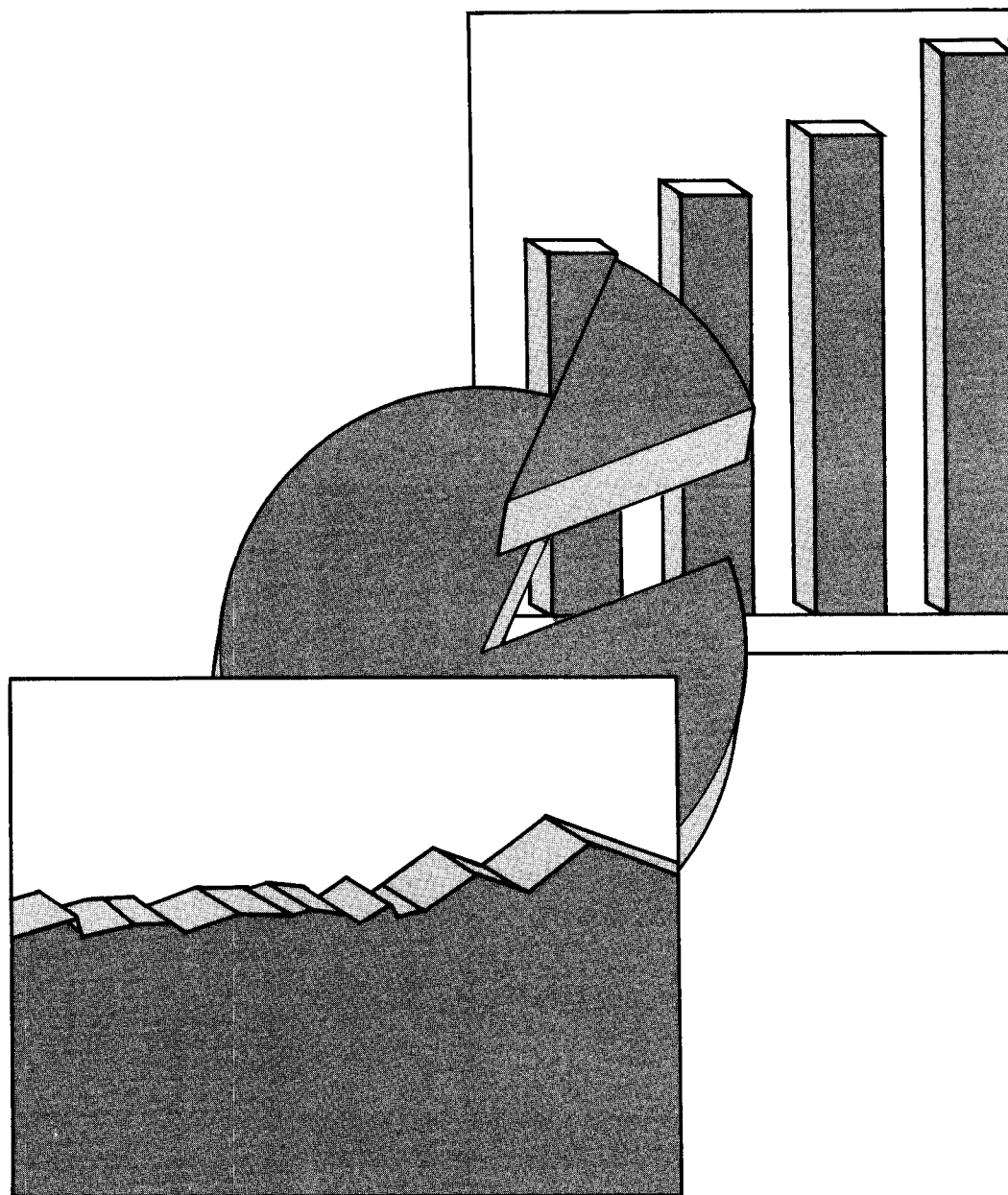


Second Quarterly

# Economic Forecast

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## National Slowdown

In 1981 a West German importer could buy an American dollar for about 2.25 Deutsche marks (DM). Now a dollar costs more than 3 DM. In other words, in Germany it costs about one-third more to buy, for instance, a box of Kellogg's cereal now than it did a few years ago. This is the case not only for Germans but also for residents of most other countries outside the United States. This also means that Americans can purchase more foreign currency per dollar, driving down the cost of imported goods as well as the expense of foreign travel.

