ECONOMIC FORECAST,

FISCAL 1982-83:

An Update

October 13, 1982

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1983 ECONOMIC OUTLOOK

THE OUTLOOK IN BRIEF

Economists in and out of government have been predicting a recovery since January, but without fundamental changes in the economy, upturns in business activity were incapable of maturing into a recovery. We believe that recent marked declines in interest rates have finally set the stage for sustainable but slow economic improvement. Anticipated increases in business activity and receding unemployment will generate more tax revenues for the state, providing approximately $500 million more in revenues during fiscal 1982-83 than in fiscal 1981-82.

The basis for our modest optimism rests on the following set of projections:

1. An increase in auto sales from expected calendar 1982 levels of 7.2 million units to 8.6 million units in 1983

2. Recovery of Michigan housing starts to 26,000 units, up from the current depressed rate of 16,000

3. A decline in Michigan's unemployment rate from a projected average of 14.5% in fiscal 1982 to 12.6% in 1983

4. A 2% increase in inflation-adjusted personal income

5. A slight increase, from 4% in 1982 to 6% in 1983, in the rate of inflation

INTEREST RATES

Short- and long-term interest rates have tumbled recently. While the prime rate stood at 16% at the beginning of July, it is currently 12.0% and may further decline over the next several months if the economy remains weak. Long-term rates had declined from 13.85% on July 2 to 11.5% as of October 8. Rates will fluctuate over the next several weeks, but are unlikely to fall much further before next year when the Fed has had an opportunity to assess the impact and consequences of these recent reductions.

The falling interest rates are in response to a combination of both real and psychological factors: (1) the Fed has contained money supply growth to the upper end of its target range, helping to allay the inflation anxieties of the financial markets; (2) demand for business credit has been reduced over the past couple of months due to the weakened economy, easing pressure on the credit markets despite recent record high levels of financing by the federal government; (3) the anticipated stimulus to the economy from the July federal tax rate cut and the Social Security inflation adjustment never materialized,

again eliminating a potential source of pressure on the credit markets; and (4) Congressional approval of a $98.3 billion tax increase to reduce the projected 1982 deficit minimizing its attendant financing requirements. Reduced inflation has permitted continued easing of interest rates.

The factors leading to the interest rate reductions should extend through the early part of a recovery, thereby providing for continuation of the lower rates through most of 1983. Lower rates will reduce business costs and improve profitability while simultaneously boosting consumer confidence by making credit once again accessible and more affordable. This should particularly assist hard-hit industries such as housing and automobiles.

AUTO SALES

Domestic car sales during the 1982 model year were down 15.9% from 1981. Sales of imported vehicles also declined 9.3%, but still captured a larger total share of the U.S. market. Imports currently hold over 30% of the U.S. market, although actual sales are only marginally changed from 1981. With the exception of May, auto sales were lower than 1981 sales for each month of 1982 despite widespread rebates and other buyer incentive programs. It now appears that calendar 1982 will be the weakest auto sales year since 1958. Major domestic automakers have already trimmed initial production of 1983 models. As a result, we project total U.S. auto sales may reach as few as 7.2 million units in calendar 1982.

This year's abysmal sales figures have been widely attributed to high interest rates and the negative impact those rates have on consumer confidence. The recent significant declines in interest rates have the potential for restarting stalled auto sales, especially if interest rates remain down long enough and are stable enough for consumers to respond. If this happens, auto production and sales could pick up modestly, perhaps attaining a rate of 6 million units by year end. Large inventories of leftover 1982 models have forced dealers to slash prices. Moreover, unusually small price increases on 1983 models have narrowed the price differential between 1982 and 1983 models, thereby eliminating much of the reason for buyers to settle for a 1982 auto. Since dealers repeatedly offered rebates or other inducements during the past year, consumers have become accustomed to the price reductions and see little justification for paying full price for a 1983 model. Both factors have depressed initial 1983 model year sales.

The auto industry is one of aging technology and expensive labor. It has already achieved its peak years and is now settling back for a slower paced, more uncertain future marked by changing consumer tastes and intensified worldwide competition. The good sales years of 11 to 12 million units will not be repeated for many years. A more typical sales year will approximate the 10 million unit mark. Even so, prospects for 1983 auto sales again hinge largely on interest rates and the health of the general economy. A slow recovery with stable, lower

interest rates and dwindling unemployment could restore consumer confidence and permit a calendar 1983 sales level of 8.6 million units.

