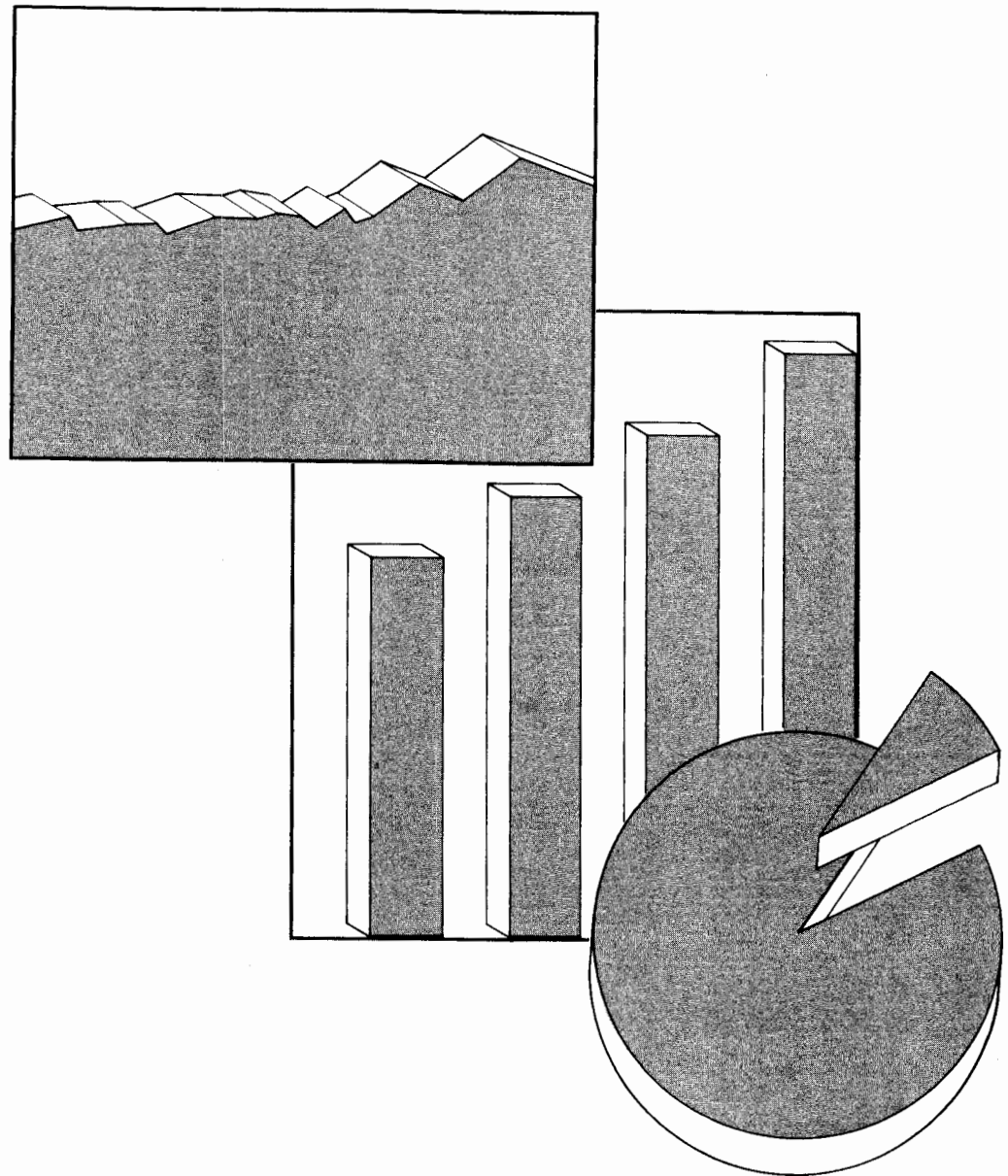


Third Quarterly Economic Forecast

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OVERVIEW

Compared with the anemic second quarter, economic activity in the third quarter was considerably improved. The gross national product rose by 2.8 percent compared with an increase of 1.9 percent in the previous quarter. The fourth quarter is expected to be generally stronger than the third, particularly in Michigan.

Monetary Policy

The favorable fourth quarter outlook is a product largely of a very loose monetary stance on the part of the Board of Governors of the nation's Federal Reserve System. Alarmed by torpor in the first half of the year, the Fed ordered its money managers to increase the nation's money stock more rapidly.