As consumers, we live better because our dollars are worth more--but as producers we are less competitive because our goods and services are more expensive to foreigners. Imports of "cheap" foreign goods have helped suppress inflation in this country but they also erode the markets for American-made goods, making us suffer as producers.

Much of the blame for the poor showing in the nation's gross national product (GNP) during the first quarter of this year can be placed on the high-flying American dollar. It has stimulated imports from other countries and retarded exports of goods from this nation's factories, farms, and mines. Manufactur-

ing actually declined during the first three months of 1985. The other major culprit was the Internal Revenue Service. Difficulty encountered by the IRS in implementing a new system for processing tax returns delayed income tax refunds, slowing American spending growth for both domestic and imported goods and services.

GNP, which is measured in dollars, represents the sum total of goods and services produced in this country. "Real" GNP is the dollar value of GNP adjusted to remove the effects of price changes on each of the goods and services that constitute total output or production. The nation's real GNP increased at a rate of less than 1% during the first quarter of this year. The actual figure, .3% (annualized), compares with national growth of 6.8% between 1983 and 1984.

## Where Michigan Stands

Gross product figures are not available for states. The most encompassing measure of economic performance for American political subdivisions is the earnings series prepared in Washington by the Bureau of Economic Analysis. These BEA data include wages and salaries of workers, other labor income, and proprietary and partnership incomes of owners of small businesses. Fourth quarter 1984 figures are the latest available.

For Michigan, this author has made projections of BEA earnings for the first quarter of 1985 on the basis of employment and earnings data supplied by the Michigan Employment Security Commission (MESC). "Real" earnings were estimated using the price index implicit in the development of "real" GNP. During the nine quarters since the trough of the last recession (fourth quarter 1982), real earnings in Michigan have grown by nearly 12% (through the first quarter of 1985) compared with just over 10% nationally.

Figures from the MESC show that the number of Michiganians with civilian jobs increased by over 400,000, or better than 11% between the last quarter of 1982 and the first of 1985. Nationally, the Bureau of Labor Statistics data show that the number of civilian jobholders rose by less than 8% during the same period. April and May 1985 figures revealed a sharp decline from the first quarter level of employment; nationally, the number of employed edged down slightly in April and May from the March level.

## What Lies Ahead

For the nation, factory orders suggest a sluggish economy in the months immediately ahead. On the plus side, the index of leading indicators rebounded in May. Consumer sentiment remains positive, tax refunds are fueling an increase in retail sales, particularly automobiles, and the value of the U.S. dollar has declined from the spectacular level reached earlier this year. The trade deficit is unlikely to have widened appreciably during the second quarter and might even have narrowed a bit.

The nation's money supply began a rapid climb during the last quarter of 1984 and continues. This increase, in the face of sluggish loan demand from the

private sector, has pushed down interest rates. The Board of Governors of the Federal Reserve System, which deals with these matters, seems concerned about the weakness of the national economy and is prepared to continue to pump up the money supply, maintaining the downward pressure on interest rates. The impact of "cheap" money on housing demand will be favorable. Nationally, construction has been an area of strength but it has not been in the Wolverine State. Space needs are less urgent in states like Michigan that have been losing population.

GNP growth in this year's second quarter was around 3% according to the early estimates. Growth in GNP of about 4.5% is likely for the third quarter, given present money policy and assuming no sharp deterioration in the trade balance.

Inflationary pressures are inherent in the weakening dollar, which increases the price of imports and gives domestic manufacturers more room to raise prices. The Federal Reserve Board will be quick to restrict monetary expansion at signs of overheating. During the first quarter of this year, the GNP price index rose by 5.6% compared with 2.7% (annual rates) the previous quarter. Consumer price increases have been moderate in recent months.

