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# ECONOMIC FORECAST 1983

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## Economic Overview

Because the index of leading economic indicators has been advancing at a slower pace than it did during the first and second quarters of 1983, a growing number of economists fear the recovery is drawing to a close and that the economy will slip back into recession by mid-1984. They point to rising prices and rising interest rates, slowing retail sales, increasing inflation, a flat unemployment rate, and budget-busting federal deficits as signs that the current period of economic expansion is ending.

Despite these fears, there is little reason at this time to expect another recession before late 1985. Many of the gains achieved earlier this year occurred at unsustainably high levels. For instance, consumer outlays grew at a faster pace than personal income, contributing to the large 9.2% increase in gross national product (GNP) in the second quarter of 1983. This process is self-limiting because consumers cannot spend more than they earn for extended periods of time without resorting to the credit markets. Even then, consumers do not have access to unlimited amounts of credit.

Contrary to most expectations, consumers saved the extra funds made available to them in July from the federal income tax cut. This increased the economy-wide savings rate and provided additional dollars for lending in the credit markets, helping to prevent interest rates from rising further. It also slowed the rate of retail sales and contributed to a lower, less frenetic, and more sustainable rate of growth in GNP. Consequently, instead of signaling the end of recovery, these lower levels of activity provide reassurance that the economy is shifting into a slower paced and extended period of growth.

* Interest rates will remain steady through the fourth quarter of 1983 and the first quarter of 1984 and then begin to rise slowly. Significant reductions in interest rates cannot and will not occur until Congress and the Administration reduce the federal budget deficit and bring fiscal policy into conformity with monetary policy.

* Total domestic and foreign auto sales in calendar 1983 will range between 8.9-9.1 million units, growing about 10% in 1984 to 9.9 million units.

* Housing starts nationwide will average 1.7 million units in 1983 and 1.9 million units in 1984.

* Inflation as measured by the consumer price index will average a low 3.1% in 1983 and increase to 4.5% in 1984.

* Unemployment will remain stubbornly high, averaging 9.7% nationwide in 1983 and 8.8% in 1984. Michigan's unemployment rate will average 14.6% and 12.8% for the same periods.

* Inflation-adjusted personal income will grow a modest 2% in 1983 and will grow an additional 3% in 1984.

## Economic Indicators

The economic recovery will be a year old in November. Led initially by major increases in consumer outlays for big-ticket items such as autos and houses, this increased spending has spread throughout the economy and produced gains in practically all areas of economic activity.

The index of leading economic indicators is a barometer of future economic activity. Increases in the index predict continued expansion during the next 12 to 18 month period; decreases indicate a weakening economy which may lapse back into recession. While a single month's change in the index is not significant in and of itself and cannot predict either an expansion or a recession, continued advances in the index provide reassurance of future growth; a series of decreases offer strong evidence of an impending recession.

Revised data show that this index increased by 0.8% in July, marking the eleventh consecutive monthly increase in the index and its longest uninterrupted rise since 1975. The increase was the smallest of recent months, indicating that the economy is slowing from its rapid growth in the first and second quarters of 1983. Further confirmation of this slowing was provided by the 0.1% decline in the index for August. Such a decline is typical, however, in a transition from the initial stages of a recovery to a more mature economic expansion.

The index consists of eleven economic indicators. The August report showed that four of the ten available indicators contributed to the August decline in the index. These four were increases in new unemployment insurance claims and reductions in stock prices, new building permits, and new business formations. Components of the index showing economic improvement were growth in the money supply, slower delivery of finished goods due to new orders outstripping production, increases in the length of the average workweek and in the price of raw materials, more orders for manufactured goods and materials, and increases in orders for new plant and equipment.

## Interest Rates

Interest rates will remain stable through spring 1984, fluctuating less than 0.3% either way before starting to rise again slowly next spring. The most important determinants of the path of interest rates are the rate of inflation in the U.S. and the supply of credit relative to total demand.