Now, with a much brighter economic outlook, all Street anticipates tighter money, a view that is manifest in rising interest rates. No real credit crunch is on the horizon, however, because of the difficulty that very high interest rates would cause countries such as Mexico, which is already hard pressed by declining petroleum prices. Oil price reductions coupled with excess productive capacity in the U.S. economy make it unlikely that price inflation will become more serious in the months ahead.

Leading Indicators

In August, the index of leading indicators of the national economy rose for the fourth consecutive month. The leading indicators index is comprised of economic statistics such as stock market prices; the volume of money available for spending by consumers, producers, and government; and the length of the workweek in manufacturing. This index historically has signaled changes in the aggregate level of economic activity. A sustained rise in the indicators is a portent of an expanding national economy and, conversely, several months of decline often precede an economic downturn.

Consumer Spending

According to both the Survey Research Center at the University of Michigan and The Conference Board in New York, consumers continue to be buoyant about their personal economic circumstances for the months ahead. Consumer spending is currently the dominant force in the nation's economic expansion. Retail sales surged 2.3 percent in August and 2.7 percent in September.

The proportion of income that consumers devote to servicing their burgeoning debt has continued to creep up, quarter after quarter. The proportion of income that consumers save averaged 4.2 percent during the first half of this year compared with 5.2 percent for all of 1984. During the third quarter, the rate of saving was very depressed as a result of the current buying spree.

Unemployment

Nationally, unemployment, which stood at 7.3 percent of the civilian work force from February through July, declined to 7.0 percent in August. Due largely to intermittent shutdowns in the automotive industry, the unemployment rate edged up again to 7.1 percent in September. In Michigan, the rate rose from 10.2 percent in August to 10.9 percent in September.

Income

According to the most recent tabulations from the Census Bureau, U.S. median family income is currently outpacing inflation.

In 1984, median family income was \$26,430, 7.7 percent higher than the 1983 median of \$24,550. After adjusting for the 4.3 percent increase in consumer prices between 1983 and 1984, real median family income still showed a significant gain of 3.3 percent. Not since 1972 has family income increased at a faster rate.¹

¹Bureau of the Census, *Current Population Reports, Consumer Income*, Series P-60, no. 149 (1985), p. 1.

In 1984 for the first time since the mid-1970s, there was a significant decline in the poverty rate except for two broad population categories: Black and Spanish-origin children. Black poverty has been particularly intense in Detroit as a result of the legions of automotive workers who have been displaced since 1979.

Between 1982 and 1984, there was a sharp increase in the proportion of families in the \$50,000 or over category. The proportion of families with incomes below \$15,000 fell appreciably, and the proportion with incomes between \$15,000 and \$50,000 declined modestly. The decade-old trend toward greater income inequality in this country, and in Michigan, is expected to continue.

Per capita real personal income, another measure of well-being, rose by 4.9 percent in 1984 and surpassed the previous peak reached in 1979. For Michigan, the 1984 per capita real personal income figure was 5.2 percent above that for 1983 but still well below the previous peak for this state, which was reached in 1978.

Evidence so far for 1985 suggests that both current incomes and prices have increased at a more modest pace than they did during 1984. Real income will also post a modest gain. Even with the pickup in the second half, 1985 real income gains are expected to be less pronounced than last year. For both Michigan and the nation, the rate of increase in real per capita personal income will be between 3 and 4 percent for 1985.

Productivity and Prices (Inflation)

The low rate of inflation continues to be the bright spot in the economy. The Consumer Price Index rose by 3.2 percent in 1983 and 4.3 percent in 1984 compared with a double-digit figure as recently as 1981. The projected increase for 1985 is 3.7 percent.

The prospect for holding down inflation in the short and long term is very favorable, due in large part to the downward pressure on oil prices, caused by the worldwide glut of petroleum, and the favorable outlook for productivity (output per hour for all persons employed in the private, nonfarm business sector).

