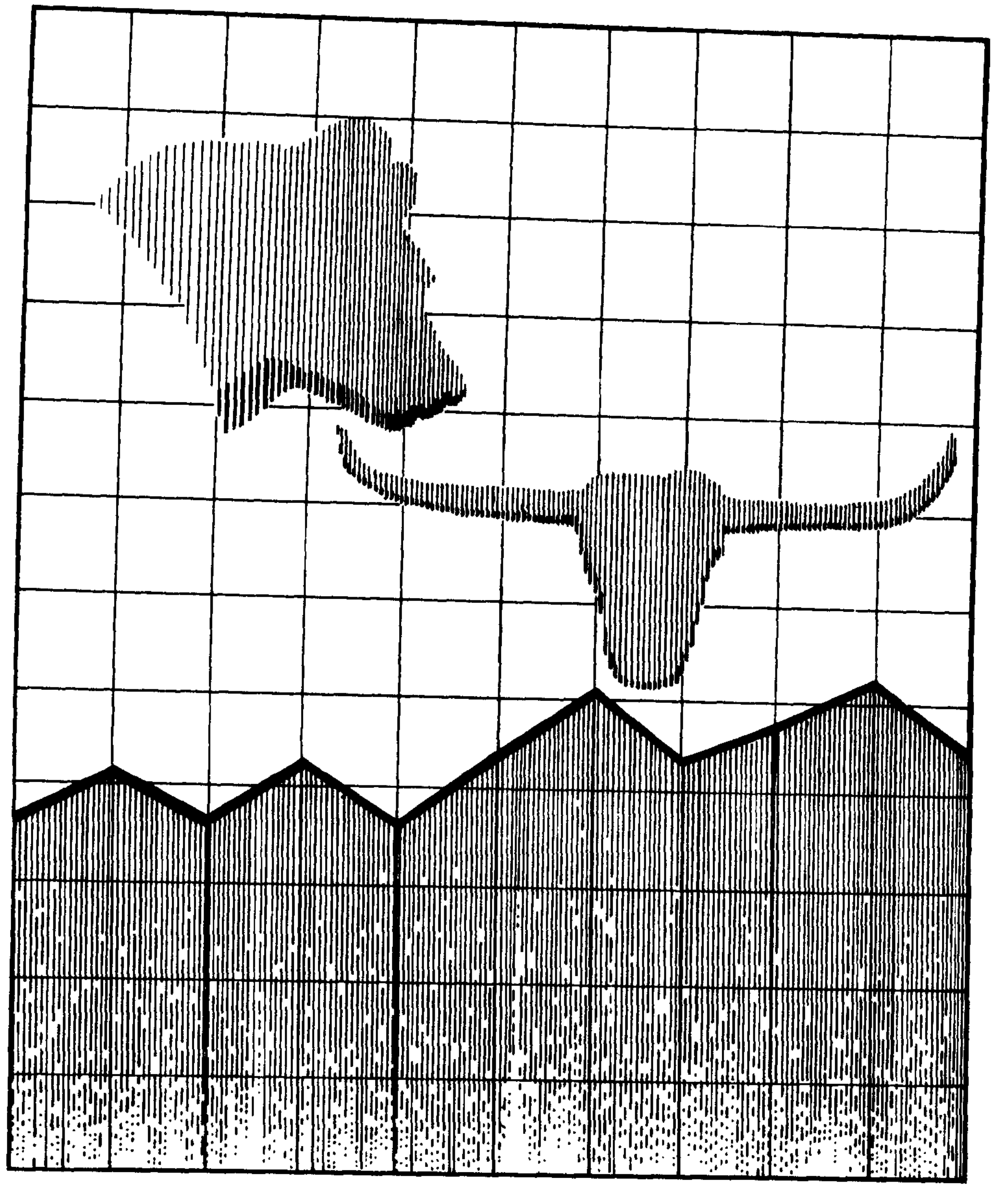
Third Quarterly

Economic Forecast

July 1984



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This publication is part of our continuing series of FISCAL AWARENESS SERVICE materials.

The FISCAL AWARENESS SERVICE (FAS) incorporates the following components:

- 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.

- The weekly "Michigan Roundup," a publication reviewing legislative actions of the week and political news from the State Capitol.

