4861

ECONOMIC OUTLOOK USA

SUMMER 1988
Volume 15 Number 1

A quarterly publication of the
SURVEY RESEARCH CENTER
Institute for Social Research
THE UNIVERSITY OF MICHIGAN

S.H. Hymans, J.P. Crary and J.C. Wolfe
Mid-Year Review and Forecast:
The U.S. Economic Outlook for 1988-89

Paul Wachtel
What's Going on Here?—
Who Makes Economic Policy and Why?

William C. Dunkelberg
Optimistic Small Business Firms
Expect Continued Prosperity

Richard T. Curtin
Cautious Optimisim among Consumers

ECONOMIC OUTLOOK USA **Vol. 15, No. 1**
ISSN 0095-3830 / USPS 330-690 / Federal Tax No. 38-6006309

Published Quarterly by the
SURVEY RESEARCH CENTER
THE UNIVERSITY OF MICHIGAN
426 Thompson Street
P.O. Box 1248
Ann Arbor, Michigan 48106

EDITOR'S NOTE:
ECONOMIC OUTLOOK USA is designed to aid private and public decision makers in achieving a better understanding of the economic and social environment in which they will be operating. The analysis of this publication incorporates direct measurements of the expectations, attitudes and plans of both consumers and business firms with the economic and financial variables traditionally used in forecast models. The philosophy of this publication is that a blend of anticipatory and traditional measures provides richer insights into prospective developments, insights which will produce more consistently reliable forecasts of both economic and social change.

The opinions expressed in this publication represent those of individual authors and do not necessarily reflect the views of the Survey Research Center or The University of Michigan. The editor, as a matter of policy, makes no attempt to reconcile divergent opinions.

SUBSCRIPTIONS:
Regular Subscribers, $29.00 U.S. per year
Academic Subscribers, $15.00 U.S. per year (available to *individual faculty and students* only)

Quantity subscriptions are available at substantial discount. For 1-99 subscriptions, contact the Circulation Manager at the Survey Research Center address (phone: 313—936-0314). Subscribers to 100 or more copies may use their own imprint on the front cover and may use the back cover for a message to customers, executives, and others. Direct inquiries to the Executive Editor at the Survey Research Center (phone: 313—936-0099).

EDITOR: F. Thomas Juster
EXECUTIVE EDITOR: Richard Barfield

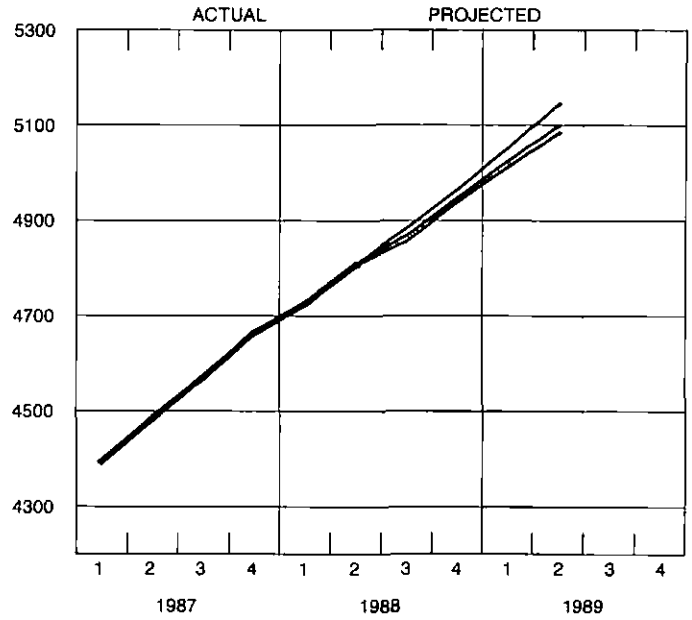
Editorial Board:
Richard Barfield
Richard T. Curtin
F. Thomas Juster
Paul W. McCracken
James N. Morgan
Burkhard Strumpel
Victor Zarnowitz

© 1988 by the University of Michigan. Second-class postage paid at Ann Arbor, Michigan. **Postmaster:** send address changes to ECONOMIC OUTLOOK USA, at the address given above. Printed in the U.S.A.

ECONOMIC PROSPECTS: Actual and projected seasonally adjusted quarterly data at annual rates.

GROSS NATIONAL PRODUCT

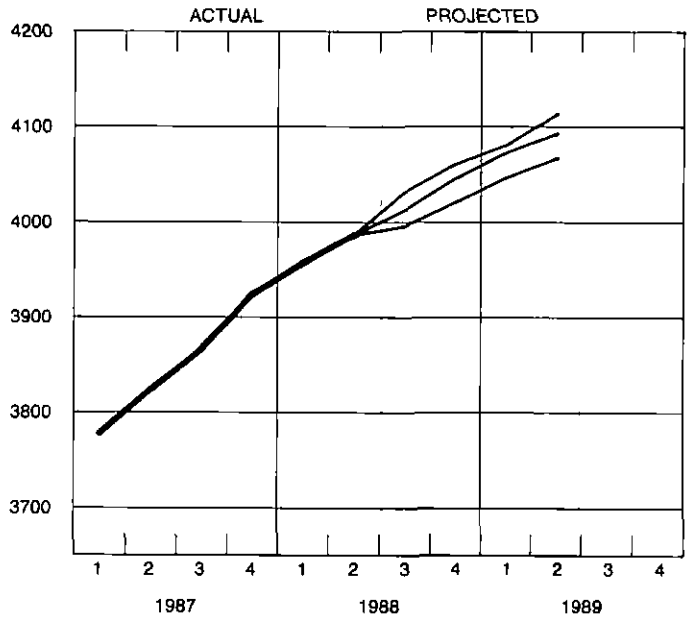
IN CURRENT DOLLARS
Billions of Dollars



Sources: Actual data are from U.S. Department of Commerce; projected data are from ASA-NBER Panel of Forecasters, revised when necessary to be consistent with latest actual data. The 3 lines display 3rd, 2nd (median), and 1st quartile values from the array of forecasts.

GROSS NATIONAL PRODUCT

IN CONSTANT 1982 DOLLARS
Billions of Dollars



Sources: Actual data are from U.S. Department of Commerce; projected data are from ASA-NBER Panel of Forecasters, revised when necessary to be consistent with latest actual data. The 3 lines display 3rd, 2nd (median), and 1st quartile values from the array of forecasts.

Mid-Year Review and Forecast: The U.S. Economic Outlook for 1988–89

Saul H. Hymans, Joan P. Crary, and Janet C. Wolfe
Research Seminar in Quantitative Economics
The University of Michigan

After the Crash

In presenting our forecast at the November 1987 Economic Outlook Conference, we concluded our analysis of the likely effects of the October stock market crash by saying, "We are therefore not convinced that the ...[crash]... will impart a long-term negative impulse to the state of aggregate demand." We went on to suggest, however, "...that some who would otherwise be both willing and able to make major expenditures will hold off for a few months just to be sure that their economic world is not collapsing around them. And that includes consumers ... and businesses...."

At the time, we were generally regarded as optimists and wishful thinkers. It turns out, instead, that *even we* were a bit too pessimistic. In November we had just come off a quarter, 1987:3, in which real final sales were (accurately) estimated to have risen sharply by 56.8 billion 1982 dollars. We forecast that the fourth quarter would experience a drop of $9.7 billion in real final sales — a temporary, post-crash drop in final demand — which would be followed by a resurgence to the tune of nearly $46 billion in the first quarter of 1988. Final demand was indeed well below par in the closing quarter of 1987, but it didn't fall below the third quarter level. Rather, it rose by just $3.7 billion, which amounts to less than 4/10 of one percent growth at annual rate. And with final sales having *held up* somewhat better than we had forecast, there was less to *make up* in the first quarter of this year. In fact, the net change in real final sales over the two quarters following 1987:3 was just under $38 billion, compared with $36 billion in our forecast.

Our accuracy in forecasting final demand following the stock market crash did not carry over to inventory investment. We expected businesses to be far more cautious in their production and ordering decisions than they turned out to be. Although inventory investment *has* declined since the first quarter of this year, inventory stocks still remain high relative to final sales, which will likely contribute to some slowing of overall economic growth during the second half of this year.

The Current State of the Economy

A more nearly complete picture of economic events before and since the stock market crash is presented by the data in Table 1, which will frame our discussion of the current state of the economy.

By mid-1984, only a year and a half into the economic recovery from the worst recession since the 1930s, the rate of growth of the American economy was already weakening. Although the consumption boom was continuing, more and more of U.S. demand was being satisfied by imports made cheap by a rising dollar. American manufacturing was falling far behind in the race to capture either domestic or foreign purchasing power.

Finally, in the early months of 1985, the dollar peaked. Based on quarterly averages, the dollar fell without stop for nearly two and one-half years, through mid-1987. By the second half of 1986 we were just beginning to feel the stimulative effects of dollar depreciation; export quantities were strengthening and manufacturing production was picking up. From the last quarter of 1986 to the stock market peak in the third quarter of 1987, real GNP rose at an annual rate of 4.7 percent (see Table 1), a considerable speed-up compared with the 2 percent growth of real GNP registered over the year *ending* in the fourth quarter of 1986. Among the major components of real GNP, only federal government purchases — already under pressure in the fight to control the budget deficit — and residential construction were declining. And in the case of home-building activity, the decline was primarily a reflection of the negative impact on apartment construction of the 1986 Tax Reform Act.

Inflation was clearly under control during 1987; for the private nonfarm sector as a whole, hourly compensation was rising at an annual rate of only 3.3 percent, while prices were rising at a rate of 2.9 percent. Consumer prices, on the other hand, were rising at a rate in excess of 5 percent; but much of this was the special reflection of oil prices, which were rising sharply again — at an annual rate of nearly 60 percent, as shown in Table 1 — following the major deflation of oil prices which had begun in late 1985. Non-oil imports were not making any substantial contribution to domestic inflation as the foreign suppliers of our imports continued to follow the dollar down in their pricing in order to hang on to the American market.

There was, of course, a general recognition that foreign producers couldn't cut their domestic-currency prices forever to hold on to the American market, and that ultimately we would indeed begin to feel a good deal more import inflation if the dollar continued to decline in value. In all likelihood, the dollar-support policy which came out of the Louvre Accord of February 1987 reflected a consistency in the desire of Japan to hold on to its major export market and the U.S. to put off the inevitable effect of rising import inflation. Such an agreement was, of course, premature. The economic fundamentals couldn't support such a stall in the depreciation of the dollar with the U.S. (and its trading partners) still so far from a balance of trade equilibrium. A strong argument can be made, then, that the engineered rise in U.S. interest rates which followed the Louvre Accord — 3-month treasury bills rose

TABLE 1. The U.S. Economy, before and after the Stock Market Crash of 1987

		1986:4-1987:3	1987:3-1988:2
Percent Changes at Annual Rate			
Real GNP and Components			
Real GNP	(1982 dollars)	4.7	4.2
Consumption	(")	3.2	1.5
Durable Goods	(")	3.1	0.5
Nondurables and Services	(")	3.2	1.7
Business Fixed Investment			
Producers' Durables	(")	13.9	10.9
Nonresidential Construction	(")	4.5	−0.5
Residential Construction	(")	−5.0	−0.9
Federal Gov't. Purchases Excluding CCC	(")	−2.4	−2.0
State and Local Gov't. Purchases	(")	2.1	3.4
Prices and Wages			
Hourly Compensation, Private Nonfarm	(1977=100)	3.3	4.7
Price Deflator, Private Nonfarm	(1982=100)	2.9	2.3
Personal Consumption Deflator	(")	5.2	4.1
Exchange Rate Index (Value of U.S. Dollar)	(3/73=100)	−10.3	−11.0
Price Deflator for Non-oil Imports	(1982=100)	3.6	4.7
Price Deflator for Oil Imports	(")	59.5	−22.1
Dow-Jones 30 Industrials	(average of daily closing prices)	52.2	−26.3
Levels in Terminal Quarter			
Civilian Unemployment Rate	(percent)	5.7	5.5
Capacity Utilization Rate, Manufacturing	(")	81.4	83.1
Real Net Exports	(billions of 1982 dollars)	−130.7	−90.1
Automobile Sales	(millions of units)	11.5	10.6
Import Share	(percent)	30.6	29.6
Personal Saving Rate	(percent)	2.3	3.8
3-Month Treasury Bill Rate	(percent)	6.0	6.2
Aaa Corporate Rate	(")	9.8	9.8
Conventional Mortgage Rate	(")	10.5	10.4
Federal Deficit	(billions of dollars)	138.3	122.5

from 5½ percent in the early months of 1987 to an average of 6 percent for 1987:3 and a peak of 6.4 percent for the month of September, while the exchange value of the dollar experienced its first quarterly rise in nearly 2½ years in 1987:3 — contributed to a financial imbalance which culminated in the stock market crash of last October.