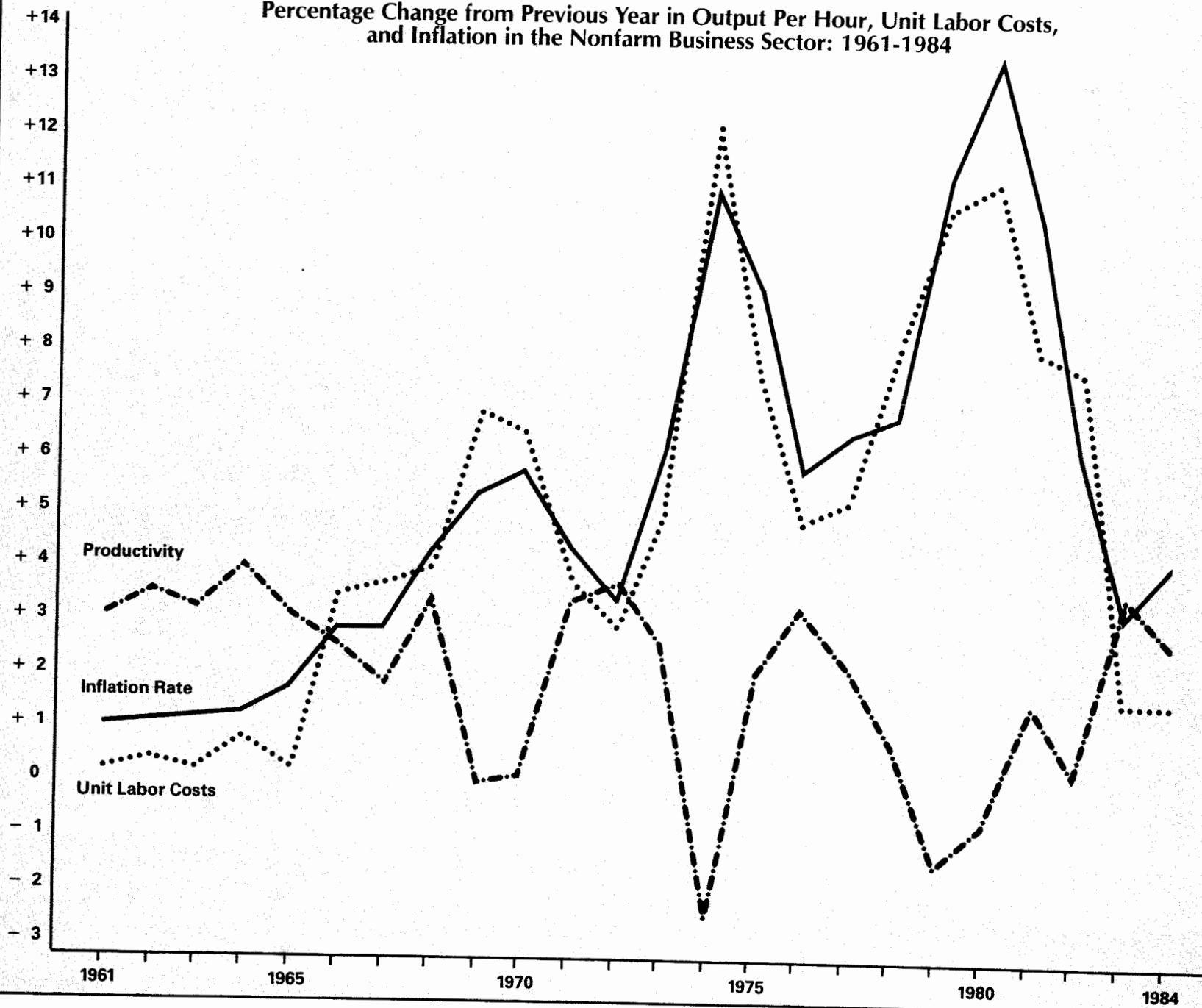
The high rates of inflation in the late 1970s and early 1980s were due, in part, to poor productivity in the U.S. economy. From 1977 to 1982, there was no improvement in productivity, and in fact, it actually declined 1.5 percent in 1979 and 0.7 percent in 1980. At the same time, compensation per hour increased by more than 8 percent annually, resulting in an increase in labor costs of more than 9 percent per year. (See Figure 1.)

In 1983 productivity rebounded with the economy, increasing 3.5 percent, the largest increase since 1972. (Productivity in the motor vehicle industry increased 14 percent in 1983.) In 1984, productivity increased a respectable 2.7 percent. Partly as a result of improved productivity, labor costs increased only 1.4 percent in both 1983 and 1984, which largely explains the low rates of inflation. The productivity performance in the first half of 1985 was poor, but this was not unexpected at this stage of the economic recovery. Labor productivity usually rises rapidly in the early months of a business expansion because production gains enable companies to use their workforces more efficiently. Then, as an expansion matures, productivity begins to suffer because businesses add workers to meet anticipated future demand and factories are operated beyond their optimum rate.