Assuming that the Federal Reserve Board does not adopt a more restrictive policy in the near future, conditions seem right for a substantial improvement in the national economy during the last half of this year. Under this scenario, interest rates will begin to rise this summer, setting the stage for a slowdown or recession during the first half of 1986. Here it must be borne in mind that consumer debt is becoming relatively burdensome. Consumers may choose to improve their own balance sheets during 1986 and restrict spending to do so.

For the economy of Michigan, the impact of "Buick City" in Flint and GM's

new Hamtramck-Detroit assembly plant must be factored in. Buick assembly activity in Flint ceased in early February. Cars will begin to roll from one of the two assembly lines of the Hamtramck-Detroit plant in mid-summer. GM's Willow Run plant in Ypsilanti also is being converted to produce a new line of cars beginning in mid-August. As a result of our automotive strength, growth here in the third quarter will exceed the national rate, and in the fourth quarter we should be well above the national rate, assuming a favorable reception for the 1986 models.

After the fourth quarter of 1985, Michigan almost surely will start to feel the impact of increased imports of passenger cars from Japan. The extent of that impact will depend on the mix of imports. If the bulk of the increase is in the downscale, less expensive models, the impact will not be as severe as it will if the imported models compete head on with the more expensive luxurious and sporty models made here. Much of the increase will be captive imports (automobiles made outside the United States but imported by U.S. manufacturers) with U.S. nameplates (company names). It seems likely that they will be targeted toward the lower priced end of the market, as part of a long-term strategy to recapture market share.

## The High-Flying Dollar

Interest rates began to rise rapidly during 1979, as rising prices caused lenders to demand a greater inflation premium at the same time that the policy of the Board of Governors of the Federal Reserve System became more stringent. The much publicized prime rate, charged by large city banks to their best corporate customers, averaged 12.67% during 1979 compared with slightly over 9% the previous year. During 1980 the prime rate

averaged over 15% and during 1981, nearly 19%.

Attracted by the high yields on dollar-dominated financial assets, foreigners increased their purchases of U.S. currency in order to invest here. Appreciation of the dollar against the Japanese yen started in 1979. The value against most European currencies began to climb in 1980. The Economic Recovery Tax Act of 1981 provided additional impetus to the dollar appreciation in two ways. First, the act increased the profitability of conducting business in this country through reduced taxes, or--through what amounts to the same thing--increased after-tax earnings. Second, the Tax Act ultimately provided a stimulus to the economy thus increasing the rate of economic growth. Foreigners, faced with the choice of investing in businesses in their own sluggish economies or here, increasingly chose the latter course.

The Voluntary Restraint Agreement limiting imports of passenger cars from Japan, also was initiated in 1981. That agreement motivated Japanese producers to concentrate on the upscale segment of the North American market, selling higher priced, higher profit vehicles as compared with those that they had sent to carve out a share of the market during the 1970s. Some of the profits from these pricier vehicles have been invested in U.S. financial assets as well as in factories and expanded sales organizations in the United States.

Also important in the dollar's spectacular rise between 1980 and 1984 was the "safe haven" factor. The United States is regarded as more politically stable than most other countries. During a time of political turmoil, those with wealth can cut their risk of losing it either by purchasing gold or stable currency or by investing in a stable economy.