Obviously the conditions were ripe for a deflation in the stock market. The Dow Industrials had risen especially sharply since late '86 (see Table 1), and the market was being viewed with increasing skepticism as the bubble grew. Once the break came, and its early dimensions turned out to match those of the 1929 stock market crash, a serious 1988 recession became the irresistible conclusion of many analysts, forecasters, and media types. Fortunately, their pronouncements carried far less weight than the economic behavior of countless consumers and businesses.

As shown by the data in Table 1, the rate of growth of real GNP has, on the average, been slower in the three quarters since the stock market crash than in the three preceding quarters — but only by about one-half of one percentage point. Consumers did indeed become hesitant after October; the rate of growth of consumer purchases dropped from 3.2 to just 1.5 percent, and the personal saving rate rose from a near-record low of 2.3 percent in 1987:3 to 3.8 percent in the most recent quarter, which is still unusually low. Recent production growth has been quite enough to

keep the unemployment rate declining. The civilian unemployment rate dropped to an average of 5.5 percent for 1988:2 and reached 5.3 per cent in the month of June before edging up to 5.4 percent in July.

What kept the economy growing as rapidly as it has since October is basically the same factor that "renewed" the expansion in the latter part of 1986: the declining dollar, the resulting improvement in U.S. competitiveness (which is not meant to imply that American industry hasn't made its own *direct* contributions through modernizing, etc), and a consequent upturn in U.S. production both for export and, finally, import competition. Some of the latter can be seen in the dramatic improvement in real net exports this year. As shown in Table 1, a $40 billion drop in the (annualized) real net export deficit occurred between 1987:3 and 1988:2, and the import share of the U.S. car market has even edged below 30 percent in recent quarters for the first time since mid-1986.

There are certainly a few weak spots in the current economy, and some areas of special concern. The Federal Reserve System acted quickly to provide the economy with needed financial support when the stock market crashed, with the result that interest rates came down late last year and during the early months of this year. By spring, however, the Fed — no longer focused on the possibility of a quick post-crash recession — switched to monetary restraint, apparently in reaction to renewed fears of inflation. Interest rates are relatively high once again, and the exchange value of the dollar has indeed risen sharply even while our foreign trade balance remains deeply in the red by any standard other than that of our own performance in the recent past. The major differences between now and a year ago, however, are 1) that the *current* rise in the value of the dollar is primarily an offset to the *panic drop* in the dollar which followed last year's stock market crash, and 2) that we are *not* now sitting atop a stock market bubble. Although stock prices may well gyrate in response to daily news about interest rates and dollar values over the next little while, a repeat of October 1987 seems rather remote.

To this point excess demand inflation is clearly much more an upside risk than a reality. In the Greenspan Fed, the inflation-watch has obviously risen to prominence. The stance of monetary policy in the near term is likely to depend primarily on the inflation outlook. In view of this summer's drought, reading the signals of inflation correctly will not be all that easy. But it will be essential to the proper conduct of monetary policy and, indeed, to the proper interpretation of certain gyrations likely to appear in the federal budget. These and related matters will be dealt with in our discussion of inputs to the forecast, to which we now turn.

Inputs to the Forecast

We are currently in the midst of the nation's worst drought in half a century. The corn and soybean crops have been severely affected, and while the winter wheat crop was harvested before being affected by the dry weather, the spring wheat crop has suffered as well. Corn, wheat, and soybean prices are all expected to rise during the second half of 1988 as the drought reduces supplies. Even under the assumption of an approximately normal yield in 1989, stockpiles of these crops will remain quite low by normal standards, and prices will therefore remain high.

Some liquidation of dairy cattle stocks has already occurred, and increased liquidation of beef cattle is expected this fall in the face of higher feed grain prices and potentially poor forage. While meat prices may soften somewhat this fall as beef cattle stocks are reduced, higher meat prices are projected for 1989 given both the higher cost of feed and the tighter supply of meat and poultry.

We have assumed that farm prices in general will rise by 8 percent (annual rate) during the second half of 1988 and by a further 6 percent during 1989. For 1990 we are assuming a more normal increase in farm prices of 4 percent.

The drought will also have an impact on federal expenditures through Commodity Credit Corporation (CCC) activity, price support programs, and disaster relief. We are projecting increases in total federal expenditures of 4 percent and 5.4 percent for fiscal 1989 and fiscal 1990, respectively, following an increase of 5 percent for the current fiscal year (see Table 2). Defense purchases are assumed to increase by 1.4 percent for fiscal '89 and by 3 percent for fiscal '90 — well below expected price increases in both years. Nondefense purchases excluding CCC activity are assumed to rise by 4.3 percent for fiscal '89 and by 2.8 percent for fiscal '90 following a 10.6 percent increase for fiscal '88. Largely as a result of the drought, CCC inventories are projected to decline by $14.2 billion in the current fiscal year and by $7.5 billion in fiscal '89 and then to increase by $5 billion in fiscal '90. These swings in CCC inventories produce abnormal movements in total government purchases but have no effect on GNP as they are offset by opposite changes in farm inventories.*

For each of the next two fiscal years transfer payments and grants-in-aid include estimates of outlays from Medicare and Medicaid, respectively, for the early stages of the catastrophic health insurance program enacted by Congress earlier this year. Subsidies in fiscal '88 and '89 include additional aid for financial institutions as well as drought relief for farmers.

Federal revenues include current estimates of the effects of the Omnibus Budget Reconciliation Act of 1987 — which was enacted following the stock market crash and which was designed to reduce the federal budget deficit through both spending reductions and revenue increases — and the Tax Reform Act of 1986. Also included are current estimates of the premium payments to be made by Social

*The CCC/inventory transaction operates in the following way. If the drought reduces farm production by 5 (billion 1982 dollars) and consumption is unchanged, farm inventory investment and therefore GNP will be reduced by 5. If the government wishes to offset part of this effect on farm inventory stocks (presumably to try to stabilize farm prices), it can reduce its own inventory of surplus commodities by, say, 4 (billion 1982 dollars) which will add that same amount to private farm inventories. This will result in two offsetting entries in the GNP accounts: government purchases will be *reduced* by 4 (since the *sale* of surplus commodities is netted out against all other government purchases) and farm inventory investment will be *increased* by 4. GNP is thus unchanged by this inventory transaction and continues to record the 5 unit drop due to the drought.

TABLE 2. Federal Government Expenditures in the National Income and Product Accounts (billions of dollars)

	Actual	RSQE Projections		
	Fiscal 1987*	Fiscal 1988†	Fiscal 1989‡	Fiscal 1990‡
Federal Government Expenditures	1058.1	1110.4	1155.1	1217.6
Purchases of Goods and Services	375.8	379.0	393.8	418.3
National Defense	290.0	296.7	300.8	310.0
Nondefense Excluding CCC	87.2	96.4	100.5	103.3
CCC Purchases	−1.4	−14.2	−7.5	5.0
Transfer Payments	409.9	433.6	459.1	492.3
Unemployment Benefits	15.5	13.5	14.1	16.4
Grants-in-aid to State and Local Governments	102.9	106.7	108.9	111.3
Net Interest Paid	139.8	152.0	162.6	172.6
Subsidies less Current Surplus of Government Enterprises	29.7	39.2	30.7	23.0
Federal Receipts	894.6	964.1	1016.4	1093.7
Surplus (+) or Deficit (−)	−163.5	−146.3	−138.6	−123.9

*Data for fiscal 1987 are from the *Survey of Current Business*, July 1988.

†Available quarters of fiscal 1988 are from the *Survey of Current Business*, July 1988; 1988:3 projected by RSQE.

‡RSQE projections and Control Forecast for fiscal 1989 and 1990.

Security recipients to cover part of the cost of the catastrophic health insurance program.

Our federal budget projections include budget action to reduce the deficit by $17 billion for fiscal '90 and by about $20 billion in subsequent years. The deficit reduction takes the form of a $4.5 billion reduction in purchases, a $5 billion reduction in subsidies and a $10 billion increase in personal taxes effective January 1, 1990. Without such action the budget deficit would exhibit virtually no improvement from fiscal '89 to fiscal '90. With such budget action taken in the context of our control forecast the federal deficit, which declines minimally from $146 billion for fiscal '88 to $139 billion for fiscal '89, declines to $124 billion for fiscal '90.

In recent testimony before the House Banking Committee Fed Chairman Alan Greenspan stated that a rise in the exchange value of the dollar was undesirable, but that *substantial* decline in the dollar's value vis-a-vis other currencies probably would not hasten the shrinking of the trade deficit given the nation's available industrial capacity. The Fed's concern in recent months has been focused on rising levels of capacity utilization and employment gains, which may be forerunners of renewed inflationary pressure. As a result the Fed has acted to push up short-term interest rates since February. Citing continued concerns about inflation and a need to realign the discount rate with other short-term interest rates, the Fed raised the discount rate from 6 to 6.5 percent on the 9th of August.

In the context of a forecast of modest economic growth over the next two and one half years, with the exchange value of the dollar drifting downward from current levels by 3–4 percent per year and the core industrial inflation rate rising from under 3 percent during 1987 to no more than about 4½ percent during 1990 we see little need for further tightening of monetary policy over the forecast horizon. We have assumed that the discount rate will remain at 6.5 percent and that the monetary base will grow by about 5 percent per year throughout the forecast period.

For the past several months a number of the members of OPEC have been exceeding their production quotas and generating a crude oil glut. We expect no quick improvement in production discipline due to the recent cease-fire agreement between Iran and Iraq. As a result oil prices are projected to be in the $16 per barrel range for the second half of 1988. During 1989 and 1990 oil prices are assumed to rise by 4 percent per year, reflecting some moderate stability in production arrangements as we look further ahead.

The Balance of 1988

Our forecast of the near-term economic outlook is summarized in Table 3. We expect real GNP to grow at an annual rate of 2.5 percent in the third quarter of this year, a rate just about matching the growth of real final sales (excluding sales of agricultural stocks by the federal govern-

ment in response to the drought conditions), but about one-half of one percentage point below the 3.1 percent GNP growth rate now estimated for 1988:2. Part of the third quarter slowdown in aggregate production is directly attributable to the drought. In 1988:2, real farm inventory stocks rose by 11.1 billion 1982 dollars (annual rate) while the federal government was increasing the stock of available agricultural commodities by $17.8 billion through Commodity Credit Corporation sales. Without the government's release of stocks, real farm inventories would have *declined* by $6.7 billion (11.1 − 17.8) in the second quarter. For 1988:3 we anticipate that the government will release another $12.5 billion in accumulated stocks, without which real farm inventories would have declined by $10 billion (2.5 − 12.5). The difference between $6.7 and $10 billion, or $3.3 billion, is the measure of the drought's differential impact on real GNP in the current quarter. Without that added loss of production, GNP growth in 1988:3 (all else equal) *would have been* forecast at an annual rate of 2.8, rather than 2.5. percent. The drought will have an even greater differential impact in the fourth quarter of the year, when we anticipate that farm inventory stocks would have declined by $18 billion (−8.6 − 9.4) in the absence of the government's CCC sales. The difference between $10 and $18 billion is our estimate of the drought's differential impact on real GNP in the fourth quarter of this year, and without that $8 billion differential real GNP growth in 1988:4 would have been forecast at 2.5 percent rather than the 1.5 percent shown in Table 3. The negative swing of $8 billion is expected to be reversed in 1989:1, which thus accounts for part of the speed-up of GNP growth which we are forecasting for the

TABLE 3. RSQE Forecast: The Calendar Year and Second-Half 1988
(billions of 1982 dollars, SAAR, unless otherwise indicated)