The federal budget deficit is central to both of these factors. Unless expenditures are dramatically scaled back or major new federal taxes imposed, the federal budget deficit will range between $150-$200 billion annually through 1985. According to Martin Feldstein, Chair of President Reagan's Council of Economic Advisors, "The budget deficit will probably average $200 billion a year through 1988." These deficits will be covered through U.S. Treasury borrowings. If the Federal Reserve Board (Fed) increases the money supply sufficiently to absorb this debt (a process known as monetization of the debt), the budget deficit will not push up interest rates. However, because large increases in the money supply tend to push up prices, monetization of the federal debt could lead to renewed double-digit inflation rates.

If the federal deficit is not covered by an increase in the money supply, the federal government will be forced to compete in the same credit markets as consumers and businesses. If the demand for credit from all sectors increases, the resulting competition for funds will bid up interest rates. Rather than pay higher interest rates, business would scale back its plans for purchase of new plant and equipment and attempt to minimize the amount of inventory it had to finance. Consumers would also restrict purchases which required credit financing. These actions would reduce machine tool orders, construction outlays, and sales of autos, houses, major appliances, furniture, and other big-ticket items. As sales decline, inventories would accumulate, forcing businesses to cut back on production and to lay off employees. Since the unemployed spend less on items such as clothing, gasoline, restaurant meals, and entertainment, rising unemployment in manufacturing industries would spread to other sectors of the economy, leading the nation back into recession. For these reasons, it is extremely important for Congress to take action now to close the deficit to prevent another recession in the next 18 to 24 months.

An expanding economy creates more jobs and generates more income and savings, thereby increasing the pool of funds available for lending. It also stimulates higher business profits from which to finance inventories, acquisitions, and expansions, thereby reducing industry demand for credit. Both factors normally help push interest rates down. However, for the next several years, this downward pressure on interest rates will be more than offset by increased government borrowing, keeping interest rates at approximately the same level as they are now.

## Auto Sales

Auto sales have shown large and continuous year-to-year gains in eight of the past nine months. Most of the sales increases have benefited domestic manufacturers. While foreign manufacturers accounted for over 30% of U.S. auto sales in January 1983, their share declined to 24.6% in March and has recently fluctuated around 28%. Domestic sales tapered off in August as low inventories of 1983 models frustrated the buying plans of many consumers. As 1984 models begin appearing on dealers' lots this month, domestic sales should start to grow again. Total domestic and foreign auto sales in calendar 1983 will reach 8.9 million to 9.1 million units. An improving economy, pent-up consumer demand, and decreasing supplies of used cars will continue to stimulate auto sales in 1984, when total sales will reach approximately 9.9 million units.

Abundant oil supplies and stabilizing gasoline prices have made consumers less concerned about fuel efficiency and more concerned about style and comfort. This shift in emphasis has encouraged a switch away from the smaller, more fuel-efficient compact and subcompact models, which foreign manufacturers have marketed so successfully in the United States, and has increased sales of larger, more luxurious vehicles manufactured by domestic automakers. As a result, U.S. automakers will benefit disproportionately from this 1984 sales increase and will squeeze the import share of the auto market to about 27.5% from the current 28.4%.

## Housing Starts

Despite rising mortgage rates, housing construction is expected to show continued improvement through 1985. Government intervention is responsible for a share of renewed housing activity; recently 22 states have sold bonds to finance lower mortgage rates. Builders have also subsidized mortgage rates by using buy-downs, which permit new homeowners to make reduced mortgage payments during the early years of the mortgage. In addition, deregulation of financial institutions has enabled savings and loan associations (S & Ls), traditional suppliers of mortgages, to pay higher interest rates on their deposits, allowing them to maintain a large pool of funds with which to finance mortgages. Prior to deregulation, depositors would transfer their funds to other institutions and to other financial assets when the interest rate available at savings and loan associations was no longer comparable with returns elsewhere, due to the ceiling on the interest rates S & Ls could pay. These institutions are now flush with funds and eager to back new mortgages. Use of innovative financing techniques, combined with these other factors, has kept housing construction active in spite of high mortgage rates. As the economy continues to improve, housing starts nationwide will increase from 1.7 million units in 1983 to 1.9 million units in 1984.

