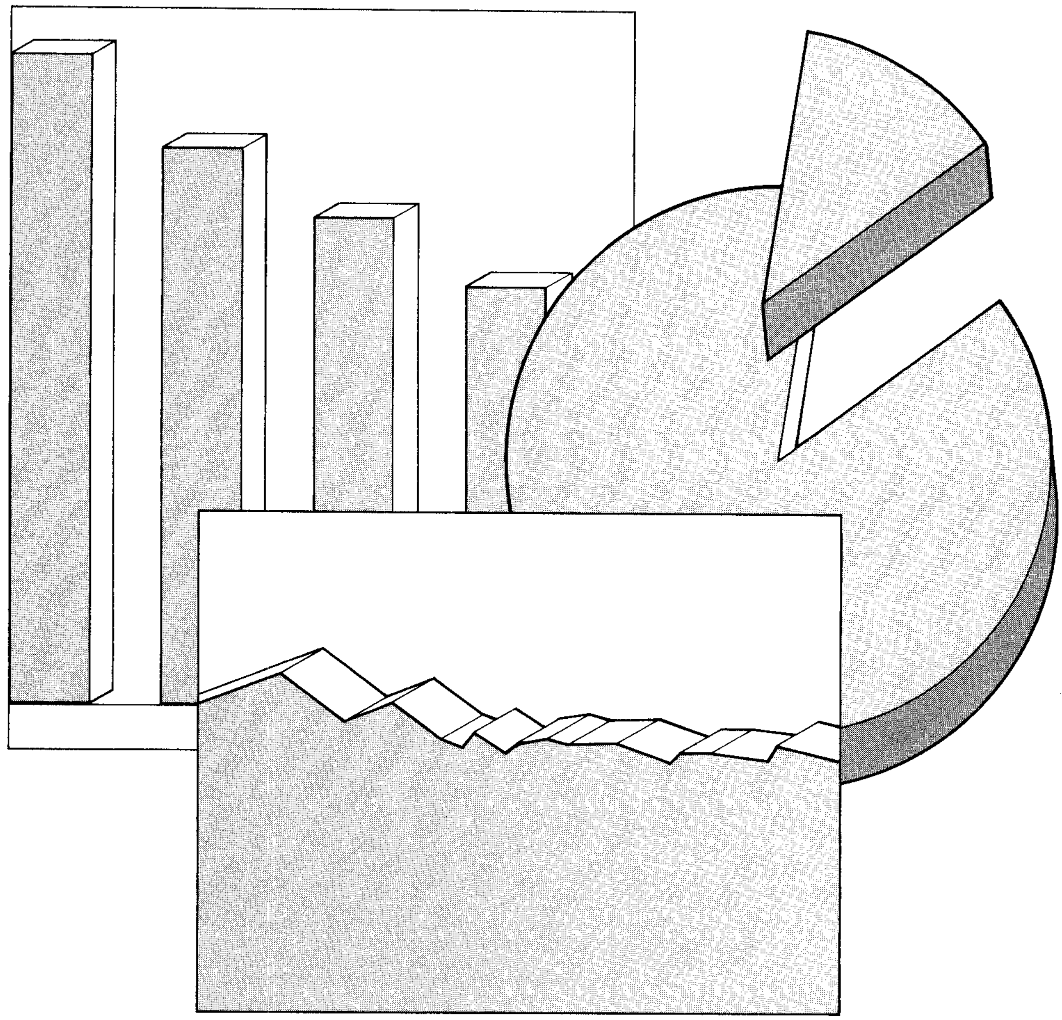
Fourth Quarterly Economic Forecast

November 1984



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

Economic Overview

Since September a broad range of statistics have indicated a significant slowing in the economy's growth and raised concern in the financial community that the U.S. economy is again poised on the edge of a recession. Compounding this perception are projections of a $130 billion trade deficit and revised estimates by the Reagan administration predicting a probable 1984-85 federal budget deficit of $210 billion.

These recent figures confirm our predictions of a year ago that the economy would grow briskly in 1984 before stalling midway through 1985. We look for the onset of a recession at that time, but its character will differ fundamentally from the recession experienced during 1980-82. While that recession was marked by major contractions in employment, output, and personal income, we expect a 1985 recession will show continued economic growth but at significantly lower rates of increase than in 1983 and 1984. We also look for a slight decline in interest rates during the first part of the year but expect interest rates will once again resume their upward course by mid-1985. Highlights of this quarter's economic forecast are as follows:

* Interest rates will remain relatively constant, falling slightly through the first part of 1985 before rising again to 1984 levels.
* National and state unemployment rates will decline modestly. The U.S. unemployment rate will fall to 7.3% in 1985 from 7.6% in 1984, while Michigan's unemployment rate will drop to 10.5% in 1985 from an average of 11.2% in 1984.
* Total auto sales in the United States will be constrained at 10.4 million units in 1984 and will rise slightly to 10.5 million units in 1985.
* Consumer prices will remain fairly steady through next year, rising by 4% nationally this year and next. The Detroit Consumer Price Index will show an increase of 3.6% annually for the same periods.
* Housing starts nationally will average 1.8 million units this year, dropping to 1.6 million units in 1985.
* Inflation-adjusted personal income will increase by 5.6% in 1984 and 4.1% in 1985.