	1988				1989	Calendar Year	
	I	II	III	IV	I	1987	1988
Real GNP and Components							
Real GNP	3956.1	3986.3	4010.5	4025.1	4057.3	3847.0	3994.5
(Percent Change, SAAR)	(3.4)	(3.1)	(2.5)	(1.5)	(3.2)	(3.4)	(3.8)
Real Final Sales Excluding CCC	3909.4	3959.1	3985.8	4010.0	4026.6	3816.5	3996.1
(Percent Change, SAAR)	(5.5)	(5.2)	(2.7)	(2.5)	(1.7)	(3.2)	(3.9)
Consumption	2559.8	2574.2	2589.3	2600.0	2611.5	2521.0	2580.8
(Percent Change, SAAR)	(4.5)	(2.3)	(2.4)	(1.7)	(1.8)	(2.7)	(2.4)
Business Fixed Investment	473.4	489.2	496.4	502.9	506.5	445.1	490.5
Residential Construction	189.5	190.8	190.1	189.6	187.1	195.2	190.0
Change in Business Inventories	66.0	45.0	37.2	24.5	37.0	34.4	43.2
Farm	14.1	11.1	2.5	−8.6	−3.8	−2.5	4.8
Net Exports	−109.0	−90.0	−85.3	−79.6	−78.9	−128.9	−91.0
Government Purchases	776.4	777.2	782.8	787.8	794.1	780.2	781.0
CCC Purchases	−19.3	−17.8	−12.5	−9.4	−6.2	−3.9	−14.7
GNP Deflator (1982=100)	119.4	120.6	121.8	123.0	124.3	117.7	121.2
(Percent Change, SAAR)	(1.7)	(4.1)	(4.2)	(3.9)	(4.3)	(3.3)	(3.0)
Current Dollar GNP (billions of dollars)	4724.5	4806.9	4886.3	4950.7	5043.0	4526.7	4842.1
Addenda							
Civilian Unemployment Rate (percent)	5.7	5.5	5.5	5.5	5.5	6.2	5.6
3-Month Treasury Bill Rate (percent)	5.7	6.2	6.7	6.7	6.5	5.8	6.4
Aaa Corporate Rate (percent)	9.6	9.8	10.0	10.0	9.9	9.4	9.8
Conventional Mortgage Rate (percent)	10.0	10.4	10.5	10.7	10.8	10.2	10.4
Exchange Value of the Dollar							
(Percent Change, SAAR)	−9.4	1.7	33.3	−4.1	−3.5	−13.7	−3.6
Automobile Sales (millions of units)	10.8	10.6	10.7	10.8	10.8	10.3	10.7
Personal Saving Rate (percent)	4.4	3.8	4.2	4.0	4.1	3.2	4.1
Federal Deficit (billions of dollars)	155.1	122.5	147.3	151.9	136.9	163.5*	143.3*

*Fiscal years.

first quarter of next year. And as discussed in connection with our input assumptions we have imposed an "approximately normal harvest" condition on the 1989 forecast.

Despite the drought's impact on farm production, the second half of this year is expected to be characterized by real GNP growth averaging 2 percent at annual rate, which will just manage to keep the civilian unemployment rate at a 5½ percent level for the remainder of the year. The paths of output and employment forecast for the balance of this year imply year-over-year real GNP growth amounting to 3.8 percent for 1988 and an unemployment rate averaging 5.6 percent for the year, down from a 6.2 percent average unemployment rate in 1987.

Our forecast for the second half of 1988 and the early part of 1989 has to be characterized as continued, but not especially rapid, growth — indeed, just enough to keep the unemployment rate steady at about its current level. And with overall unemployment at just about 5½ percent, economic growth averaging and running close to 2½ percent at annual rate is about right. Much less would imply rising unemployment; much more would yield rising inflationary pressures. As it is, even if we stay near current rates of resource utilization, we can expect to move to a somewhat higher average inflation rate as economic behavior becomes fully adjusted to the generally tighter markets.

Before going beyond the near-term outlook summarized in Table 3, it would be useful to take note of the monetary conditions inherent in that forecast. It is our view that short-term interest rates will begin to back off from their current levels by year-end, for two principal reasons. The first is that short rates frequently overshoot their ultimate level in response to a change in monetary policy, and we believe that happened when it became clear a few months ago that the Fed had tightened credit conditions. And second, the slower growth which we forecast to characterize at least the next two to three quarters will take a little pressure off interest rates both directly and as a result of some relaxation of whatever fears may recently have developed about future inflation. The modest easing envisioned for short-term interest rates will be accompanied by little more than a stabilizing of longer-term rates, including mortgage rates. With long rates remaining at relatively high levels, we anticipate a continued weakness in construction activity and some weakening in the growth rate of business capital spending as well.

We expect that the dollar will be declining again by the fourth quarter of this year. The sharp fall of the dollar following the stock market crash — 9 percent over the half-year ending 1988:1 — was clearly a panic reaction, and the dollar is now back to just about where it was a year ago. The trade deficit fundamentals can be expected to exert further downward pressure on the dollar, while continued shrinkage of our trade deficit is likely to keep the *rate* of decline of the dollar at a moderate level.

Finally, we note that the federal budget deficit reached an annual rate of about $122 billion in 1988:2, but it can't remain that small. A one-time income tax revenue gain amounting to about $20 billion at annual rate appeared in that quarter as a result of some forward-shifting of personal income following passage of the 1986 Tax Reform Act. This implies an automatic jump in the deficit rate in 1988:3, and in addition the federal drought relief discussed above will provide a further temporary increase in the federal deficit during the next few quarters. It appears, however, that the fiscal 1988 deficit will come in at a level which is acceptable under the 1987 Budget Reconciliation Act.

1989–90: The Outlook and Policy Issues

The major aspects of our forecast for 1989–90 are summarized in Table 4. We are forecasting real growth at a rate of 3.2 percent for the first quarter of next year as the economy bounces up a bit following the negative impacts of the 1988 drought, which are concentrated in the fourth quarter of '88. GNP growth is forecast at a rate averaging 2⅓ percent for the second and third quarters of next year, and at a slightly lower 2.1 percent for the closing quarter of 1989. The continuation of economic growth through at least the end of next year derives from two principal factors: 1) Export growth continues to outpace import growth, though by a smaller margin than in either 1987 or 1988; and 2) business capital purchases continue strong as the demand for U.S. manufacturing production continues to increase.

Growth in the consumer sector, on the other hand, is expected to lag behind the overall growth of real GNP, with purchases of nondurable goods being especially sluggish for the second year in a row. Car sales, on the other hand, are forecast at 10.8 million units for 1989, just above the 10¾ million units forecast for calendar 1988 — thus, a second very solid year following the 10¼ million sales of 1987.

The pace of real growth forecast for 1989 is accompanied by a virtually constant unemployment rate. Inflation, however, can be expected to pick up during next year as the economy remains at high levels of resource utilization. The core industrial inflation rate — as measured by the private nonfarm GNP deflator — accelerates from a pace below 3 percent during 1987 to about 4.2 percent during the second half of next year. Consumer price inflation is forecast to be very close to 5 percent *throughout* the next year and a half. The food price inflation resulting from the drought is the major reason that consumer prices rise at a 5 percent pace in the second half of this year and the first half of next year. After mid-'89, however, the continuation of the 5 percent pace of consumer price inflation reflects the general, but modest, step-up in most rates of price increase during 1989.

The modest softening of short-term interest rates which we expect to begin by the end of this year is forecast to continue into the middle of next year. By then we expect 3-month treasury bills, for example, to be about 35 basis points below current levels, or at about 6.4 percent. We expect the drop in short rates to stall at that level as the economy continues on a moderate growth path with steady unemployment and an upward inflationary drift. The 35 basis point drop in short-term interest rates, however, will not be enough to provide much of any decline in long-term interest rates. Conventional mortgage rates, for example,

TABLE 4. Summary of RSQE Forecast

		Actual	RSQE Forecast				
		1987:4-1988:2	1988:2-1988:4	1988:4-1989:2	1989:2-1989:4	1989:4-1990:2	1990:2-1990:4
Percent Changes at Annual Rate							
Real GNP and Components							
Real GNP	(1982 $s)	3.3	2.0	2.8	2.2	1.2	1.7
Consumption	(")	3.4	2.0	1.7	1.5	1.3	1.3
Durable Goods	(")	10.9	3.2	1.4	1.8	1.3	1.2
Business Fixed Investment, Producers' Durables	(")	18.2	6.3	3.6	4.1	2.8	1.3
Business Fixed Investment, Nonresidential Construction	(")	−6.8	3.8	3.1	4.1	2.9	1.5
Residential Construction	(")	−2.0	−1.3	−5.6	−1.6	−1.0	0.5
Exports	(")	16.5	5.5	8.4	9.5	8.2	7.7
Imports	(")	0.2	1.0	6.6	7.6	2.5	0.0
Government Purchases Excl. CCC*	(")	0.3	0.5	1.6	1.2	−0.7	−0.4
Final Sales Excluding CCC*	(")	5.4	2.6	1.6	1.8	1.7	2.0
Prices							
Private Nonfarm Sector							
Hourly Compensation	(1977=100)	3.9	4.6	5.2	5.2	5.9	5.5
Unit Labor Cost	(")	3.0	4.3	3.7	3.7	4.7	3.9
Price Deflator	(1982=100)	2.4	4.1	3.6	4.2	4.4	4.4
Personal Consumption Deflator	(")	3.8	5.0	5.1	5.4	5.6	5.6
Oil Imports Deflator	(")	−25.2	−6.0	2.0	4.0	4.0	4.0
Non-oil Imports Deflator	(")	5.6	0.2	6.9	7.7	7.8	7.2
Exchange Rate Index (Value of U.S. $)	(3/73=100)	−4.0	13.0	−3.4	−3.5	−3.5	−3.0
Levels in Terminal Quarter							
Civilian Unemployment Rate	(%)	5.5	5.5	5.5	5.5	5.6	5.8
Real Net Exports	(billions 1982 $s)	−90.1	−79.6	−77.8	−75.9	−61.3	−39.3
Automobile Sales	(millions of units)	10.6	10.8	10.8	10.8	10.8	10.9
Import Share	(%)	29.6	28.0	28.3	28.9	29.6	30.4
3-Month Treasury Bill Rate	(%)	6.2	6.7	6.4	6.4	6.4	6.5
Aaa Corporate Bond Rate	(")	9.8	10.0	9.9	9.9	10.0	10.0
Conventional Mortgage Rate	(")	10.4	10.7	10.7	10.7	10.7	10.8
Federal Deficit	(billions of $s)	122.5	151.9	135.4	134.1	120.8	108.4

*CCC is net purchases by the Commodity Credit Corporation.

are expected to peak at about 10.8 percent at the start of 1989 and to drift only to 10.7 percent in the spring of the year. In other words, we envision a *relatively* tight monetary policy over the next year, with much of its bite coming out of the construction sector, especially residential construction.

Our outlook for 1989 has been summarized without saying a word about the presidential election. In effect, we are anticipating that the new president, whether Mr. Dukakis or Mr. Bush, will take a bit of time before enunciating and proposing any major changes in macro-economic policy. Neither candidate, for example, is currently promising any dramatic shift in policy (which candidate Reagan clearly *was* during the 1980 campaign), and, if that keeps up as expected, the new president will not have to "deliver quickly" right after the inauguration. As time goes on, however, the need will develop to enunciate a policy that deals with the 1990 and subsequent budgets to assure that they meet the Gramm-Rudman-Hollings targets. In our view, this

will be essential because the current, status-quo budget track will fail to meet the GRH targets after next year.

As explained in our discussion of input assumptions, we have implemented a fiscal policy swing of about $20 billion, in a mixture of expenditure reductions and tax increases, in the federal budget for 1990. Some of the expenditure cuts begin in 1989:4, and the full policy swing is in effect by the first quarter of 1990. We have made no provision for any easing of monetary policy to offset the contractionary swing in fiscal policy. Under these assumptions, 1990 would, in our view, turn out to be a minimal growth year — real GNP growing at rates averaging less than 1½ percent during the year. Unemployment would begin to edge up early in the year and would exceed 5.8 percent before year-end. While the rate of inflation would stop accelerating in such a scenario, it would have remained high enough for long enough that interest rates would be slow to come down in response to the economic slowdown (with a "no-change" monetary policy). The slowdown would, however, accelerate the rate of improvement of our trade imbalance, principally by halting the growth of imports.