MORTGAGE RATES AND HOUSING STARTS

Declining short-term interest rates are beginning to exert downward pressure on long-term rates. Reduction in long-term interest rates will not immediately make mortgage money either less expensive or more accessible. The current financial difficulties of the nation's saving and loan associations and banks stem in part from aggressive reductions on 30-year mortgage rates during 1980. At that time, many savings and loan associations approved mortgages at 12-13% only to have the cost of their funds soar to 18-20% shortly thereafter. In light of their resultant damaged profitability, few of these mortgage lenders are likely to reduce mortgage rates quickly and take a chance of replicating their earlier mistake. Since lenders' costs of loanable funds continue to fall, mortgage money may soon become more accessible if not significantly more affordable. Mortgage rates have recently fallen to 15.13%, the lowest in 20 months. Moreover, sales of new single family homes rose 2% in August, the most recent month for which data is available.

Buyers are unlikely to embrace 14-15% mortgage rates on conventional loans until they are certain the rates will not continue to decline. Consequently, the housing industry cannot hope to benefit from the recent good news on interest rates for at least another 4 to 6 months.

Housing starts nationwide, which had fallen to a 911,000 annual rate in June, may improve to 1.1 to 1.4 million units in 1983 if current interest rate trends continue. Michigan housing starts could recover to 26,000 units in 1983, up from the current 16,000 unit rate.

EMPLOYMENT

The national unemployment rate in September reached a postwar record of 10.1%, up from 9.8% in August. This percentage is likely to edge higher during the last quarter of 1982 as marginal businesses, unable to hang on long enough to realize the revenue from a slightly improved economy, continue to close their doors and dismiss employees.

Even though interest rates are declining, businesses have apparently given up hope for a vigorous and long-awaited recovery. Inventories will be further reduced to minimize finance costs until sales begin to improve again. Consequently, industrial production and resulting employment levels will remain depressed through the last three months of this year. As the recovery takes hold late this fall and early winter and production increases, the unemployment rate will again decline, averaging just over 9% during 1983.

Michigan's September unemployment rate was 15.9%, higher than the earlier 15.7% rate set in March of this year, and the highest since 1931, the peak of the Great Depression. To the extent that declining interest rates stimulate construction activity and auto production,

Michigan's unemployment rate will fall. Unemployment will decline to about 14.5% by year end and average around 12.6% during 1983.

PERSONAL INCOME

Inflation-adjusted (real) personal income declined 1.6% from 1981 during the first quarter of this year and increased by 3.1% in the second quarter. Higher levels of employment late this year, along with receding inflation, will result in a modest improvement during the remainder of 1982, averaging out to a 1% increase this year relative to last and increasing an average of about 2% next year.

INFLATION

Inflation, as measured by the consumer price index, should range from 3 or 4 percent in 1982, down from the current annual rate of 5.4%. Inflation is expected to run about 6% during calendar 1983.

Food prices will remain relatively unchanged due to an extraordinarily good harvest. Declining interest rates will slow increases in housing costs, and OPEC's failure to fashion a production and pricing agreement should ensure ample petroleum supplies and softer prices.

Although prices have generally climbed as the economy pulled out of a recession, this recovery will be so modest as to preclude any significant price increases. According to Donald Straszheim, Vice President of Wharton Econometric Forecasting Associates, demand is currently so weak that even a substantial recovery would not exert much upward pressure on prices.

The business failure rate continues to climb even though there are inclement signs of a recovery. Economy-wide prices on manufactured goods are relatively unchanged from last year because of the large number of distress sales. Prices are not likely to rise significantly over the next year. A July survey by the National Federation of Independent Business indicated only 20% of the federation's 2,300 members planned to raise prices during the next 3 to 6 months. This is the smallest percentage since the survey began in 1973.

The weak economy has encouraged companies to reduce employee benefit costs and demand wage concessions in an attempt to cover costs at lower output levels. Most of the concessions will extend through 1983 or beyond. This also removes a major source of pressure for price increases.

Many of the economic indicators could fluctuate moderately up or down over the next several months, but will show an overall upward trend. The economy has posted 2 consecutive quarters of positive growth in real GNP, hence officially signaling the end of the recession. Although bankruptcies and unemployment continue to rise, interest rates are down and bond prices up. The economy is now poised for recovery. We believe the prognosis for 1983 is modestly improved over 1982 and will provide a basis for increased optimism in 1984.