Leading Economic Indicators

Designed to predict the strength of economic activity during the subsequent 12- to 16-month period, the monthly Index of Leading Economic Indicators is the principal barometer for determining whether the economy is growing or contracting. Components of the index are the number of new claims filed for unemployment insurance, length of the average workweek, building permits issued, orders for new plant and equipment, vendor deliveries, business inventories, private sector credit demand, net growth in the nation's money supply, stock market prices, net new business incorporations, prices of raw materials, and orders for consumer goods.

Only ten of the twelve components are immediately available for preliminary calculation of the monthly index. As data on business inventories and private sector credit demand become available, the index is recalculated and a revised figure released. Consistent increases in the index indicate that the economy will continue to expand during the next year. Vacillation between monthly increases and decreases in the index suggest that the economy is stabilizing. Three consecutive monthly declines in the index typically signal a recession. However, the index tends to overstate the frequency of recessions and has often predicted economic downturns which never materialized.

The Index of Leading Economic Indicators declined 0.9% in June, 0.8% in July, and rose 0.5% in August. The August increase was later revised to a 0.1% decline, producing the "magic" three months of consecutive decline used to foretell a recession. However, since other data on the economy continued to indicate strong activity, the validity of the index came into question. This question was temporarily set aside by release of September's preliminary index showing a 0.4% increase.

As additional data have tended to substantiate spreading economic weakness, there is reason to believe that the preliminary September increase in the index will be transformed into a decrease when the other two components are included and a revised reading is released next month along with a preliminary reading for October. With the approach of the traditionally strong holiday sales period, we expect the index will continue to rise and fall with a mixture of increases and decreases, leaving the official status of the economy in doubt (recession vs. expansion) for several more months. As we noted in the previous forecast:

> 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 workweek 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.

Consequently, the index must be only one of several measures used to gauge the performance of the economy. The remainder of this forecast examines several other important economic variables.

$ $ $ $ $ $ Interest Rates

The prime lending rate is the interest rate that banks charge their most creditworthy corporate customers. Since late September the prime rate has been reduced six times, falling from 13% to 11.25%. As many other corporate and consumer interest rates are pegged to the prime rate, they have floated down with the prime.

In the short term, this easing of interest rates should stimulate economic activity by reducing the cost to the borrower of financing autos, houses, furniture and appliances, business inventories, and manufacturing equipment. As financing costs fall, total monthly payments on purchases become affordable for more people and generate sales to those who were previously locked out of the market because of high credit costs. A decline in the total purchase and finance costs effectively broadens the market by making goods affordable for a larger group of buyers.

Over the longer term the economic consequences of lower interest rates are more ambiguous. If credit conditions are eased to stimulate the economy artificially and the resulting demand cannot be met by existing output capacity, prices will be bid up and the consequence will be a renewed surge in inflation. If the credit markets regain confidence in the government's ability to contain inflation and interest rates fall to a more typical two to three percentage point spread above the annual rate of inflation, lower interest rates can stimulate economic growth without additional inflationary pressures.

The economy currently has considerable excess manufacturing capacity. During the past several months, the capacity utilization rate has hovered around 82%, below the 85% rate which generally triggers expansion and increased financing requirements. Thus, production could expand considerably without generating additional upward pressures on either prices or interest rates. However, a growing economy entails increased borrowing by both consumers and businesses. Should the economy continue to expand rapidly, any consequent large increases in private sector demands for credit, either from consumers to finance purchases of goods or from businesses to finance inventories or expansion, could frustrate long-term economic growth.

With a projected federal budget deficit of approximately $210 billion for fiscal year 1984-85, a major share of the available pool of credit funds will be borrowed by the government to cover the federal debt. The federal government will continue to borrow regardless of the cost of credit and will pay whatever interest rate is required to attract the funds it needs. The remaining funds are available to the private sector. With consumers and businesses engaged in a bidding war against the government for credit, interest rates will remain more than two to three percentage points above the inflation rate. If the Federal Reserve Board attempts to satisfy all credit demands by increasing the supply of money, the consequence may be inflation with recession. If it does not, the ensuing credit crunch may maintain price stability but still produce recession.