We are not here urging the particular mix of fiscal restraint that we chose to implement in this forecast. Rather, we are intending to point out the overwhelming likelihood that *some* shift to a permanently tighter fiscal stance is going to become unavoidable before much time will have passed in the life of the new administration.

Nor are we advocating that any permanent shift toward fiscal restraint in 1990 should be unaccompanied by an easing of monetary policy. On the contrary, our 1990 scenario points up the likelihood that we *would* want to accompany fiscal restraint with an easier monetary policy, or at least be on the watch for any deflationary shocks that could tip a vulnerable, slow-growth economy into a 1990 recession.

What's Going on Here? — Who Makes Economic Policy and Why?

Paul Wachtel
Professor and Chairman, Department of Economics
Graduate School of Business Administration
New York University

With the presidential election looming and the catalogue of economic problems as long as ever, concern about economic policy-making has begun to intensify. It has become all the more important to know how policy is formed in this country, who the policy makers are, and how they interact. Although there is an ample amount of very competent analysis within the government, there is no single body that determines macroeconomic policies; and a serious lack of coordination exists among policy makers.

In the 1980s, the difficulties in articulating and formulating a coherent set of policies have been enormous. Fiscal policy is, more often than not, the haphazard consequence of a never-ending struggle between the Congress and the president. Monetary policy — which is conducted by a supposedly independent body, the Federal Reserve — sometimes appears to be on a roller coaster.

Thus, this is an opportune time to examine the institutions that make policy and see how they are responding to the issues of the late 1980s.

Monetary Policy

The Federal Reserve System was created about 75 years ago as a regulatory body for the banking system. Its role has evolved to include the conduct of macroeconomic monetary policy by the Federal Open Market Committee. This important policy-making body includes no elected officials, and some of its members, the presidents of regional Federal Reserve banks, are not even presidential appointees. The others, the members of the Federal Reserve Board, are presidential appointees but with long terms which are supposed to free them from the concerns of politics. This was not always the case; until 1935 both the Secretary of the Treasury and the Comptroller of the Currency were *ex officio* members of the Federal Reserve Board.

The most influential individual on the committee is the chairman of the Board of Governors, who has been since last summer Alan Greenspan. Ironically, the four-year term as chairman starts toward the end of the president's

term. So President Reagan was saddled with a Carter choice, Paul Volcker, as the Fed chairman (although Volcker was, albeit reluctantly, reappointed by Reagan in 1983), and Greenspan will in all likelihood serve through most of the next president's term.

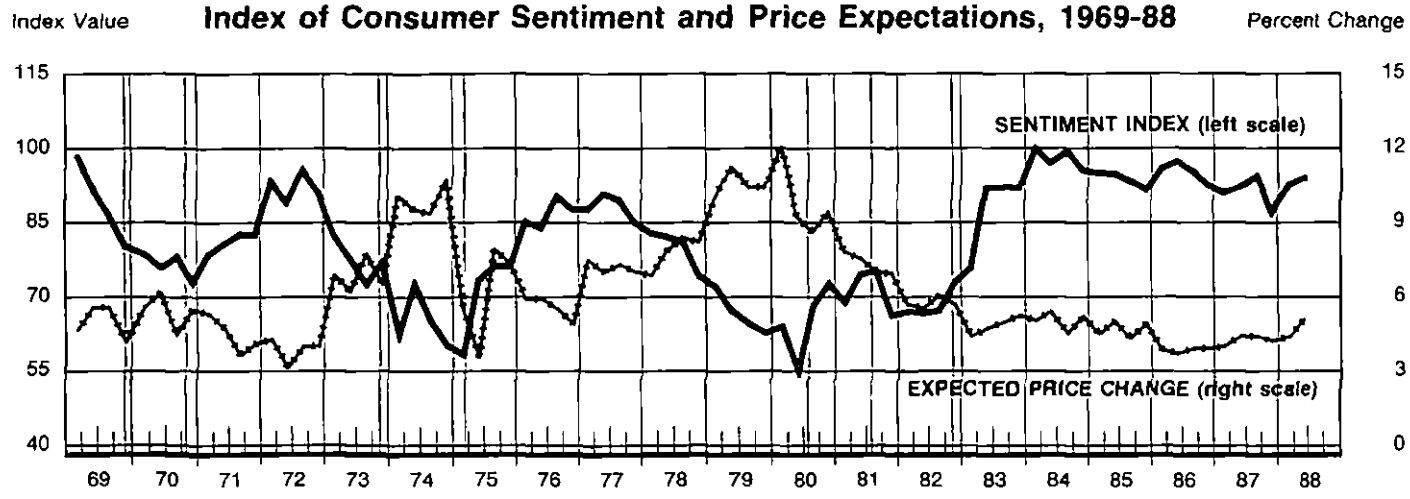
The Federal Reserve has recently been lambasted in what is otherwise an excellent book on the political economy of monetary policy, *Secrets of the Temple* by William Greider. Greider's contention is that the major institution for the conduct of macroeconomic policy in the U.S., the Fed, is not governed democratically and that it has made choices that run counter to the consensus view of the American people. That the Federal Reserve is an anomalous institution, removed from the basic forms of constitutional government, is undoubtedly correct. However, it is erroneous to argue that the inflation fears of the bankers and economists who run the Federal Reserve outweigh the interests of the public or that the Board of Governors is lacking in concern for the well-being of the economy.

The fear of inflation permeates American public opinion, and it is the underlying reason for the historical separation of the Federal Reserve from the executive branch of government. In the absence of such separation, monetary stability could well be sacrificed to the government's revenue needs, which can most readily be met by printing money. Nevertheless, there have been a few occasions of misguided political interference in monetary policy making. In January of this year, the Treasury Department's chief economist, Michael Darby, sent a letter to the members of the Federal Reserve Board urging the Fed to speed up monetary growth. As it turned out, Darby's fears of a recession in the aftermath of the stock market crash were unfounded. The Fed was wise to maintain its independence and ignore this blatant attempt of the executive branch to influence monetary policy.

The Fed's fear of inflation and its willingness to incur the risk of recession in the battle against inflation are ideas that are shared by most Americans. Price inflation is often cited by respondents to Survey Research Center surveys as the basis for their expectations concerning personal financial and business conditions, two important components of the SRC Index of Consumer Sentiment; and movements in the index frequently represent reactions to price inflation. In fact, the sustained decline in the index in the 1970s and the sustained high level of the index since 1983 can both be attributed to changes in consumer fears about inflation (see the chart). The simple fact is that the Fed is responsive to and shares the public's concern with inflation. The Fed's massive assault on inflation in the early 1980s was in tune with both public and political opinion.

For well over a year the Fed has apparently been maintaining monetary policy on a roller coaster as it juggles policy to accommodate various economic goals. At first it followed a vigorously expansionary policy in an effort to lower interest rates and bring down the foreign exchange value of the dollar. This policy was dictated by a desire to right the ominous trade deficit. Rapid expansion of the money supply and a dollar that went into a fearsome free fall brought about renewed fears of inflation and a sharp reversal in policy. By the end of 1987, policy was dominated by fears of a recession induced by the market crash. Nevertheless, throughout early 1988 the Fed flirted repeatedly with a tighter monetary policy as it reacted to indications that inflationary pressures were emerging. By mid-summer, the possibility of an election-year recession had pretty much disappeared; and Greenspan warned Congress in his mid-year testimony that short-term interest rates are likely to rise because "at this juncture [the Fed] might be well advised to err more on the side of restrictiveness rather than of stimulus." This is hardly the type of policy making that we would expect from an institution that is truly removed from the public's and the president's concerns.

In fact the Fed appears to be nervously juggling the immediate effects of its actions on three public concerns. First, the Fed is eager to avoid a recession in an election year. But it does not want to be accused of stimulating the economy in order to assist the campaign needs of the party in power, an accusation that has been made before. Second, the Fed would like to see the trade deficit reduced quickly. Third, it would like to avoid a renewal of inflation from high import prices and wage pressures emerging



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

from a labor market that is tighter than it has been in over a decade. If anything, the Federal Reserve should have more independence so it can follow a more stable policy which would lead to gradual improvement in the trade deficit without the possibility of jerking the economy into either a recession or a renewal of inflation.

Fiscal Policy

Fiscal policy is more difficult to discuss because for all intents and purposes we do not have any. For almost a decade the Congress and the president have gone through the motions of trying to create a tax system and an expenditure plan for the government that generate a reasonably balanced budget. There have been several legislative efforts to bring this about, including the Gramm-Rudman-Hollings Act, which has been largely ineffectual, and a proposed balanced budget amendment to the constitution, which is largely rhetoric. This stalemate is a reflection of the absence of a public consensus concerning the sacrifices which should be made to reduce the budget deficit.

A major legacy of the Reagan years has been the inability of the government to deal seriously with the deficit. On the tax side of the budget there has been some success. Some of the excesses and mistakes of the original supply-side legislative effort have been corrected by the Tax Reform Act of 1986, which is viewed as a small but clear step toward a more efficient revenue system. Nevertheless, any serious efforts at restructuring the budget and solving the chronic deficit problem are clearly on the back burner until a new president takes office in 1989. The deficit has declined somewhat because the economy has been more robust than expected and interest rates lower than anticipated and not because of any constructive efforts to change policy.

Policy Prospects

The government entities responsible for setting macroeconomic policy are well aware of the challenges that they face. Each winter the government agencies concerned with macroeconomic policy prepare their annual evaluations of the problems of and prospects for the economy. These remarkably lucid statements are the *Economic Report of the President*, prepared by the Council of Economic Advisers in the White House; *Monetary Policy Objectives*, the Federal Reserve's report to the Congress; and *The Economic and Budget Outlook*, the Congressional Budget Office's report to the Senate and House Budget Committees. The three make interesting reading and cause one to wonder why the implementation of policy is not more effective.

The reason why policy may be less than ideal is hinted at by a disturbing note that runs through all three of the February 1988 reports. In each one there is a tendency to lay the blame for our problems at someone else's door.

Fed chairman Greenspan concluded his February 23rd congressional testimony by saying:

> We face formidable challenges over 1988 and beyond in meeting national economic goals of sustaining growth and progress toward price stability. Some of these relate to the short-run outlook for the economy, as the possible effects of the stock market decline and the build-up of inventories late last year work through in 1988.
>
> But our more fundamental task remains managing the process of restoring internal and external balance that is now underway. This is a challenge that cannot be negotiated by the Federal Reserve alone. It will require complementary and consistent actions by our colleagues in the Congress and the administration, as well as by our major trading partners....

The *Economic Report of the President* opens with unbridled praise for the Reagan administration:

> The longest peacetime expansion in the history of the U.S. economy entered its sixth year in 1987. Growth was vigorous.... The unemployment rate dropped ... to its lowest level in 8 years.... Significant improvement [was made] in the real trade deficit.... Dramatic progress was made in reducing the federal budget deficit.... [This] did not occur by accident. It was shaped by government policies explicitly directed toward fostering the inherent dynamism of the private sector.

However, in discussing the activities of the Federal Reserve, the *Report* is critical:

> Immediately following the ... drop in the Dow, the Federal Reserve's operations were exemplary.... While it was appropriate for the conduct of policy to change subsequently ..., the stance of monetary policy at the end of 1987 may have underestimated the risks to adequate economic growth.

The Congressional Budget Office is a bipartisan group that carefully avoids political judgments except when it comes to our major trading partners, whose monetary and fiscal policies are criticized. The CBO emphasizes the absence of international policy coordination as the source of the American trade deficit and places little emphasis on the budget deficit.

A significant failing of our policy makers is their inability to coordinate activities and consider the longer-run implications of our macroeconomic policies. The relative success of the American economy in the 1980s as compared to the 1970s should not obscure the fact that the way in which policy is made has not changed. An important item on the agenda of the next administration should be improved policy coordination both within the federal government between the monetary and fiscal policy authorities and among the major industrial nations.