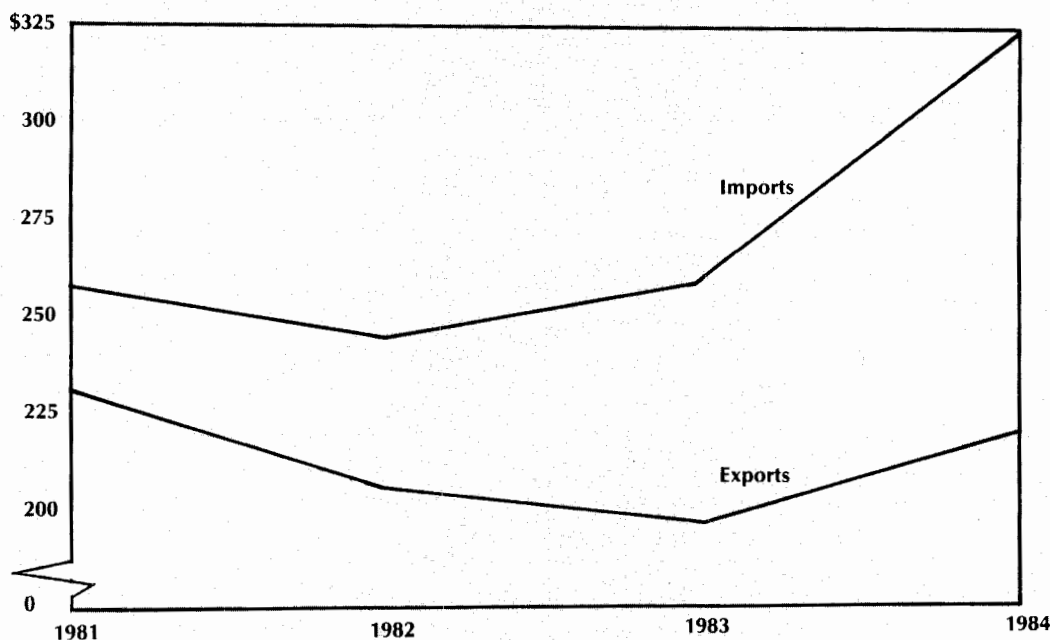
Exports of U.S. merchandise were valued at \$233 billion in 1981, the recent peak. They declined to \$199 billion in 1983 and recovered somewhat in 1984, to a level of \$219 billion. Merchandise imports stood at \$261 billion in 1981, slipped to \$245 billion in 1982, recovered to \$259 billion in 1983 and rocketed to \$326 billion last year. The trade gap, accordingly, nearly quadrupled, from \$28 billion in 1981 to \$106 billion in 1984 (Figure 1). If computed terms of "real" dollars (constant, 1972 dollars) the trade balance shifted from a positive \$11

billion in 1981 to a negative \$34 billion in 1984 (Table 1).

U.S. exports of automobiles, valued in 1972 dollars, were \$6.8 billion in 1981 and \$6.6 billion in 1984, reflecting a "real" decline of about 3%. Imports of automobiles, also valued in 1972 dollars, rose from \$10.7 billion in 1981 to \$17.6 billion in 1984, a "real" increase of over 60%. Over half of the growth in the automotive deficit occurred during 1984, largely attributable to imports of North American nameplates from Canada. That resulted partly from the depressed Cana-

**FIGURE 1**  
**U.S. EXPORTS AND IMPORTS OF**  
**MERCHANDISE: 1981-1984**

Billions of  
Current Dollars



SOURCE: Survey of Current Business, U.S. Department of Commerce, Bureau of Economic Analysis, Washington, D.C., March 1985, p. 11, and July 1984, pp. 60-61.

**TABLE 1**  
**BALANCE OF U.S. EXPORTS AND IMPORTS**  
**OF MERCHANDISE: 1981-1984**

	Exports	Imports	Balance		Exports	Imports	Balance
	(Billions of Current Dollars)				(Billions of 1972 Dollars)		
1981	\$233	\$261	— \$28		\$90.7	\$79.6	+ \$11.1
1982	209	245	— 36		81.4	79.7	+ 1.7
1983	199	259	— 60		76.7	89.1	— 12.4
1984	219	326	— 107		82.1	116.0	— 33.9

SOURCE: *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, Washington, D.C., March 1985, p. 11, and July 1984, pp. 60-61.

dian dollar vis-a-vis the U.S. dollar, but mostly from a production mix favorable to Canada. Michigan, in particular, has been affected adversely by the automotive trade deficit with Canada.