- A private letter of political and social comment providing additional insight into and analysis of the complicated and changing scene for subscribers to use in formulating their own strategic plans.

- Specialized research monographs covering topics such as Michigan's labor force, current population projections, taxation, and education.

- The monthly "Michigan Revenue Report," tracking significant changes and revisions in state revenue flows as projected by our economic models and estimates.

- A documentation service providing copies of public documents of current interest, such as budget messages, appropriations acts, policy briefings, agency reports, legislative committee assignments, phone lists, executive orders, and a comprehensive list of budget adjustments for the present and following fiscal years.

- Services of the Bibliographic Search Division which provides bibliographic research and access to computerized databases, printed indexes, and regional, national, and international reference sources.

FAS ON TAPE

- 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.

Economic Overview

The economy continues to grow at an usually rapid pace. Consumer spending has shown no signs of diminishing. Businesses are contributing to the expansion by rebuilding inventories and investing in new facilities and equipment. Unemployment has shown sustained improvement and inflation remains moderate. And, despite rising interest rates, housing and auto sales and sales of other consumer durables remain remarkably strong, although the rate of increase is beginning to slow.

Our projections for 1984 and 1985 remain essentially unchanged. The following are highlights of our forecast:

* Interest rates will keep rising due to the heavy credit demands of government, business, and consumers. The prime rate will fluctuate around 13.5% by year-end.

* The national and state unemployment rates will continue to decline but not as quickly as earlier in the recovery. Unemployment nationally will average 7.3% in 1984 and 6.8% in 1985. Michigan's unemployment rate will drop to an average of 10.7% in 1984 before declining to 9.5% in 1985.

* Total U.S. auto sales will rise to 10.4 million units in 1984 and 11.2 million units in 1985.

* Price pressures will start to build, with consumer prices rising an average of 4.9% this year and 5.6% next.

* Housing starts nationally will average 1.8 million units this year, dropping slightly to 1.7 million units in 1985.

* Inflation-adjusted personal income will increase about 5% in 1984 and 4.5% in 1985.

Leading Economic Indicators

The index of 12 leading economic indicators is designed to "lead," or foretell, overall economic activity during the next 12-to-16-month period. Consistent increases in the leading indicator index signal continued growth, while a string of declines in the index indicate an economic slowdown. For the first time in 21 months, the leading indicator index dipped a slight 0.1% during May. The index will probably be revised upward later this month when data on the other two components of the index -- inventories and private sector credit demand -- become available.

Four of the ten available indicators contributed to increases in the index: increases in orders for new plant and equipment, growth in the nation's money supply, a reduction in the number of new claims for unemployment insurance, and increases in orders for consumer goods. The major component pulling down the index was a sharp reduction in the length of the average workweek. Other indicators contributing to the index's decline included new building permits, vendor deliveries, net business formation, stock market prices, and prices of raw materials.

Even assuming that the May reading for the leading indicator index will be revised upward, it is unlikely that the uninterrupted gains in the index will continue for very much longer. Many of the indicators are approaching a plateau and will contribute relatively little to advance the index during the coming months. For instance, in the first year of the recovery, strong employment gains made a major contribution to the growth of the index. New claims for unemployment insurance have hovered around the 350,000 level for the last few months and are unlikely to decline much further. Moreover, as employers substitute new employees for overtime hours, the average work-week will decline. Hence, the leading indicator index may begin to turn negative even though the labor market and the economy continue to project considerable strength.

$ $ $ $ $ Interest Rates

As the recovery has matured, credit demand has intensified and interest rates have resumed their upward spiral. The prime rate alone has increased four times in the past three months. All sectors of the economy have contributed to this situation. Consumers are optimistic about the economy, feel more secure about their jobs, and have shown an almost unbridled willingness to spend down savings and assume new debt to make the purchases they deferred during the recession. Businesses have similarly stepped up their credit demands. During the initial stages of the recovery, higher sales volumes and lower break-even thresholds generated record profits, enabling many firms to expand output and rebuild inventories by reinvesting profits rather than relying on loans. However, as sales improved, many businesses started to expand operations or buy new equipment. In the process, they increasingly returned to the credit markets to obtain the necessary funds.