Despite the recent slowdown in productivity, the long-term outlook remains favorable for a number of reasons.

1. Business fixed investment has been strong, helping to diffuse new technology and increase real capital per worker.
2. Real outlays for research and development have been rising for several years.
3. Outlays for education and training continue to rise.
4. The baby-boom generation is entering the prime working ages, becoming mature and highly productive workers. Their presence is increasing rather than depressing productivity, as it did a decade ago.
5. The costs of regulation have leveled off, after increasing sharply in the 1960s and 1970s.
6. The current economic recovery is opening

FIGURE 1
Percentage Change from Previous Year in Output Per Hour, Unit Labor Costs,
and Inflation in the Nonfarm Business Sector: 1961-1984



up more economies of scale and improving capacity utilization rates.

7. Labor-management relations have improved, with more emphasis on increasing efficiency.
8. The decline in energy-intensive prices since 1981 has moderated the trend toward less energy-intensive, but often lower-productivity, equipment.²

Improved productivity will be a major factor in keeping inflation under control in the next few years — increasing the chances for a continuation of the current economic expansion.

Foreign Trade and the Value of the Dollar

During July, imports declined sharply. This nation's trade deficit with other countries narrowed from an annual rate of \$161 billion in June to \$126 billion in July, and there was further improvement in August. The value of the U.S. dollar against other major currencies has declined since February, raising the prices of goods imported to the United States and reducing the prices of exported goods. Moreover, the economies of Canada and several other of our principal trading partners have exhibited considerably more strength than ours in recent months, lessening their pressure to export to the United States.

Vehicle Sales and Production

Other good news, particularly for residents of the Wolverine State, is the very brisk rate of new car and truck sales during August and September. As a result, this country's vehicle manufacturers have the most ambitious fourth-quarter production schedules since 1978. For the first time since February, all of Michigan's assembly plants will be producing.

In addition, Saturn headquarters, along with the engineering, research, and development components of that organization, will be located in Michigan. That, plus the merger of Electronic Data Systems (EDS) into General Motors, means there are thousands of additional GM white collar, high-paying jobs on the horizon.

²John Kendrick, "Prospects for Productivity Gains: 1984-1990," *Economic Policy Issues*, no. 4 (New York: The Conference Board, Inc., 1984), p. 8.

Increasingly, auto manufacturers are turning to their suppliers and to independent consultants and laboratories in their search for better materials and better means to manage resources. The research and development facilities of many suppliers are located in southeast Michigan because of the advantage of being at the heart of this nation's "automotive culture." Many of these facilities are being expanded and new ones are opening. Oakland and Washtenaw counties are the focus of vehicle technology. Ann Arbor has become known as Automation Alley.³ If the motor vehicle industry is considered "high tech," according to a recent analysis Michigan ranks second only to Delaware in high technology employment as a percentage of total nonagricultural employment.⁴

Construction

During 1983 and 1984, residential construction was a stellar performer in this country in terms of its contribution to the recovery. But thus far in 1985, this industry's performance has been lackluster. The value of new residential units in place is well below last summer's pace. An especially depressed segment is single-family housing. Total private residential construction is well below the record posted in 1973.

The building of new offices and stores continues to pace the industry, whereas factory construction has leveled off. The volume of total, nonresidential private construction set a new record during 1984, a level that likely will be surpassed in 1985. Highways, bridges, and other public construction have been depressed for a number of years — the record level of activity was 1968.

In Michigan, construction has been an exceptionally depressed industry since 1979, as shown by employment and by our share of building permits for the five most important categories (Table 1). The two construction sectors in which Michigan is performing reasonably well are industrial building and the rehabilitation of existing structures. About a third of the units to be rehabilitated are located in Wayne County, with another third in Macomb and Oakland counties combined.

³Kenneth R. Sheets, "Silicon Valley Doesn't Hold All the Chips," *U.S. News and World Report*, 26 August 1985, p. 45.

⁴John U. Burgan, "Cyclical Behavior of High Tech Industries," *Monthly Labor Review*, May 1985, p. 14.