Weakness in the economy, coupled with an easy money policy by the Federal Reserve System, has produced declining interest rates in recent months. This trend is expected to continue for the short term. The foreign exchange value of the U.S. dollar already has descended from the high levels of late winter and early spring. This too is expected to continue.

A sharp decline in the dollar's

value--to 1981 levels--is not in the immediate offing, however, because a sharp turnaround in the profitability of investment in other countries is unlikely this year. Europe, in particular, still suffers from overcapacity in major industries and in many industries from an increasing technological lag behind the United States, Canada, and Japan. Also, Europeans and Canadians are eager to reduce their own interest rates as a means of economic stimulation. The interest rate gap between the United States and our trading partners will not diminish appreciably. Consequently, the trade deficit promises to handicap growth in goods production in this country for the foreseeable future.



## Fiscal Policy

President Reagan's tax reforms would shift some of the tax burden from households to the business sector by, among other things, abolishing business investment incentives. The incentives have favored durable goods manufacturers and have worked to the advantage of states like Michigan, home to heavy industry. The cash flow engendered by these incentives has made it easier to finance projects in this state such as GM's Buick City, Chrysler's Dodge City, and Ford's Rouge Steel renovations. These state-of-the-art plants keep Michigan in the competition.

It seems doubtful that Congress will follow the President's recommendations to kill the investment tax credit and accelerated depreciation. Too much is at stake in the Midwest where massive capital infusions still are required to retool and develop competitive new products for the marketplace.

Reduced rates of taxation on both consumers and businesses will stimulate business activity provided Congress and the Administration find avenues for closing the federal budget deficit in the years ahead. If the effect of tax changes this year is merely to increase the size of the deficit between federal expenditures and revenues, then the end result will be a return to high interest rates. The recommendation to repeal the federal deduction for state and local taxes has serious implications for state and local finance but does not seem materially significant in the short-term economic outlook for this state and the nation.

A Presidential recommendation for higher gasoline and diesel fuel taxes would have furthered this nation's quest for "energy independence," that now-forgotten goal fostered by OPEC's price

initiatives in 1979. Higher prices, through taxes, would tend to encourage conservation of energy and would give American more control over the price of motor fuel in future energy crises.

## The Automotive Scene

The Oldsmobile and Fisher Body factories in Lansing were idle during much of 1984 for conversion to production of a new front-wheel drive GM car. As a result, Michigan's share of U.S. vehicle production dropped below 30% for the first time since 1980. This year, rear-drive passenger car production ceased in Flint to make way for Buick City. In Ypsilanti, Willow Run Assembly, last home of the ill-fated X-car, is down for conversion.

Meanwhile, the new Orion Township plant north of Pontiac is in full production; the new Pontiac Fiero is being made in a rebuilt Fisher Body plant in Pontiac; the old Pontiac assembly plant has been revived to produce the obsolescent rear-drive automobiles; and the Clark Avenue plant in Detroit continues to produce rear-drive cars. The brand new Hamtramck-Detroit Poletown plant is scheduled to come on line this summer.

General Motors also makes urban transit buses and a full range of trucks in Michigan. Chassis for recreational vehicles and delivery trucks are made in Detroit. The small S-Truck pickup is manufactured in Pontiac along with medium- and heavy-duty trucks and coaches. Large pickups and Blazers, Jimmys, and Suburbans are made in Flint. Blazers and Jimmys, like the Ford Bronco made in Wayne, are Jeep-like vehicles. The Suburban is a station wagon on a truck chassis. Under present plans, GM will cease production of pickups in Flint when it launches the new 1987 model. The new pickup will be produced in Pontiac and in a new plant being built in Fort Wayne, Indiana.

Chrysler produces passenger cars in Detroit and trucks in Warren. Last fall, Chrysler began producing cars in a new plant in Sterling Heights. Chrysler also is creating "Dodge City," an expansion and renovation of its Warren truck plant. Ford makes passenger cars in Wixom, Wayne, and Dearborn and Broncos and light trucks in Wayne. In Flat Rock, Mazda Corporation is building a plant to produce small, luxury cars for the 1987 model year.