Despite the higher tax revenues created by an expanding economy, the federal government has continued to run extraordinarily large budget deficits. An expanding demand for credit from all three sectors of the economy has not been matched by corresponding increases in the supply of loanable funds. The recent rises in interest rates have consequently reflected the impact of two separate factors: (a) increased competition among consumers, businesses, and government for available credit; and (b) fear on the part of investors that this heavier credit demand will be met by an increase in the money supply, and, indirectly, in the rate of inflation. If inflation increases, the purchasing power of the repaid dollars will decline, reducing the effective return on investment.

However, rising interest rates also increase debt service on the $1.3 trillion federal debt. Interest owed on the federal debt has accumulated faster than tax revenues have grown, forcing even greater government dependence on the credit markets. Unless (a) total credit demand is reined in or (b) the supply of credit is radically increased, interest rates have only one way to go, and that is up. Rather than pay higher interest rates, consumers and businesses would curtail their purchasing plans. As sales slowed, inventories would accumulate, forcing businesses to cut back production and employment. This could throw the economy back into recession.

As noted in the last forecast, we believe the Federal Reserve Board will work for the remainder of this year to keep monetary growth within the announced target ranges, thereby helping to prevent any major surge in inflation. However, interest rates will edge higher over the next few months, with the prime rate averaging 13.5% by year-end.

A credit crunch remains a very real possibility during 1985. If the 1984 tax bill approved by Congress last month is signed into law, such a crunch might be averted. The tax bill would eliminate foreign tax credits for U.S. companies with overseas subsidiaries, but would permit these companies to sell tax-exempt bonds to foreign investors. This would expand access to foreign credit markets and would, in theory, have the effect of exporting our credit crunch to other nations. Whether and how this strategy works will be reviewed and explained in subsequent forecasts.

Unemployment

The national unemployment rate showed a major improvement in June, falling to a seasonally adjusted rate of 7.1% from 7.5% in May and 7.7% in April. Much of the improvement was attributable to fewer than usual high school and college students entering the labor force during the month of June. At 11.6%, Michigan's unemployment rate in June continued to hover above that of the nine other major industrial states. Michigan's unemployment rate was only slightly changed from the 11.7% rate reported in May and still considerably higher than the 10.6% rate of April. Since June of 1983, total employment in Michigan has climbed by 164,000 while total unemployment has declined by 147,000. Most of the employment gains have occurred in the construction and durable manufacturing industries.

The unemployment rate is the ratio of unemployed persons to the total labor force. Since the labor force itself has grown, it will take more new jobs to produce a one percentage point reduction in the unemployment rate than it did earlier this year. Consequently, the unemployment rate will decline more slowly even if considerably more jobs are created. In addition, during the recession many of the least cost-efficient firms were forced out of business. Those who survived were able to reduce their fixed costs and increase productivity, resulting in lower per unit labor and overhead costs. Many eliminated jobs will only slowly be replaced by new jobs. Finally, higher levels of productivity mean that output will increase more rapidly than either jobs or employment. Unemployment nationwide will average about 7.3% in 1984 and fall to 6.8% in 1985. Michigan's unemployment rate will decline to an average rate of 10.7% during 1984 and drop to approximately 9.5% in 1985.

Auto Sales

So far this year auto sales have reached their highest levels since 1979. Domestic auto sales have amounted to an annual rate of about 8 million units; with the addition of imports, total sales have been averaging 10.3-10.4 million units. In spite of rising interest and financing rates, total sales in June reached a 10.8 million unit rate, down modestly from the 11.2 million unit rate of May; import sales accounted for approximately 23% of the total.

Domestic manufacturers are producing almost at capacity now and, hence, are unable to further expand production to take advantage of strong consumer demand. Import restraints have prevented foreign manufacturers from taking advantage of this demand. With interest rates rising and a U.S. auto strike looming in September, auto sales are likely to taper off later this year. As a result, total auto sales are likely to be constrained to 10.4 million units this year. With the addition of new capacity next year, auto production and auto sales will rise, increasing to approximately 11.2 million units in 1985.