TABLE 1
Michigan Indicators of Construction Activity: 1979-1985

Year	Employment (in thousands)	Percentage Share of U.S. Valuation of Building Permits				
		Residential	Industrial	Office	Mercantile	Rehabilitation
1979	139.5	3.4%	5.7%	2.5%	3.3%	2.7%
1980	116.8	2.5	4.0	2.6	2.4	4.6
1981	106.8	2.0	4.6	1.4	2.4	3.1
1982	89.5	1.5	5.1	.9	1.3	2.5
1983	86.5	1.5	2.7	1.7	1.6	2.8
1984	89.2	1.8	3.8	2.3	1.8	3.4
1985 ^a	89.2	2.2	5.0	3.5	2.6	4.3

SOURCE: Developed from Michigan Employment Security Commission, special release; and Bureau of the Census, special release.

^aProjections by the author based upon incomplete data for 1985.

OUTLOOK

The fourth quarter of 1985 promises to be even stronger than the third, especially in Michigan. (This forecast is based on the assumption that the U.S. and Canadian Chrysler strike will be less than six weeks' duration.) Four months ago, leading indicators and a number of other economic series were suggesting underlying weakness in the U.S. economy. Now, on balance, economic data point to underlying strength, particularly for Michigan. The first half of 1986 will be stronger than previously anticipated, but the prospects for recession beginning in the final half still are significant.

On the automotive front, the key question is: how much are the clearance sales of 1985 models taking from the 1986 production run? Some, to be sure. This, coupled with the general financial overextension of consumers and the onslaught of imports suggests that vehicle inventories will be getting out of hand by February or March. Production cuts seem likely. But Michigan still will be phasing in its new Poletown and Willow Run assembly plants and, for 1986 as a whole, Michigan vehicle production will increase, unless national sales are much weaker than expected. Vehicle sales are expected to total 15.4 million units for all of

1986. This will be a slight decline from 1985, and imports will comprise a larger share.

The construction industry also should fare considerably better in Michigan during 1986 because of increased building permit activity this year. All factors considered, by the end of 1985, Michigan's unemployment rate is likely to lie in the 9.5 to 10 percent range, compared with 10.9 percent in September.

See Table 2 for the expected behavior of the broad economic indicators during the fourth quarter.

COMPARISON OF THE CURRENT ECONOMIC EXPANSION WITH THE 1961 TURNAROUND

In 1982, the depth of the recession, civilian employment in this state averaged 360,000 below the figure for 1979, the previous peak. While in the nation as a whole, civilian employment was up by 700,000, in Michigan the unemployment rate had doubled, going from 7.8 percent to 15.5 percent.

In 1979, before the onset of the recession, Michigan's automotive industry employed approx-

TABLE 2
Projections of Michigan and the United States
Broad Economic Indicators,
1985 and 1986

	1984	1985	1986	Percentage Change	
				1984-1985	1985-1986
Earnings (current \$ in millions)					
Michigan	81,382	86,900	93,800	6.8%	7.9%
United States	2,141,000	2,286,000	2,426,000	6.8	6.0
Earnings (1984 \$ in millions)					
Michigan	81,382	83,800	87,200	3.0	4.1
United States	2,141,000	2,204,000	2,256,000	2.9	2.4
Civilian Employment (thousands)					
Michigan	3,871	3,930	4,050	1.5	3.1
United States	105,005	107,300	109,000	2.2	1.6
Vehicle Production (thousands)					
Michigan	3,000	3,300	3,400	10.0	3.0
United States	10,900	11,500	11,100	5.5	-3.5
Unemployment Rate (% of civilian work force)					
Michigan	11.2%	10.0%	9.5%	-	-
United States	7.5%	7.2%	7.6%	-	-

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

imately 750,000 people in the manufacture of vehicles and components for vehicles. By 1982, there were around 500,000 so engaged. In relative terms, several small labor markets in northern Michigan were hardest hit, but in terms of sheer numbers, Detroit, Flint, and other mature automotive centers felt the brunt. In the city of Detroit, about one person in eight lived in poverty in 1979; by 1982, that figure was more than one in three.

The recent recessionary period was not unlike 1956-1961, when Michigan employment declined by 270,000 in the face of a national increase of nearly 2 million. During the earlier period, Michigan lost the Packard and the Hudson companies.