Optimistic Small Business Firms Expect Continued Prosperity

William C. Dunkelberg
Chief Economist, National Federation of Independent Business, and
Dean of the *School of* Business and Management, Temple University

Introduction

The National Federation of Independent Business currently has over 500,000 member firms, nearly one out of every seven employers in the U.S. Since 1973 NFIB has surveyed a random sample of its membership quarterly. Each sampled member receives two requests to participate in the mail survey; the response rate is typically 30 percent. Firms are queried about the levels and conditions of important economic variables and report planned changes in the variables for the immediate future. The NFIB questions and indexes are patterned after the pioneering consumer survey work of the late George Katona, a founder of the Survey Research Center.

Small firms (having under 500 employees) produce nearly half of the gross domestic product and employ half of the private work-force. Ninety percent of all firms have fewer than 20 employees, and 98 percent have fewer than 100. Small firms produce a disproportionate share of the new jobs for the U.S. economy, particularly in slow economic periods. The collective decisions of these small firms have a profound impact on the strength of the economy.

This report is based on the April 1988 quarterly survey of 1936 member firms.

Opinions about the Economy

The Small Business Optimism Index* rose from 101.8 in January to 104.5 in April, a gain of almost 3 points. Seasonally adjusted, the Index rose from 101.8 to 102.4, a modest gain of 6/10 of a point (see Chart 1).

The longer the recovery goes on, the larger is the proportion of economic agents which believes that the expansion cannot be sustained. Firms have become decidedly less optimistic about future expansion each April, with 67 percent expecting growth in 1983 compared to 22 percent in 1988 (see the table). Apparently, many believe that the law of gravity applies to economic statistics as well as apples. Views about the possibility of further growth are about as weak now as in 1980, but for very different reasons. In 1980, 48 percent expected a deterioration, while in 1988, particularly in many regions of the country, businesses just figure it can't get any better.

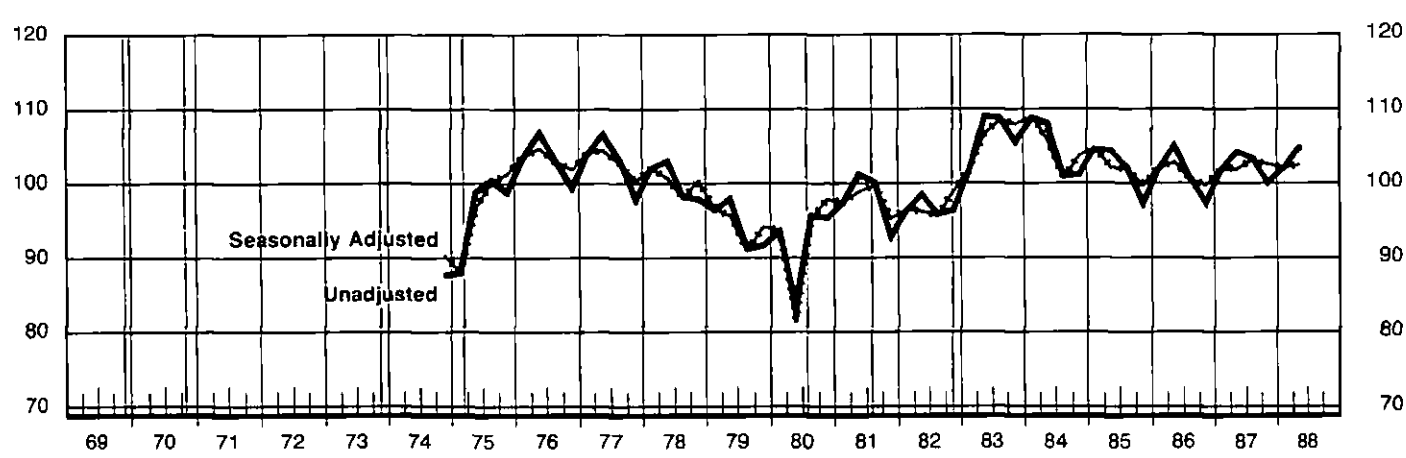
Expectations About ...	Percent Giving Response in April of ...				
	1980	1983	1986	1987	1988
Business Conditions					
Better	16	67	31	24	22
Worse	48	4	11	14	12
Good Time to Expand	3	19	29	20	21

Employment

On average, small firms increased employment by .06 employees per firm in the first quarter of 1988. Seasonally

*The Index is based on 10 questions, including plans for hiring, capital spending and inventory change, earnings trends, current satisfaction with inventories, expected economic conditions, the climate for business expansion, job openings, expected real sales, and expected credit conditions.

CHART 1. Small Business Optimism Index
(10 Questions, 1978 = 100)



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

adjusted, it was the strongest first-quarter hiring performance since 1984, following January's stunning gains (the best since 1978). Firms apparently retained many employees from the fourth quarter and continued to increase employment, offsetting typical seasonal declines. Fifteen percent of all firms added an average of 3.7 workers to payrolls, and 13 percent cut employment an average of 4 workers.

Manufacturing firms were the heavy employers in the first quarter, adding an average of 7/10 employees per firm. The weak dollar has certainly improved the outlook for manufacturers.

Plans to add to employment were the strongest since 1978, when 26 percent of all firms planned to increase employment. Twenty-five percent of the firms plan labor force additions in the next three to six months, led by manufacturing, where 33 percent plan to increase employment (see Chart 2). Only 5 percent (of all firms) plan reductions.

Job openings — reported by 22 percent of all firms — stood at one point below the expansion-high level of 23 percent reached in January. This suggests that the nation's unemployment rate will remain stable or even head south again. Openings are heavy in construction (27 percent), services (29 percent), and manufacturing (29 percent). In New England, an astounding 50 percent of all firms have at least one job opening, up from 42 percent in January.

Inflation

In the April 1988 survey, the percent of firms planning to raise prices fell 3 points from January levels to 24 percent of all firms, 5 points above the 19 percent recorded in April of 1987 and 1986 (see Chart 3). Although not large, there is a clear upward drift in the percent of firms planning to raise prices. Wholesale firms planned price hikes most frequently (33 percent), followed by construction (28 percent) and retailing and services (25 percent).

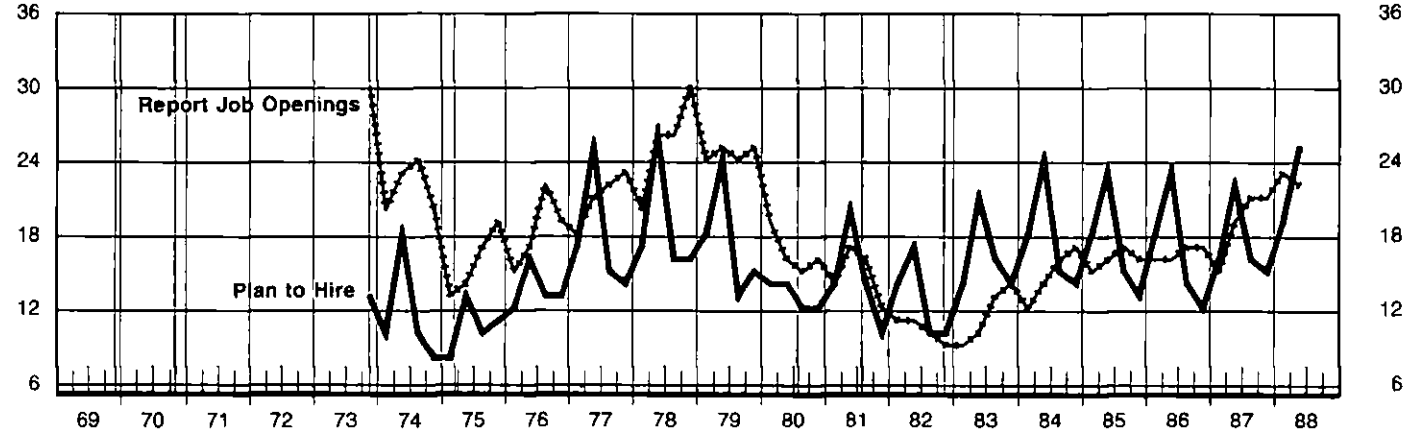
Based on plans to raise prices, non-food inflation should start to pick up, heading toward the 5 percent level. Reports of actual price increases continue to rise, supporting the general perception that prices in general may be on the way up. Reports of price increases in the first quarter (30 percent) were the highest since 1981.

With import prices on the rise (providing domestic producers room to raise prices) and wage costs starting to stiffen in the face of still-strong demand and tight labor markets, 1988 could deliver a bit more inflation than currently expected. However, it should be remembered that general inflation is a *monetary* phenomenon. Absent supporting increases in the money supply, rising prices in growing sectors should be offset by declines elsewhere, as demand weakens in less popular sectors. The role of prices is to signal resource reallocation. Where demand grows, prices and profits rise to generate the needed investment and increase in capacity and to attract labor. Where demand falls and profits fade, prices should fall, encouraging resources to leave for greener pastures. With downward price inflexibility, a persistent characteristic of today's economy, these kinds of price changes can be confused with general monetary inflation, as both raise the average level of prices. The challenge for the monetary authority is to determine the extent to which the price changes that are occurring are reasonable and desirable before acting to snuff out an inflation that may not in fact be present.

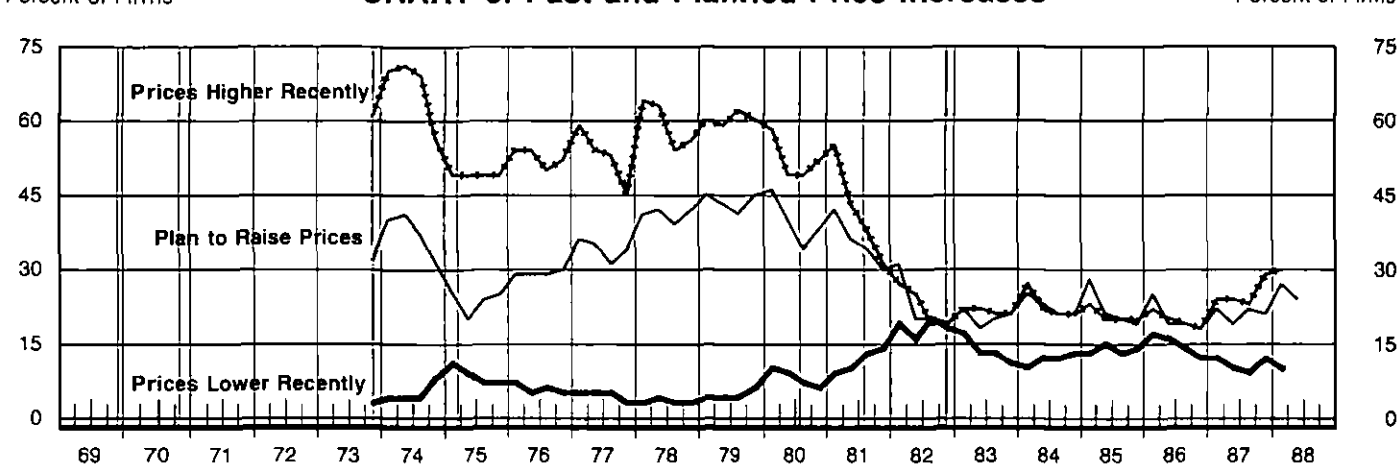
Labor Costs

Of all firms surveyed in April, 24 percent reported increases in employee compensation, up one percentage point from the fourth quarter figure. With job openings at expansion-high levels, there is still little evidence that compensation might be responding to any tightness in the labor market. Seventy-five percent of the firms that increased compensation reported gains of less than 7 percent, producing an average gain of 5.6 percent, somewhat lower than the average for 1987, but still typical of expansion figures. Including those firms not changing compensation, the overall increase in compensation was 1.4 percent for all firms for the quarter, about 5.6 percent at annual rate.

CHART 2. Hiring Plans and Job Openings



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

Plans to raise compensation fell a surprising 4 percentage points to 20 percent of all firms, but remained several points above the April figures of the past few years. The average planned increase was 5.5 percent. Including firms not planning any increases, the overall planned increase was 1.1 percent, or about 4.5 percent at an annual rate.