## Consumer Prices

The rate of inflation as measured by the consumer price index will average a mere 3.1% in 1983, the lowest rate of increase in almost two decades. The major factors responsible for this remarkably small increase are energy and food prices and wage concessions. A worldwide oil glut contributed to a petroleum price cut of over 15%, reducing not only the price of gasoline and other petroleum fuels, but also the raw material costs of a wide variety of manufactured goods.

Food prices have also moderated. While a combination of the payment in kind (PIK) program, drought, flooding, and other severe weather conditions reduced corn, soybean, and vegetable harvests and led to increased prices, it also raised feed prices for cattle and hog producers. Rather than pay the additional cost for feed, meat producers sold much of their stock, increasing the supply of meat and contributing to a decline in meat prices. Since meat is by far the most expensive item among consumer food outlays, the decline in meat prices more than offset the higher cost of fresh vegetables.

Wage concessions have also contributed to lower rates of inflation. As unemployment continued to climb last year, many employees agreed to relinquish hard-won fringe benefits, granted pay concessions, or agreed to extraordinarily small wage and cost-of-living settlements in an attempt to preserve their jobs and prevent additional layoffs. As a result, unit labor costs rose more slowly than other producer and consumer prices. Lower labor costs were also largely responsible for improving business profitability during the first and second quarters of 1983. However, when the economy moves out of recession, labor typically demands and receives settlements which cause unit labor costs to rise more rapidly than other prices.

The combination of these factors builds a higher base for inflation in 1984. Slaughter of livestock this fall will contribute to meat shortages and higher prices next spring, almost certainly guaranteeing higher food prices next year. As a consequence, inflation will increase to 4.5% in 1984 from the projected rate of 3.1% in 1983.

## Unemployment

Unemployment will continue to decline slowly. Industry's resolve to increase productivity, reduce per unit labor costs, and improve its competitive position in the world marketplace will lead to higher levels of output without commensurate increases in employment. In addition, the entry of new job applicants into the job market and the reentry of discouraged jobseekers will initially increase the size of the labor force and the number of unemployed individuals, helping to keep the unemployment rate high even through businesses have started to hire more workers. Unemployment nationwide will average 9.7% in 1983 and decline slowly to 8.8% in 1984. Michigan's unemployment rate will average 14.6% in 1983 before declining to 12.8% in 1984.

## Personal Income

Despite the slow gains in employment, increased dividend earnings from higher business profits, combined with a decreased need for federal and state entitlement programs, will contribute to a 2% increase in inflation-adjusted personal income during 1983. As the economic recovery continues through 1984, real personal income will rise by an average of 3%.

## Summary

Although the economic recovery started off slowly, it quickly gained momentum and has settled into a pattern of expansion which is in almost all respects average for post-World War II recoveries. In part because the recession lasted so long and was so severe, the economy is comparatively lean and efficient. The resulting improvements in productivity and efficiency have reduced the volume of activity required for businesses to show a profit. In addition to boosting profits, these improvements have reversed the trend of inflation and offer promise of a transition to a sustained period of lower inflation. Such a transition would benefit all sectors of the economy, including government as well as business and labor.

In conclusion, the United States can expect continued expansion and economic growth throughout 1984. However, unless remedial action is taken soon to correct the imbalance between federal outlays and receipts, the resulting conflict between government spending policy and the Federal Reserve Board's monetary policy will force interest rates to rise so high that economic growth will be choked off, causing recession to set in. Successful resolution of the federal budget problem could permit a more enduring period of economic growth.