In our last forecast we noted the creation of a possible escape hatch. The 1984 tax law eliminated foreign tax credits for U.S. companies with overseas subsidiaries. Under this new law, U.S. companies could sell tax-exempt bonds to foreign investors. The intent was to open up foreign credit markets and to prevent a domestic credit crunch. To date, however, these bond sales have met with a less than enthusiastic reception due to U.S. registration requirements and restrictions on resale of the securities. Most bonds purchased so far have been bought for international political and trade considerations. Consequently, the potential success of this strategy to avoid a U.S. credit crunch appears very limited. We look for a weakening economy to force interest rates to dip slightly during the end of this quarter and into the first part of 1985 but rise again to 1984 levels by late spring as the effect of this credit crunch begins to be felt.

Unemployment

Both the national and state unemployment rates have stabilized during the past several months. The national unemployment rate has fluctuated between 7.4% and 7.5% since July, while Michigan's unemployment rate declined from 11.5% in July to 10.9% in August, the same rate as in October. Both have shown remarkable improvement since November 1982, the last month of the most recent recession. At that time the national unemployment rate stood at 10.7%, while Michigan's unemployment rate had reached 17.0%.

A major reason that the unemployment rate has stabilized is that the number of new jobs created has matched the number of new job seekers entering the labor force. However, the employment gains of the early months of the economic recovery are not likely soon to be repeated. As growth in the economy has slowed, fewer new jobs are being created. While some additional employment will be generated during the heavy retail months of November and December, employers are being cautious and are unlikely to do as much hiring as is usual at this time of year. Consequently, after adjustment for seasonal variations, the unemployment rates for both the United States and Michigan may actually rise during November and December.

Nationally, employment in the service industries has grown most rapidly this year, expanding by 27% (570,000 jobs) in the eight months ending in August. Trade employment grew almost as much with employment expanding by 25% (537,000 jobs); manufacturing employment came in third with a gain of 23% (486,000 jobs). Employment in mining increased 2%, government 3%, transportation 4%, finance 6%, and construction 10%.

Michigan's employment gains have paralleled the national trends with the state gaining 15,000 jobs in service industries, 28,000 in trade, and 26,000 in construction during the first eight months of 1984. Michigan's manufacturing, although up by 7,700 jobs, still employed 229,000 fewer people than before the 1980-82 recession. Employment in government and in transportation declined statewide in the January-August period.

Employment prospects during 1985 are somewhat less promising than for this year. Although we anticipate additional increases in consumer spending, relatively little of this spending will have any immediate benefit to the domestic economy. The reason is that part of this demand will be met through sales of current inventories and consequently will not entail increased production. In addition, the strength of the dollar will continue to make imported goods relatively less expensive than domestically produced goods. Increases in consumer spending on foreign goods stimulate employment and economic activity in other nations but not in the United States.

Since the labor force will continue to grow, the likelihood of major reductions in the unemployment rate is fairly remote. At the national level, we project that unemployment will average 7.6% during 1984, declining slightly to 7.3% during 1985. In Michigan, the 1984 un- employment rate will average 11.2% and decline to 10.5% in 1985.

Auto Sales

The General Motors strike, first in the United States and then in Canada, reduced automobile production and temporarily constrained sales. Nonetheless, 1984 auto sales are the strongest since 1979 and will likely total 10.4 million units, including both domestic and imported makes.

Interest rates have not proven to be a serious deterrent to auto sales. While fixed-rate loans are available, most consumers are choosing to finance their new vehicles with adjustable rate loans in the expectation that interest rates will decline, reducing financing costs. Import sales account for slightly more than 23% of total industry sales, down about two percentage points from their share in 1983.

Increased capacity will permit U.S. automakers to expand production in 1985. During the first part of the year, this larger capacity will permit higher sales, particularly of the more popular models. However, with the expiration of import quotas next spring, weakening of consumer spending, and anticipated increases in interest rates next summer, auto sales will trail off during the second half of the year. Auto sales will consequently total 10.5 million units in 1985, only marginally higher than the 10.4 million units projected for this year.

Inflation

Consumer prices have continued to show moderation this year and are likely to average an increase of 4% nationally for all of 1984. The Detroit Consumer Price Index is expected to show an even smaller increase, averaging 3.6% over the entire year.

Ample food supplies and declining energy prices have been major contributors to this price restraint. High foreign exchange rates and the abundance of high-quality imported goods have also increased the competitive pressures on U.S. producers and retailers, restricting their ability to charge higher prices without sacrificing market share. Moreover, prices paid by producers for raw materials such as steel and energy have shown virtually no increase this year. Since increases in producer prices tend to be passed on to the consumer, producer price stability has further eased pressures on consumer prices.