With employment at a record-high percentage of the over-16 population, and small-firm job openings at expansion-high levels, some upward pressure on compensation might be expected. However, the impact of operating in a world "labor market" (through the competition for final goods markets) coupled with good inflation experience seems to be keeping the lid on wage increases.

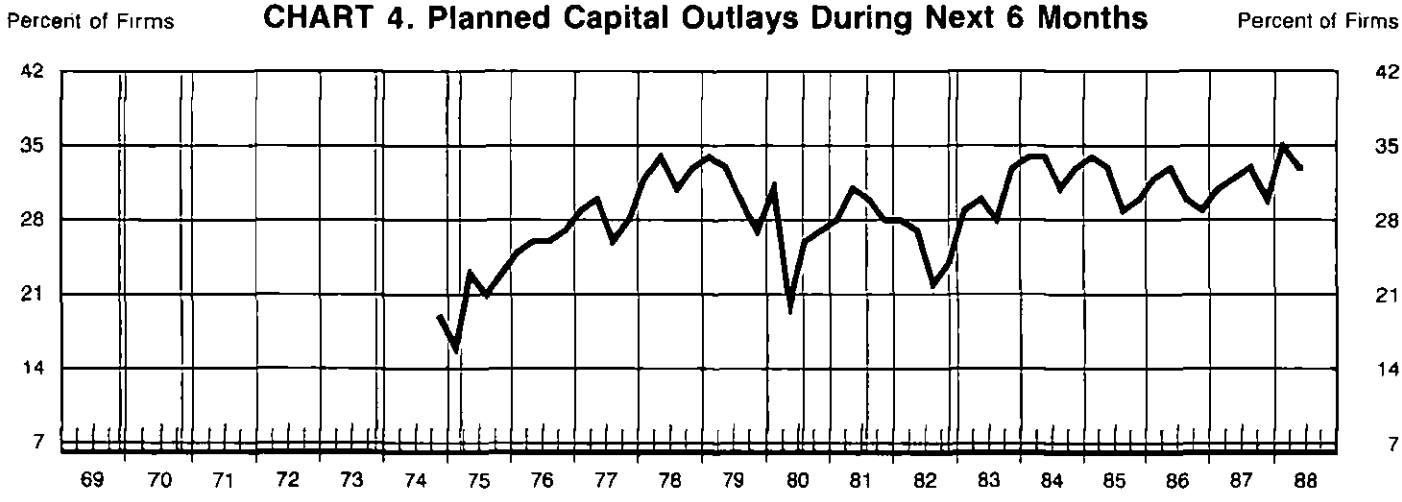
In this new environment, with differing labor demands, it will be interesting to see how low the unemployment rate can go before we encounter significant labor shortages. Structurally adjusted (for age and sex), the current unemployment rate must certainly be "full employment." At least for 1988, we will be fortunate to have the engine of the expansion located in the manufacturing sector, where there still probably exists a fairly fluid labor supply left from the devastation of manufacturing in the early 1980s (hiring plans are high, but few firms report job openings they cannot fill).

Capital Expenditures

Plans to make capital outlays were expressed by 33 percent of all firms (32 percent, seasonally adjusted) in the April 1988 survey, down slightly from the January reading (see Chart 4). The January figure (35 percent) was the largest percentage of firms to report capital spending plans in the history of the NFIB surveys. Actual outlays during the last six months were reported by 55 percent, one of the higher figures in the expansion (but well below the record-high level of 64 percent attained in 1979).

The frequency of outlays for new equipment and vehicles rose slightly to 45 percent. The proportion of firms making outlays for new structures fell 2 points to 6 percent, while the percent making improvements to existing structures rose one point to 16 percent of all firms. Three percent reported the acquisition of new land for future expansion, down 3 points from the highest figure in this decade reported in January.

The percent of firms reporting outlays for new structures has been stuck around 7 percent for the last seven years, and has been unaffected by the shift from recession to expansion. Smaller capital outlays (under $20,000) were reported by 34 percent of all firms, while 6 percent



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

reported outlays of $100,000 or more. These figures were little changed from fourth-quarter levels and only marginally better than 1981 levels.

Plans remain strong in spite of the stock market collapse, and actual spending is headed in the right direction. There is certainly no indication that capital spending will collapse, and with profits holding ground, particularly in manufacturing, the floor may stay under capital spending during the first half of 1988. Capital spending will shift its focus somewhat from productivity and cost reduction to outright capacity expansion, but — in comparison to the 1960s — cost control will account for a substantially higher portion of the capital spending pie. There is little risk that capacity will grow too fast and create recessionary pressures through an overhang of excess capacity.

Inventory Investment

The April survey revealed that plans to add to inventories increased in frequency in spite of a dramatic drop in satisfaction with current inventory holdings in January. Apparently, firms were able to reduce holdings to their satisfaction via strong sales in the first quarter, or the expectation of stronger sales has made firms more comfortable with current stocks. In the April survey 21 percent of firms reported actual inventory gains in the past few months, slightly below the 23 percent which had planned to increase holdings. Fifteen percent reported reductions, 5 percentage points more than had planned reductions in January. This leaves small firms in a strong inventory position, satisfied with current holdings and planning accumulations with a strength typical of second-quarter periods in the current expansion.

Twelve percent of firms reported inventory stocks too high, a decline of 5 points from the January survey, which displayed the lowest levels of inventory satisfaction since 1982. Apparently, accumulations of new inventory were pervasive in the first quarter, with the proportion reporting "higher" inventories exceeding those reporting "lower" by 13 points in retailing, 12 points in wholesale trades, and 10 points in manufacturing.

Retailers seem prepared to take the inventory off the hands of the wholesale firms, as the percent planning to add to inventories exceeded the percent planning reductions by 10 percentage points. Those planning to add to inventories exceeded those planning reduction in every industry classification.

Borrowing Activity and Interest Rates

In the first quarter 1988 survey, the average interest rate paid for short-term money fell to 10.9 percent. Fifty-one percent of the loans made were tied to the prime rate, exposing more small firms to the risk of rapidly rising interest rates.

The pace of borrowing activity fell to a record low 36 percent of all firms. The percent of firms borrowing regularly has not exceeded 44 percent and has only twice risen above 42 percent since 1981, after exceeding 50 percent in the late 1970s. High real (inflation-adjusted) money costs are discouraging borrowing, especially with inflationary profits missing from inventory holdings. Profits remain strong as well, providing the internal cash needed to meet many financing demands.

The percent of firms reporting that they faced higher rates when borrowing fell from 26 percent in October to 12 percent in January and then to 7 percent in April. Only 2 percent of all firms expect credit conditions to ease further, while 8 percent expect tightening. The proportion of firms reporting that loans were "harder to get" has varied between 6 and 9 percent since 1982, well below the 27 percent reporting loans harder to get in 1980. Credit was even more available in the 1976–77 period, when as few as 4 percent reported loans harder to get. Thus, from the standpoint of credit availability, monetary policy does not appear to have been particularly restrictive during the past four years, nor is it a problem now. Credit demands seem to have fallen for small firms in spite of heavy consumer, government, and financial market demands.

A Concluding Note on Policy

The federal budget deficit has become the symbol (rightly so) of the inability of the U.S. to "live within our means." The spending demands of government, consumers, and businesses exceed our capacity to produce. Consequently, the credit demands of these sectors exceed U.S. savings, and we must borrow from the rest of the world to finance the spending appetites of these three sectors. It should be no surprise that the budget deficit, the trade deficit, and net capital inflows are all about the same size. We are trying to spend $150 billion more than we produce (and earn). To do that, we must borrow; but savings are inadequate in the U.S., and so we borrow the savings of other nations (producing a capital inflow to the U.S.). The money we borrow is used to pay for the goods we must import. Each year, the claims held by foreigners who lend to us accumulate, increasing the "servicing" burden (interest and profits earned by foreign holders of U.S. assets).

Congress still has the opportunity to effectively eliminate the deficit without severely impacting the economy, by allowing growing domestic demand to pick up the slack created by spending adjustments. However, this is not (politically) likely to happen. Except for already obvious reductions in defense spending now built in to the budget for the next few years, Congress shows little inclination to slow the growth of nondefense spending and entitlements and is creating an ever-growing agenda of new spending programs that it would like to implement.

Editor's Note: As OUTLOOK went to press, results from the July NFIB survey became available. Overall, they were quite consistent with the April survey results, though some differences emerged. The Small Business Optimism Index was down about two points from the April reading (seasonally adjusted), and the proportion of firms reporting that now is a good time to expand was also down about two points. Further, inflationary pressures seem to be mounting, with a trend toward more frequent and larger price increases — both actual and planned — having become more evident recently. But the author reports that "there is no sign that the economy is poised to enter a recession."

Cautious Optimism among Consumers

Richard T. Curtin
Director, Surveys of Consumers
Survey Research Center
The University of Michigan

Persistent Strength

The most recent surveys indicate that consumer confidence has regained the very favorable levels recorded before the stock market crash. In the second quarter surveys, the Index of Consumer Sentiment was 93.6, up from the depressed fourth quarter 1987 reading of 86.4 (see the chart below). The recovery from the stock market crash was rapid, with most of the gain recorded by the end of the first quarter, when the Index rose to 92.3.

This is not the first time in this long expansion that the persistent strength in consumer confidence has confounded the pessimists. For the past five years, consumer sentiment has been more favorable than anytime since the mid-1960s. Since the second quarter of 1983, only in the fourth quarter of 1987 has the Index fallen below 90; during the five years prior to that the Index never reached 90. Overall, the Index has averaged 93.6 during the past five years, with the second quarter 1988 reading exactly equal to that average.

To be sure, this long expansion has been marked by divergent trends in consumer attitudes and expectations. The Index components that reflect expected improvement have gradually weakened since reaching a cyclical peak at the start of 1984, while the components that reflect assessments of current economic conditions have generally strengthened (see the top chart on p. 21). At present, it is not so much that further improvement is expected, but that consumers expect that the gains won over the long expansion will be maintained during the year ahead.

Since the start of 1988, consumers have become increasingly concerned with rising interest rates and, more recently, with rising inflation. Both of these concerns strike at the core of the current strength in consumer confidence and represent a serious threat to its continued maintenance at high levels. Offsetting these concerns, consumers continue to favorably view income and employment prospects for the year ahead.

Higher Inflation Rate Expected

Consumers expected the rate of inflation to average 5.0% during the year ahead in the second quarter 1988 surveys, up from 4.3% one quarter and one year earlier (see the bottom chart on p. 21). Importantly, these price expectations have risen sharply in the months from April to June, rising from 4.5% to 5.6%, as the extensive media coverage given to the drought has heightened fears of potential increases in food prices. This is the highest rate of inflation expected by consumers in more than four years.

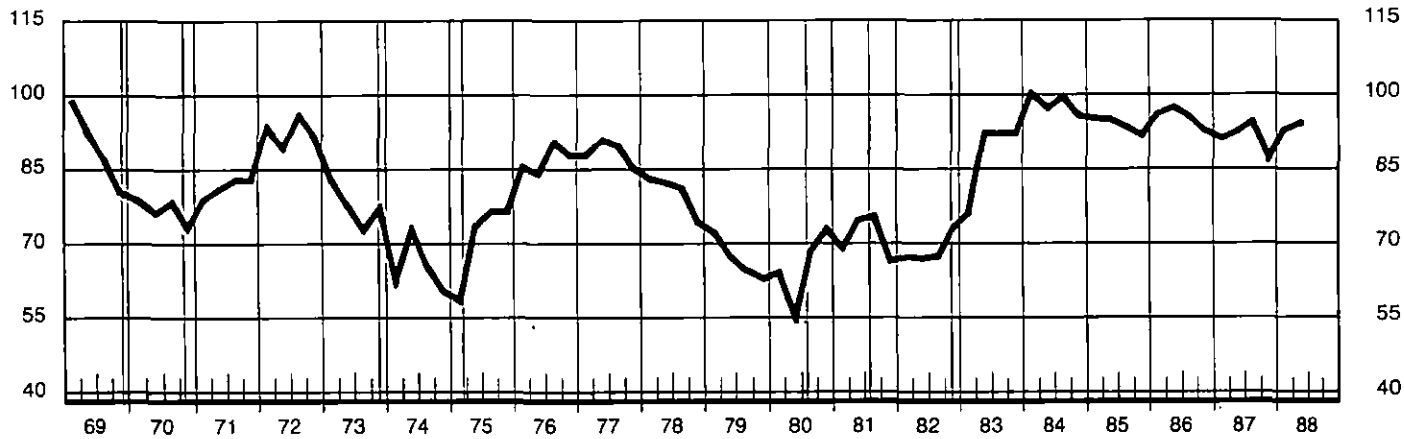
Personal Finances: Strong but Vulnerable

Despite the heightened awareness of potential increases in inflation during the year ahead, at present American families continue to view their own personal financial situation in favorable terms, even if somewhat diminished from prior readings.

