permanently increased the cost to banks of savings deposits. To maintain their spread between deposit costs and loan earnings, banks must charge loan rates which are higher than savings rates. However, the fear that federal borrowing will crowd out private credit demand during 1983 or 1984 by driving up interest rates ignores several relevant factors. First, as employment rises and wage and salary income increases, the pool of funds available for lending will also increase. Second, the introduction by banks of a wide variety of money market-type accounts has increased the supply of funds available for lending without stimulating new loan demand. Unless demand increases, interest rates must fall. Increased credit demand, from whatever source, would simply moderate the downward trend in interest rates that could otherwise be expected.

Third, business borrowing is likely to remain low over the next twelve to eighteen months. The recession forced a number of companies to find methods to reduce costs and increase profits on smaller volumes of business. As demand for output increases, profits will increase even faster, thereby providing firms with internal financial resources from which to pay for inventories, purchases, and capital expansion. Moreover, firms are unlikely to permit inventories to grow to the levels they attained prior to the recession, and this will reduce the amount of funds needed to finance inventories.

Fourth, due to a decrease in the velocity of money, the money supply has been able to expand rapidly without reigniting inflation. Provided the Federal Reserve Board maintains a firm grip on the money supply, funds will be available to accommodate needs without contributing to an increase in interest rates either because of renewed inflation or investor fears of renewed inflation.

Finally, major reductions in the rate of growth of inflation have eliminated much of the impetus for buying in anticipation of price increases, and this has restrained the rate of increase in demand for short-term business borrowing and for consumer installment credit. While the immediate impact of this is a slower economic recovery, the long-term implications are for a more enduring and stable rate of economic growth.

Left unchecked, continued twelve-digit federal budget deficits could derail economic growth. Over the next eighteen months, however, the probable impact will be a moderation in the rate of decline of interest rates. Short-term rates will decline by no more than one percentage point over the next year, while long-term interest rates will decline at about half that rate. Declines in interest rates will reinforce current gains in economic activity.

Auto Sales

Domestic auto sales during the first quarter of 1983 averaged a 6.0 million unit annual rate, the highest in two years. With the addition of imports, that translated into a total 1983 sales rate of 8.6 million units.

While that is hardly cause for celebration, it does indicate that the four-year decline in sales has been reversed.

Domestic car sales increased 7.0% in May over last year, although May 1982 was the strongest sales month of that year. On a seasonally adjusted basis, May sales of domestic vehicles translated into a rate of 7.28 million units. Because a large share of this sales increase was concentrated in larger, more profitable vehicles, profits of domestic auto manufacturers increased more than sales.

Automobile sales will show sustained improvement as consumer confidence continues to increase and consumers spend a larger portion of their income. During the current calendar year, total U.S. auto sales will improve modestly to 8.9 million units, while 1984 will show total auto sales of approximately 9.9 million units.

Housing Starts

Unseasonably warm weather in many parts of the country, combined with lower mortgage rates, contributed to the unusually large increase of 34% in the number of housing starts during the first quarter of this year. On a seasonally adjusted annual basis, housing starts increased to 1.69 million units from 1.26 million units in the fourth quarter of 1982. Housing starts declined 8.8% in March and 8.4% in April to a seasonally adjusted annual rate of 1.49 million. However, the number of newly issued construction permits continued to rise in April, suggesting the number of housing starts will resume their upward trend during the warmer summer months. Thus, while the factors which contributed to the giant rate of increase during the first quarter could not be sustained, housing starts nationwide should reach 1.70 million units during 1983.

Inflation

Monthly increases in the Consumer Price Index have been the smallest in over two decades. So far this year consumer prices have increased a scant 1.8%. Increases in the prices of consumer goods and services have been offset by two factors: energy prices declined and food prices remained constant. Flooding, mud slides, snowstorms, tornadoes, and other severe weather conditions this spring destroyed many crops. This will increase the price of groceries later this year. The new federal payment-in-kind program has also reduced by a third the amount of acreage farmers intend to plant this year, and this will help drive up grain prices and, indirectly, meat prices.

The recent 15% reduction in petroleum prices is unlikely to be repeated soon. The longer that oil prices remain at the current $29.50 bbl., the longer they are likely to stay there. Increased manufacturing output will increase energy demands, firming prices and helping to prevent new price cuts. Moreover, higher federal and state gasoline taxes have increased the cost to consumers, and gasoline prices will probably edge up during the heavier driving months of the summer. Consequently, the small increases in the Consumer Price Index are temporary and do not accurately reflect the underlying rate of inflation. For the year as a whole, inflation will average around 4.6% and increase to 5.5% in 1984.

Unemployment

The unemployment rate has started to recede as consumers have quickened the pace of purchases and employers have determined that the sales increases of the past several months will be sustained. To date, almost half the increases in employment have been concentrated in manufacturing industries. Service industries have accounted for 39% of employment increases, and the remainder have been spread over other sectors of the economy.

At the national level, the seasonably adjusted May unemployment rate was 10.0%, down from 10.1% in April. In Michigan, the May unemployment rate was 14.9%, unchanged from April. While more positions usually become available as the weather warms up, the overall unemployment rate is likely to fluctuate around the current level before finally showing a sustained decline toward the end of the year. Part of the reason for the fluctuation is that about 150,000 jobseekers in Michigan have despaired of employment prospects and withdrawn from the work force. As employment opportunities expand, many of these people will return to the work force seeking employment. However, because the number of job openings is expected to grow more slowly than the number of people seeking work, the unemployment rate will be pushed back up. This will help maintain the national unemployment rate at about 9.7% for the year, while Michigan's unemployment rate will average about 14.6%. Unemployment will decline further in 1984, averaging 8.8% nationwide and 12.8% in Michigan.

Personal Income

Sustained employment gains and increased dividend earnings from higher business profits will contribute to a 2% increase in inflation-adjusted personal income during 1983. As the economic expansion extends throughout 1984, personal income will rise 3%.

Summary

The economic recovery, although weak by historic measures, is showing greater strength than generally anticipated only three months ago. To date, consumers have shown a reluctance to increase spending faster than increases in personal income. Since unemployment will restrain increases in aggregate personal income, improvements in economic activity will remain slow if consumers continue their conservative spending patterns. Despite this fact, the economy will steadily improve throughout this year and next and could show surprisingly strong gains if increased optimism makes consumers less cautious in their spending plans.

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