In 1961, however, the nation stood on the threshold of a new era. The interstate highway system, initiated in 1956, was well under way.

Families were moving to the suburbs and demanding more and more personal transportation to work and to the new shopping malls. Gasoline was cheap. The love affair was on. Cars grew in size and power, and personal trucks began to appear in the suburbs.

As cars became bigger and more plentiful, iron and steel production set new records; Michigan's share of that production rose. Other supplier plants expanded their Michigan operations. By 1965, the unemployment rate here was below 4 percent with 4.5 percent nationally, and southeast Michigan was experiencing a labor shortage.

In contrast to the 1960s, the 1980s is a decade of downsizing, a reversal of many of the trends of twenty years ago. For Michigan, the results are evi-

dent in the nonfarm wage and salary employment figures in Table 3. Employment in durable goods manufacturing is not now as dominant as it was in the earlier era, either here or nationally. Nor is it the engine of growth that it once was. With smaller cars, steel requirements are far less, and a larger proportion of those requirements are met by foreign producers. In contrast, the nation's mills produced 133 million tons of steel in 1966 for use in vehicles and machinery, as well as in highways, bridges, and other structures. The 1985 figure will be about 81 million tons. For Michigan, the 1985 figure is projected to be about 6.5 million tons compared with 10 million in 1966. Both here and nationally, steel production peaked in 1973. The stories of foundries, forgings, and a number of other automotive-related industries are similar.

TABLE 3
Percentage Change in Nonfarm Wage and Salary Employment
in Michigan and the United States,
by Industry Group: 1961-1963 and 1982-1984

	Michigan		United States	
	1961-1963	1982-1984	1961-1963	1982-1984
Manufacturing				
Durable Goods	13.5%	8.6%	6.0%	4.4%
Motor Vehicles	17.7	11.6	17.2	23.0
Nondurable Goods	4.6	5.1	1.7	1.9
Construction	3.1	-.3	5.3	11.3
Transportation, Communication, and Public Utilities	-.2	-3.3	0	1.8
Wholesale	4.1	12.8	3.7	5.2
Retail	1.4	5.7	4.0	9.3
Finance, Insurance, and Real Estate	3.9	1.3	5.3	6.4
Services	10.1	7.1	8.6	9.1
Mining	-3.7	-9.6	-5.5	13.7
Government	6.6	-2.0	7.3	.9
TOTAL	7.4%	4.7%	4.9%	5.5%

SOURCE: Developed from Michigan Employment Security Commission, special release; and Bureau of Labor Statistics, *Supplement to Employment and Earnings* (Washington, D.C.: 1985), pp. 3, 4, 8, 13, 62, 76, 120, 127, 136, 147, 153, and 165; and various previous *Supplements*.

Between 1957 and 1961, productivity in the automotive industry grew by 17 percent. Between 1977 and 1982 there was no growth. In 1961, the hourly wage rate in motor vehicles was 24 percent above the figure for all manufacturing industries; for steel it was 36 percent above the manufacturing average. In 1982, automotive and steel industry wage levels had climbed even higher to 37 percent and 57 percent, respectively, above those for manufacturing as a whole. The cost of labor to produce materials for vehicle production, and to produce the vehicles themselves, quite simply grew out of line with the rest of the American economy. Now, those high wages are being validated with better productivity, meaning more car, truck, and bus production with fewer workers. Indeed, motor vehicle manufacturing productivity soared by 14 percent in 1983, the most recent year for which data are available.

To be competitive, the industry also is turning more and more to "outsourcing," the use of foreign sources for components. To be competitive in the

very small car market, Detroit will be outsourcing entire vehicles; partners in Korea and Japan will be building mini-compacts and shipping them to the United States for sale by domestic manufacturers.

The loss of the GM Saturn plant was a heavy blow. (A PSC special memorandum analyzing the lessons of Saturn will be issued soon.) That facility, with the supplier plants that would have located nearby, would have absorbed a great many more displaced Michigan automotive workers than will now be the case. For Michigan, ironically, prosperity can be sustained only if there are fewer employees in the automotive plants and offices already in the state.

In short, the Michigan turnaround this time has been much weaker than the rebound of the 1960s. The economic structural changes that have been taking place in recent years have not favored job expansion in the way that they did two decades ago.

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