Among all families in the second quarter 1988 surveys, 41 percent reported that they were financially better off than a year earlier, just below the 43 percent recorded one year ago. Income increases were reported by 30 percent of all families in the second quarter of 1988, also just below the year-earlier figure of 33 percent. Only 10 percent singled

INDEX OF CONSUMER SENTIMENT

February 1966 = 100



Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

out recent price increases as the cause of a worsened financial situation, largely unchanged from one and two years earlier.

Although these evaluations of personal financial progress have suffered some recent declines, they nonetheless remain very favorable by historical standards. In the 114 quarterly readings since 1960, only in 23 quarters has 40 percent or more of respondents reported being financially better off. Moreover, 19 of these 23 quarters have occurred in the current expansion — from the fourth quarter of 1983 to the present. These favorable evaluations have been due more to low and stable inflation rates than to gains in nominal incomes. Only in the early 1960s did fewer families cite rising prices as the cause of worsening finances.

It has not been just the low rate of inflation that has promoted more favorable assessments, but that the inflation rate has remained relatively stable at those low rates. The uncertainty caused by the inflation of the 1970s led to a pervasive sense of economic insecurity and an inability to plan ahead. The lower and more stable inflation rates that have prevailed since then have given consumers a new sense of confidence in their ability to make financial plans and provide for future financial needs.

A resurgence in inflation, concentrated in food prices, makes these gains especially vulnerable to reversal. Thus far, the expectation of rising prices has only had a minimal impact on personal financial prospects for the year ahead. In the second quarter 1988 surveys, 36 percent of all families expected their financial situation to improve, between the 39 percent recorded one quarter earlier and the 34 percent recorded one year earlier. Importantly, just 9 percent of all families in the second quarter of 1988 expected their financial situation to worsen during the year ahead.

Although expected inflation rates have demonstrated a high correspondence with personal financial prospects over the past quarter century, the minimal impact thus far recorded reflects several factors. First, it reflects the initial and tentative reaction of consumers to the potential impact from the drought. Only if these initial fears are reinforced by further adverse developments during the months ahead will the impact of these higher inflation expectations be felt. Second, although inflation expectations have increased, they are still modest when compared with the rates experienced in the past. And finally, recent income gains have been strong and have partially offset the expected losses due to inflation.

Outlook for Economy Rebounds

Consumers' evaluations of prospects for the national economy have posted a strong recovery from the low levels recorded following the stock market crash. In the second quarter 1988 surveys, 53 percent expected good times financially in the country as a whole during the year ahead, up from a low of 41 percent in the fourth quarter of 1987, and just above the year-earlier figure of 51 percent. Although this represents a substantial decline from the 69 percent recorded at the start of this expansion, it still remains as favorable as the peak levels recorded in the prior expansion.

Longer-term prospects for the national economy have also improved, but the balance of opinion still points toward bad rather than good times financially over the next five years. Among all families in the second quarter 1988 surveys, 38 percent expected bad times financially over the longer run compared with 44 percent that expected bad times in the economy as a whole. Despite its negative cast, this represents the most optimistic reading in more than a year.

More than any other facet of consumer sentiment, long-term economic prospects have been the most troublesome to consumers. Although most other economic assessments have been more favorable in the 1980s than anytime since the 1960s, consumers' assessments of the longer-term prospects for the economy have never reached the high levels recorded earlier. In the current expansion, the proportion of families that expected the reoccurrence of a recession over a five year horizon has never fallen below 33 percent. In comparison, during the 1960s as few as 11 percent of all families expected a recession over the longer term. The optimism of the 1980s has always been tempered by the realization that significant economic challenges remain on the horizon.

The major concern about the long-term vitality of the economy has been employment prospects. The recent gains in the international competitiveness of U.S. products, due to the decline in the value of the dollar, has improved short-term prospects for employment. In the second quarter 1988 surveys, the majority of families expected the unemployment rate to remain unchanged at its current ten year low during the year ahead — at 59 percent, it was the highest proportion to expect an unchanged unemployment rate ever recorded. Increases in the national unemployment rate were expected by 27 percent of all families, the lowest proportion recorded in more than two years. For the consumer, these favorable prospects represent the primary source of the current strength in the national economy.

Interest Rate Increases Expected

Interest rates were expected to increase by 60 percent of all families in the second quarter 1988 surveys. This represents a sharp rise from the post-crash low of 49 percent recorded one quarter earlier and returns interest rate expectations to the very unfavorable levels recorded in the second and third quarters of last year. Just 10 percent of all families expected interest rates to decline during the upcoming year.

Buying Attitudes Remain Favorable

Attitudes toward buying conditions for homes, vehicles, appliances, furniture, and home electronics have remained at favorable levels in the recent survey.

Favorable attitudes toward buying conditions for homes were held by 72 percent of all families in the second

quarter 1988 surveys. This represents an improvement above the 1987 year-end low of 65 percent, but remains below the 77 percent recorded one year earlier and the all-time peak of 85 percent recorded two years earlier. As shown in the chart, sales of new and existing single family homes in the second quarter of 1988 posted the first quarterly increase since the end of 1986. The fourth quarter 1986 peak in home sales followed the peak in favorable home buying attitudes reached earlier in 1986.

Favorable attitudes toward buying conditions for appliances, furniture, and home electronics were held by 75 percent of all families in the second quarter 1988 surveys. This reading was identical to the year-earlier figure and was the highest proportion recorded since mid-1986. Since 1960, there have been only three quarterly readings that exceeded 75 percent — all recorded in 1986.

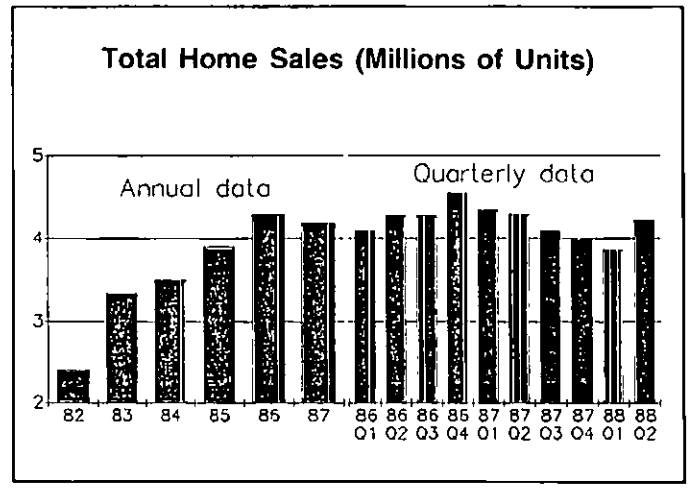
Favorable vehicle buying attitudes were held by 63 percent of all families in the second quarter of 1988, just below the year-earlier reading of 65 percent, and significantly below the all-time peak of 76 percent recorded two years earlier. Total unit sales of cars and light trucks remained at very favorable levels during the first half of 1988, showing only a very small decline in the second quarter (see the chart). The pattern of quarterly sales rates are dominated by the third quarter peaks, corresponding to the periods of deep discounting by vehicle manufacturers — a pattern that consumers have now come to expect.

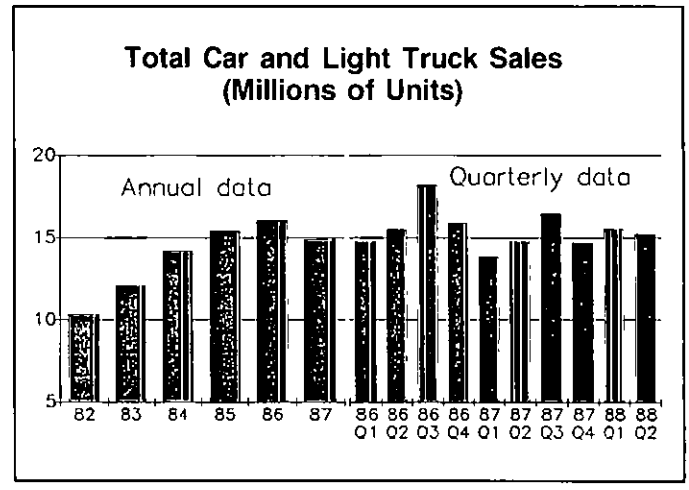
Changing Purchase Rationales

Although the overall incidence of favorable buying attitudes has remained high, the reasons given by consumers for the favorable attitudes have changed substantially. Compared with a year earlier, consumers much less frequently cited the availability of low interest rates on credit purchases in the second quarter of 1988. When asked about home buying conditions, the proportion of families that cited low mortgage rates fell to 37 from 52 percent during the past year, and for vehicle purchases favorable mentions of low interest rates fell to 18 from 36 percent.

But the opposite was not true: complaints about high interest rates have not increased in frequency. Thus, increases in interest rates have meant that current rates are no longer viewed as a positive attraction, but thus far the extent of those increases has not been viewed as a cause for postponement of purchases.

Indeed, rather than postponement, consumers are now as likely apt to cite the appeal of borrowing-in-advance of rising interest rates. In the second quarter 1988 surveys, as many families mentioned the appeal of borrowing-in-advance of rising mortgage rates as thought that current





mortgage rates were already too high and cause for postponement (13 versus 11 percent).

In contrast to their reaction to impending interest rate increases, consumers are not likely to react to escalating prices with advance buying. Their inflation fears are focused on food prices, not on the prices of homes, vehicles, appliances, furniture, or home electronics. Quite the contrary: consumers still expect, and are willing to wait for, price discounts.

This continued reliance on discounts is nowhere more evident than in the vehicle market. Unlike home buying attitudes, references to borrowing-in-advance of rising interest rates on vehicle loans have not increased in frequency. This reflects the now more common reaction of consumers to wait for renewed discounting by vehicle manufacturers rather than to speed up their purchases.