With the new plants coming on line, domestic automobile production this year should exceed the 1984 figure of 7.8 million by 300,000 to 400,000 units, assuming there is no downturn in sales of domestic new cars this year. Michigan's share of U.S. production will be above the 30% figure during the last half of 1985, although below that percentage for the year as a whole. Counting the Pontiac truck complex as one plant, Michigan will have 19 active assembly plants by the end of 1987, assuming that none now active is shut down. There will be 26 separate production lines for the assembly of cars, trucks, or buses in this state as things now stand. This will represent over one-third of U.S. vehicle assembly capacity.

Currently, domestic car dealers are maintaining sales by offering special financing and discounts on several slow-selling models, evidence that the market is cooling--this at a time when the Japanese have increased their self-imposed quotas by 25%. Thus, although car production in Michigan is slated for a sizable boost this fall because of plant openings, there seems little reason to expect continued production vigor after the initial inventory buildup of new models. Michigan will gain market share, but of a stagnant or declining production total.

After 1986 Mexico will become an important factor in the U.S. automotive market. The government of Mexico is

insisting that companies who do business in that country increase their production there and begin exporting. So far, a few Chrysler and GM models have made their way north. By 1990 made-in-Mexico cars will account for 400,000 to 500,000 U.S. sales. The Koreans also have big plans for the American market; Canadian sales of their inexpensive Pony have exceeded their wildest expectations.

In the longer run, GM's Clark Avenue and Pontiac Assembly plants, both producers of aging, rear-drive vehicles, will likely close. Ford's Dearborn Assembly plant could be a closure candidate during the 1990s, along with Chrysler's Jefferson Avenue assembly plant in Detroit. The stark truth is that there will be capacity to produce more North American vehicles than the market can absorb at then current prices. Some of the older, less efficient plants will close.

## Automotive Linkages

Over half of the steel made in Michigan is destined for the automotive industry. Consequently, when car and truck production lags in this state, the steel industry here is hurt, too. In steel, as in automotive production, Michigan made gains during the 1984, but at rates below the national level. We lost industry share in both vehicle production and in steel production. Generally speaking, Michigan's steel industry is younger, thus more modern, than that of the nation as a whole. Consequently the long-term national cutback of obsolete steel production capacity has diminished the size of the national industry more so than here in the Wolverine State.

Our share of U.S. production has increased over the years, although the level of production is depressed. Last year's production was about 30% below the



peak levels of nearly 11 million tons reached during the 1970s. Production last year was well below the relatively depressed 1981 level, although well above the recessionary 1982 figure. So far this year, tonnage of steel poured in Michigan mills is 13% below the first quarter 1984 figure compared with a 12% decline nationally. The downriver communities of Ecorse and River Rouge are principally affected by the fortunes of the steel industry.

Foundries in this state also are heavily dependent on the automotive industry. Michigan's foundries were among the nation's older, prior to the capacity reductions of 1979-1983. Our share of the national total of foundry activity has declined during the past half decade and that trend continues. Most recently, General Motors announced the closure of its Pontiac foundry and a consolidation of operations at its Saginaw locations. Foundry activity should increase during the last half of this year with increased vehicle manufacturing in this state. The long-term trend, however, is toward less heavy metal per car.

Michigan also is a major producer of forgings, stampings, and other metal products that are incorporated into vehicles. About half of the state's fabricated metals production is destined for the automotive industry. These industries have been increasing their share in the U.S. totals during the last few years, although activity levels are diminished from their former peaks. Activity has risen substantially from the depressed 1982 and 1983 figures, and employment figures for April 1985 suggest that the recovery in fabricated metals industries is continuing.