These influences are expected to continue through 1985. The major threat to stable prices comes from the labor sector. Workers perceive that recent record corporate profits were financed by employee wage concessions and insist that labor is due its share of the wealth. Higher wages might result in higher consumer prices, but given widespread import penetration in a broad variety of product markets, it is far more likely that higher wage costs would be at least partially absorbed by business. We expect that in 1985, management and labor will continue to negotiate arrangements in which labor receives a portion of the profit and some limited job security guarantees in exchange for relaxation of work rules. The net result is likely to be an increase in productivity with minimal pressure for price increases. Consequently, consumer prices will rise in 1985 at approximately the same rate as in 1984 -- 4% nationally, 3.6% in Michigan.

Housing Starts

Mortgage rates in November declined to their lowest level in six months, removing a major deterrent to housing starts. As interest rates continue to fall during the next several weeks, mortgage rates are expected to decline further. This may stimulate a modest recovery in housing construction over the next several months, providing secondary benefits to the rest of the economy. Housing activity is important not only for the direct stimulus it gives to the economy, but also for the indirect stimulus it provides to sales of appliances, home furnishings, and other consumer goods such as linens and lawn care equipment.

Housing starts nationally will average 1.8 million units during 1984. However, as the economy weakens and interest rates resume their upward trend late next spring, housing starts will begin to decline. Consequently, new starts during 1985 will total about 1.6 million units.

Personal Income

Personal income consists of several components. The largest is wage and salary earnings, comprising approximately 60% of total personal income. Other components are transfer payments such as Social Security, interest earnings and dividends, rental income, and assorted other payments. Since wage and salary earnings account for such a large share of total personal income, it is a major determinant of consumer spending levels and, consequently, of economic growth.

Total personal income increased 0.6% in October following a 0.7% increase in September and 0.6% in August. Growth in wage and salary earnings contributed less than one-fourth of the October gain in personal income. Wage and salary earnings rose only $4.2 billion in October, approximately one-third its $12.3 billion increase of September. Larger Social Security outlays and interest earnings accounted for more than half of the October increase in total personal income.

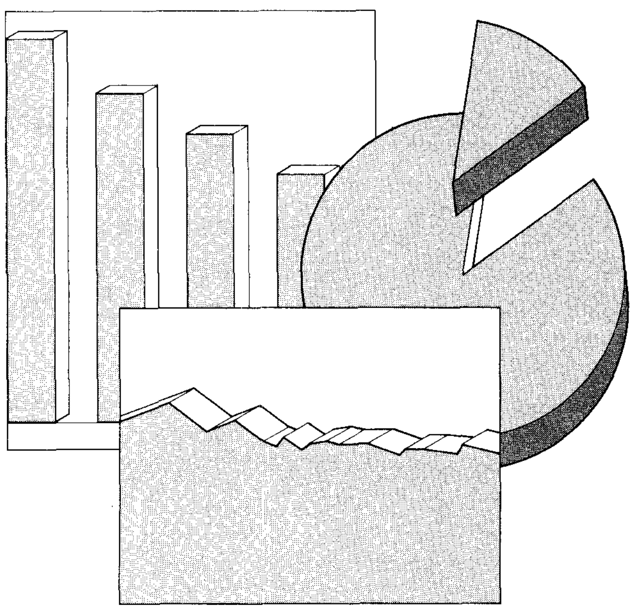
As hiring slows, aggregate wage and salary earnings will increase more slowly and consequently contribute less to future gains in total personal income. Since employment income is more likely than interest income to be spent for consumer goods, lower rates of growth in employment income will constrain consumer spending, further slowing economic growth.

After adjustment for inflation, we project that personal income will grow this year by an average rate of 5.6% and will rise during 1985 by a slower rate of 4.1%.

Summary

After a full year of rapid growth during 1984, the economy will slow significantly during 1985. Although this slower growth period will be characterized as a recession, the economy will not contract as it did in the 1980-82 period. Thus, measures of the economy will show a mixture of advances and declines. We project that the state and national unemployment rates will decline to an average of 10.5% and 7.3%, respectively, in 1985. Housing starts will decline by 200,000 units to 1.6 million; and inflation adjusted personal income will grow by 4.1% in 1985, down from 5.6% in 1984.

U.S. auto sales will rise slightly, to 10.5 million units from 10.4 million, during 1984. Consumer prices will remain constant, rising an average of 4% nationally and 3.6% in Michigan in both this year and the next. Interest rates will ease through the first quarter of 1985 before rising again to 1984 levels.



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- 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.

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- 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.

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- 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.

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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.

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