Inflation

For the 12 months ending in May, consumer prices, as measured by the U.S. consumer price index (CPI), rose 4.2%. The CPI in May rose at an annualized rate of 2.4%, compared to a 6.0% rate in April. For the first five months of 1984, consumer prices rose at an annualized rate of 4.6%. The inflation performance for Michigan has been even better, with the Detroit CPI increasing at a rate of only 3.7% over the same period.

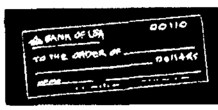
Producer prices, which tend to have a delayed impact on consumer prices, show little sign of any significant increase in inflation over the next few months. Producer prices were unchanged during the three months ending in June. Ample petroleum supplies should keep energy prices relatively stable. Increased competition, both domestically due to industry deregulation and internationally due to the record strength of the dollar, will help restrain price increases. High interest rates should discourage large inventory holdings and commodity speculation, helping further to curb demand pressures and inflation.

These moderating influences will be partially offset in 1985. The nation's factories are operating at approximately 82% of capacity. Capacity constraints will prevent output from increasing quickly. If demand remains as strong as it has recently, producers will be able to satisfy this demand only by using obsolete and expensive capacity. This would cause prices to rise more rapidly. Record industry profits have also raised labor's wage expectations and will make it more difficult to retain the wage concessions won during the recent recession. Since labor costs are a major component of product prices, higher wages will eventually be reflected in consumer prices. Consumer prices will rise an average of 4.9% in 1984, but will increase by approximately 5.6% in 1985.

Housing Starts

Housing activity is important not only for the direct stimulus it provides to the economy, but also for the indirect stimulus provided to sales of appliances, home furnishings, and consumer goods such as carpets and drapes. The rate of housing starts has shown considerable volatility during the past few months. National housing starts in May ran at an annual rate of about 1.78 million units, down 10.5% from the unusually high rate (1.99 million units per year) posted for April. The strong rate for April, in turn, followed a particularly poor showing in March. However, if the March and April rates are averaged and taken as a base, the May rate reflects a decline of only 1%. Permits issued in May for new housing (an indication of future housing activity) were running a modest 1.3% below April's annual rate. Consequently, there is little reason to believe that housing activity has started a substantial downturn. Housing starts in May were still 0.2% over the vastly improved rate of last May.

Mortgage rates have consistently risen since February. In late June mortgage rates climbed to their highest level (14.5% on a conventional 30-year fixed-rate loan) since October 1982. Although high rates dampen housing activity, this effect has been greatly offset by two factors. First, the proliferation of creative financing techniques such as builder buy-downs and adjustable rate mortgages has enabled consumers to obtain mortgages whose initial rates run below those of fixed-rate mortgages. Second, the baby boom generation has reached the prime age for home ownership and is exhibiting considerable housing demand. Consequently, 1984 will be a relatively good year for housing activity, with housing starts reaching 1.8 million units nationally. In 1985, high mortgage rates will further dampen activity, with housing starts declining slightly to 1.7 million units.



Personal Income

Personal income is defined as all income received by individuals, whether it originates from employment, government, or savings and investments.

Personal income is a key determinant of consumer spending, and, as such, it provides some insight on the future direction of spending activity.

Personal income rose a healthy 0.6% in both April and May, down slightly from the extremely strong growth rates experienced earlier in the year. Interest earnings attributable to rising interest and dividend payments have played a slightly more important role in this growth while wage and salary income, by far the largest component of personal income, contributed slightly less to overall growth. The strong growth rate of personal income thus far in 1984 suggests that consumer spending will maintain its strength for the remainder of the year. Continued moderation in inflation rates implies that these income gains will not be eroded by declines in purchasing power. Consequently, personal income, after adjustment for inflation, will rise at a rate of 5% in 1984 and 4.5% during 1985.

Summary

The economic recovery has matured into an expansion. Strong business and consumer spending combined with tight monetary policy and the federal government's seemingly insatiable appetite for credit will cause interest rates to edge higher this year and next. Higher interest rates will begin to slow economic growth later in 1984, but pose no significant economic problems until 1985.

Continued economic growth, higher employment levels, and modest inflation rates will contribute to a 5% increase in inflation-adjusted personal income during 1984 and a 4.5% increase in 1985. These gains will boost auto sales to 10.4 million units this year and 11.2 million units next. Housing starts will reach 1.8 million units in 1984 before declining slightly to 1.7 million units in 1985.