Among other Michigan manufacturing industries, the machinery, electrical machinery, and textile industries also depend on vehicle manufacturing for an appreciable proportion of their markets. Machinery manufacturing continues to

recover whereas electrical machinery and textiles have not yet exhibited real strength. Automotive electrical components, such as wiring harnesses that carry electricity throughout the vehicle, generators, and motors are pouring in from Mexico. The Mexicans also are becoming major exporters of engines and transaxles. Textile manufacturing in this state consists mostly of seat belt, interior trim, and carpeting for passenger cars.

The extent to which nonmanufacturing activities, such as consulting, banking, insurance, transportation, communication, and other services depend directly on the automotive industry for their markets is not known, although the figures for this state must certainly be formidable.

## Other Goods Production

Western Michigan is home to a number of office fixture and home appliance manufacturers. Names like Gibson, Steelcase, and Herman Miller are well known in Greenville, Grand Rapids, and Holland where their factories are located, and around the world where their products are sold. Heavy home appliances and office fixtures and furniture are rapidly growing industries in western Michigan.

The Kellogg Company of Battle Creek, Gerber Products of Fremont, and other food processors are familiar to grocery shoppers around the world. Michigan is the leading grower of tart cherries and navy beans, and among the leading producers of blueberries, asparagus, and wine.

Dow Chemical is headquartered in Midland, Upjohn in Kalamazoo, and a number of other chemical and pharmaceutical companies have Michigan operations. Kalamazoo also is home to several paper manufacturers and there are numerous other forest product companies in this state.

In addition, Michigan mines produce minerals including iron ore, copper, limestone, gypsum, and sand and gravel. Michigan wells produce oil, gas, and brine.

Chemicals, food processing, farming, and papermaking are depressed industries in this state, with no sign of early recovery. The lumbering industry and sawmilling, along with mining are recovering economically, although still deeply depressed. The publishing industry is rapidly growing.

The statistical bag for the construction industries is mixed. On the one hand, contract awards data prepared by the F.W. Dodge Division of McGraw-Hill Information Systems Company and the building permits series prepared by the U.S. Census Bureau suggest great vigor in construction activity in this state. On the other hand, employment and earnings data from the BEA, MESOC, and the Bureau of Labor Statistics depict an industry deeply recessed, and remaining so, at least through April 1985. Nationally, construction has recovered and is growing. Evidently there is a backlog of projects that will provide impetus to Michigan builders in the months ahead.

## Other Sales and Service Industries

Hard-pressed retailers got some relief last year by way of a 9.8% sales increase over the still-depressed 1983 level. In 1983, sales figures (not adjusted for inflation) still stood below 1981, although 5.6% ahead of the extremely depressed 1982 level. Between 1982 and 1984 retail sales grew by 20% in this state compared with 21% nationwide. For the greater Detroit area the increase was 21%, implying an increase of 19% for the outstate area.

Durable goods have been making more retail rapid retail gains than nondurables in the Detroit area, in Michigan and in the United States as a whole. Retailers in this state outpaced their national counterparts (7.6% here compared with 4.5% nationally) during the first three months of 1985, according to Current Business Reports from the Bureau of Census.<sup>1</sup> For the Detroit area the gain was 5.0%. American consumers still are signaling confidence in the economy and a willingness to buy big-ticket items. In the months immediately ahead retailers, particularly car dealers, gasoline service stations, and building, lumber, and hardware dealers, can expect brisk sales.

Wholesalers are doing exceptionally well in Michigan, increasing their share of the growing national industry from 3% during 1982 to 3.2% the first quarter of this year. April 1985 employment data from MESOC indicate continued rapid growth in Michigan wholesaling.

Business services are growing rapidly in this state, and the surge in employment growth in this category is apparent in MESOC data through April 1985. Business services include advertising, management consulting, computer-related services, custodial care of buildings, and other services provided to businesses. Michigan's growth is marginally ahead of the national figure, which is rapidly growing as well.

Automotive repair and miscellaneous repair services have made substantial gains since 1982, but not at the same rate as business services. The lodgings industry, another of the service categories, is also making slower gains than business and repair services. Employment in the health care industry is declining, a trend expected to continue in part because of cost-containment measures being

<sup>1</sup>Current Business Reports: Monthly Retail Trade, U.S. Department of Commerce, Bureau of the Census, March 1985, pp. 5, 9.

implemented by government and business. There is excess health care capacity in most Michigan cities, although it is still felt to be in short supply in rural areas.

The group of businesses in the finance, insurance, and real estate category is growing in Michigan, but very slowly, and below the national rate. The group of Michigan businesses in the transportation and public utilities category is growing more slowly than finance, insurance, and real estate, and below the national rate. Employment in public utilities is declining whereas air transportation is growing fast. Trucking and warehousing is a growth industry, too, although not as rapidly as air transportation.

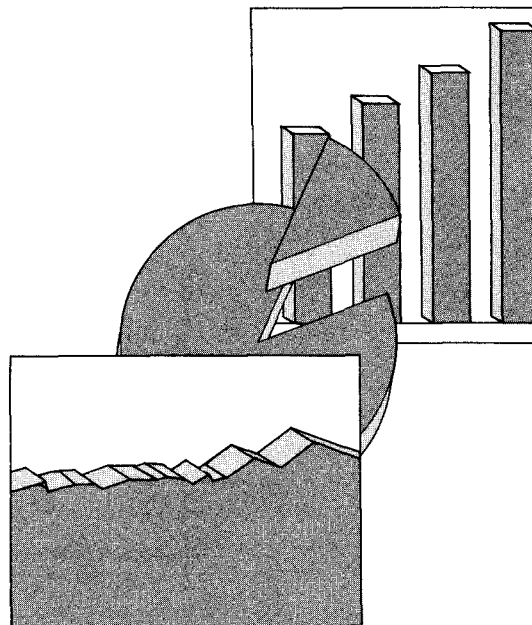
In the years ahead trucking and warehousing will benefit from their proximity to Michigan's many vehicle assembly plants. The automotive industry is developing just-in-time material flow techniques, encouraging suppliers to build factories or warehouses nearby so that they can deliver parts as they are needed to the assembly lines. This development will increase the market for short-haul, less-than-truckload cartage companies.

## Summary

Declining interest rates and buoyant consumer attitudes point to a national economy that is much stronger during the second half of 1985 than the first. For Michigan, the opening of three automobile assembly plants will provide additional impetus during the second half, especially during the last quarter.

By the last quarter of this year the economic expansion will be three years old. As expansions go, durable goods markets become saturated, debt accumulates, and consumers decide that it is time for a breather, to, among other things, repair household balance sheets. Very likely interest rates will be rising.

The likelihood of a weak-to-recessionary economy both here and nationally during the first or second half of 1986 is high. These considerations suggest the scenario in Table 2 (see page 11).



**TABLE 2**  
**PROJECTIONS OF MICHIGAN AND UNITED STATES**  
**BROAD ECONOMIC INDICATORS:**  
**1985 and 1986**

	1984	1985	1986
<b>Earnings (current \$ in millions)</b>			
Michigan	\$81,382	\$88,616	\$94,200
United States	\$2,141,000	\$2,286,000	\$2,400,000
<b>Earnings (1984 \$ in millions)</b>			
Michigan	\$81,382	\$85,000	\$86,700
United States	\$2,141,000	\$2,193,000	\$2,210,000
<b>Civilian employment (thousands)</b>			
Michigan	3,871	4,000	4,050
United States	105,005	107,100	108,000
<b>Vehicle production (thousands)</b>			
Michigan	3,000	3,300	3,300
United States	10,900	11,500	11,000
<b>Unemployment rate (% of civilian labor force)</b>			
Michigan	11.2%	10.1%	10.5%
United States	7.5%	7.3%	8.1%

SOURCE: 1984 actual data on earnings from Regional Economic Information System, Bureau of Economic Analysis, U.S. Department of Commerce, Washington, D.C.; on civilian employment and unemployment rate from special release, Bureau of Labor Statistics, Department of Labor, Washington, D.C.; on vehicle production, special release, Motor Vehicle Manufacturers Association, Detroit.