Actual and Projected Economic Indicators

seasonally adjusted

SERIES FORECAST BY THE ASA-NBER PANEL													
ECONOMIC INDICATOR	Quarterly Data										Annual Data		
	Actual					Projected					Actual	Projected	
	1987:2	1987:3	1987:4	1988:1	1988:2	1988:2	1988:3	1988:4	1989:1	1989:2	1987	1988	1989
GROSS NATIONAL PRODUCT*	4,482.2	4,568.0	4,662.8	4,724.5	4,819.7	4,799.4	4,868.7	4,947.6	5,026.2	5,099.5	4,526.2	4,832.3	5,136.6
GNP IMPLICIT PRICE DEFLATOR* (index, 1982 = 100)	117.3	118.2	118.9	119.4	120.9	120.5	121.6	122.9	124.1	125.2	117.7	121.1	126.0
CORPORATE PROFITS AFTER TAXES*	141.1	149.5	145.7	149.4	166.6	151.4	153.5	157.6	158.8	158.6	141.3	153.2	159.1
UNEMPLOYMENT RATE (percent)	6.23	5.97	5.90	5.70	5.43	5.50	5.50	5.50	5.50	5.50	6.18	5.60	5.65
INDUSTRIAL PRODUCTION (index, 1977 = 100)	128.2	130.9	133.2	134.5	136.0	135.4	136.2	137.5	138.0	139.0	129.8	136.0	139.4
NEW PRIVATE HOUSING UNITS STARTED (millions)*	1.606	1.619	1.533	1.477	1.477	1.520	1.520	1.500	1.460	1.480	1.634	1.500	1.500
CONSUMER PRICE INDEX (annualized percent change from prior quarter or year)*	4.94	3 94	3.59	3.40	4.79	4.15	4.33	4.60	4.65	4.70	3.70	4.00	4.80
3-MONTH TREASURY BILL RATE (%)	5.73	6.03	6.00	5.76	6.23	6.15	6.40	6.60	6.63	6.63	5.83	6.20	6.20
NEW HIGH-GRADE CORPORATE BOND YIELD (percent)	9:65	10.14	10.37	9.64	NA	9.85	10.10	10.27	10.24	10.25	9.69	10.00	10.29
GNP IN 1982 DOLLARS*	3,823.0	3,865.3	3,923.0	3,956.1	3,988.1	3,978.9	4,004.2	4,037.6	4,064.6	4,084.2	3,847.0	3,999.1	4,091.8
PERSONAL CONSUMPTION EXPENDITURES (1982 dollars)*	2,516.6	2,545.2	2,531.7	2,559.8	2,577.2	2,576.7	2,588.8	2,599.4	2,614.3	2,625.8	2,520.9	2,580.4	2,633.0
NONRESIDENTIAL FIXED INVESTMENT (1982 dollars)*	434.8	462.8	464.8	473.4	491.6	497.7	502.6	508.0	514.9	519.0	445.2	500.8	517.5
RESIDENTIAL FIXED INVESTMENT (1982 dollars)*	197.6	192.1	192.7	189.5	190.0	195.5	196.0	194.4	193.9	193 9	195.2	195.5	194.4
CHANGE IN BUSINESS INVENTORIES (1982 dollars)*	27.8	13.0	67.1	66.0	36.0	40.5	28.4	20.3	29.4	28.4	34.4	36.5	25.2
NET EXPORTS (1982 dollars)*	-126.0	-130.7	-126.0	-109.0	-90.1	-118.3	-108.4	-98.2	-92.2	-90.1	-62.5	-111.4	-88.6
FEDERAL GOVERNMENT PURCHASES (1982 dollars)*	332.1	342.1	347.7	327.8	331.0	335.7	340.3	343.3	338.2	339.8	339.0	338.2	340.3
STATE AND LOCAL GOVERNMENT PURCHASES (1982 dollars)*	440.1	440.8	444.9	448.7	452.3	451.7	453.7	456.4	459.2	460.8	441.2	452.4	462.8

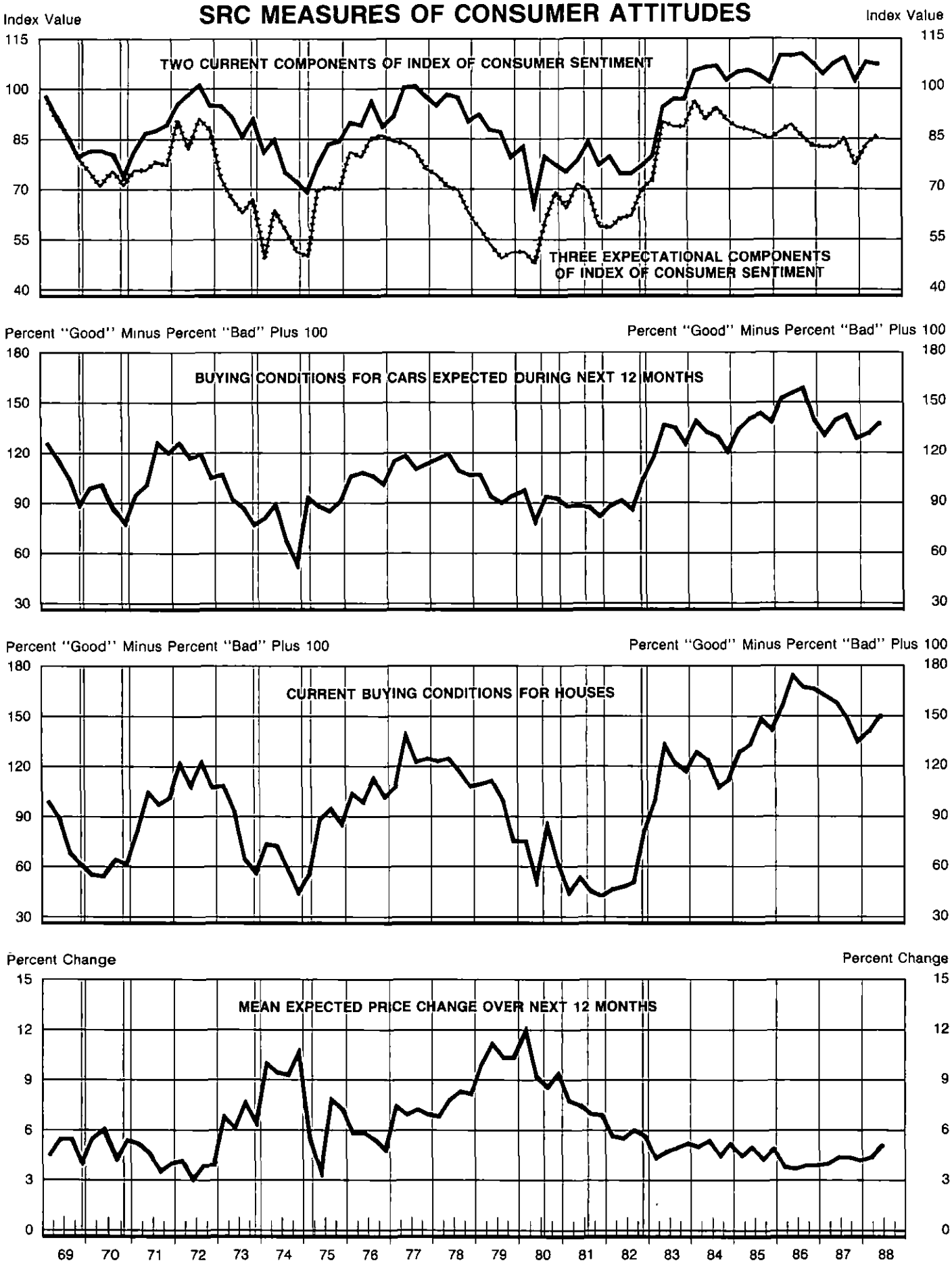
SERIES FROM THE CURRENT-DOLLAR GNP ACCOUNTS													
ECONOMIC INDICATOR	Quarterly Data										Annual Data		
	1986:1	1986:2	1986:3	1986:4	1987:1	1987:2	1987:3	1987:4	1988:1	1988.2	1985	1986	1987
GROSS NATIONAL PRODUCT*	4,180.4	4,207.6	4,268.4	4,304.6	4,391.8	4,482.2	4,568.0	4,662.8	4,724.5	4,819.7	4,014.9	4,240.3	4,526.2
PERSONAL CONSUMPTION EXPENDITURES*	2,739.0	2,772.1	2,842.8	2,876.0	2,921.7	2,992.2	3,058.2	3,076.3	3,128.1	3,189.1	2,629.0	2,807.5	3,012.1
GROSS PRIVATE DOMESTIC INVESTMENT*	686.6	667.8	653.0	656.4	685.5	698.5	702.8	764.9	763.4	758.2	643.1	666.0	712.9
NET EXPORTS*	-93.0	-101.2	-109.1	-114.3	-119.1	-122.2	-125.2	-125.7	-112.1.	-88.6	-78.0	-104.4	-123.0
GOVERNMENT PURCHASES*	847.8	868.8	881.8	886.5	903.8	915 7	932.2	947.3	945.2	961.0	820.8	871.2	924.8
DISPOSABLE PERSONAL INCOME*	2,965.1	3,016.3	3,032.4	3,064.7	3,143.9	3,154.1	3,224.9	3,315.8	3,375.6	3,421.0	2,838.7	3,019.6	3,209.7
PERSONAL SAVING RATE* (percent of disposable income)	4.6	5.1	3.3	3.2	4.2	2.2	2.3	4.3	4.4	3.9	4.4	4.0	3.3

Note: (1) All data are at annual rates and in billions of current dollars unless otherwise indicated. (2) To facilitate comparison and evaluation of forecasts, both actual data, released in August, and projected data, released by ASA-NBER in June, are displayed for second quarter 1988. (3) ASA-NBER projections have been rescaled so that they are consistent with the GNP and components series affected by the Commerce Department's July revisions.

Sources: Projections: American Statistical Association—National Bureau of Economic Research panel of forecasters.
Actual Data: U.S. Departments of Commerce and Labor, Board of Governors of the Federal Reserve System.

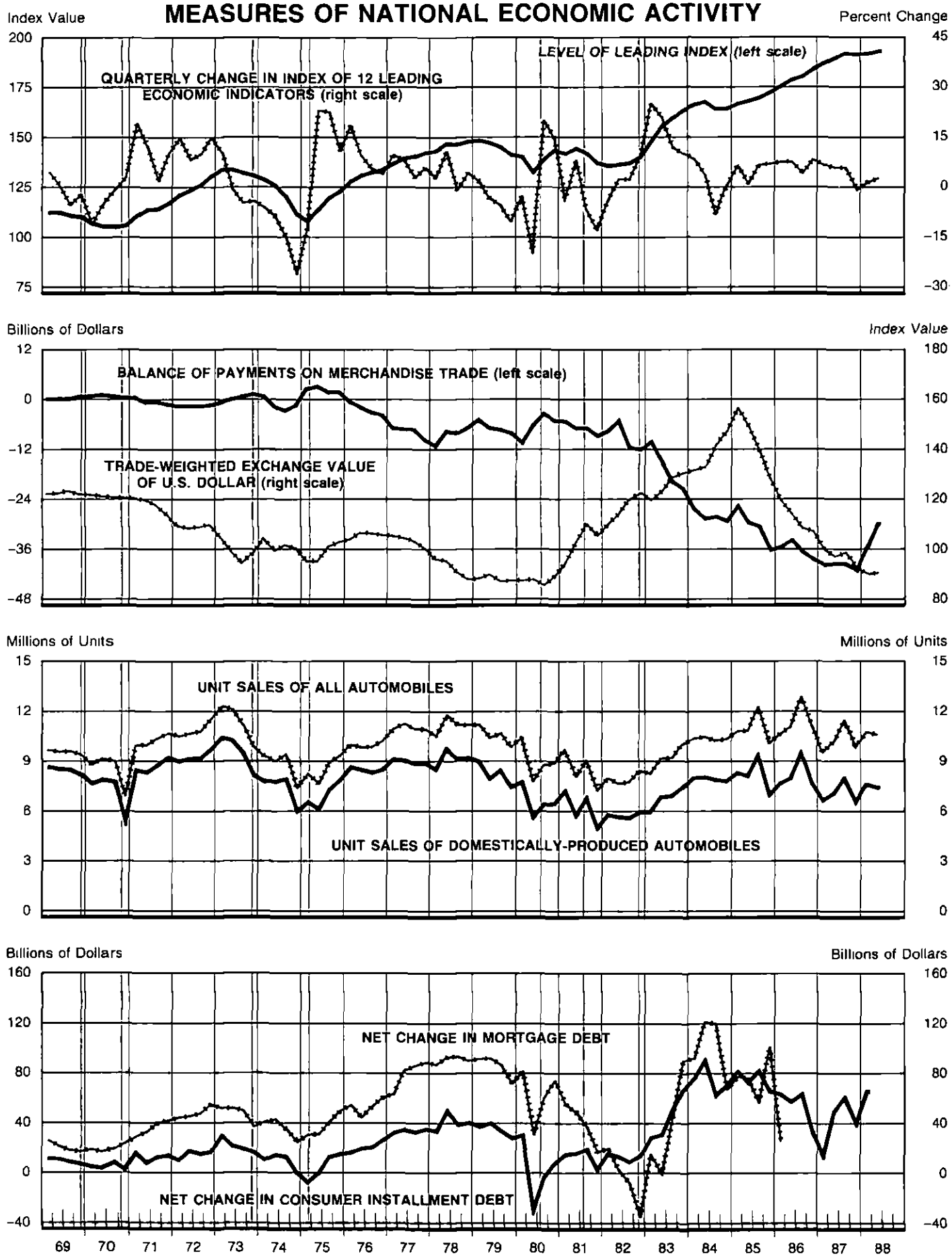
*Substantial revision of the data for series marked with an asterisk has occurred since the last printing.

SRC MEASURES OF CONSUMER ATTITUDES



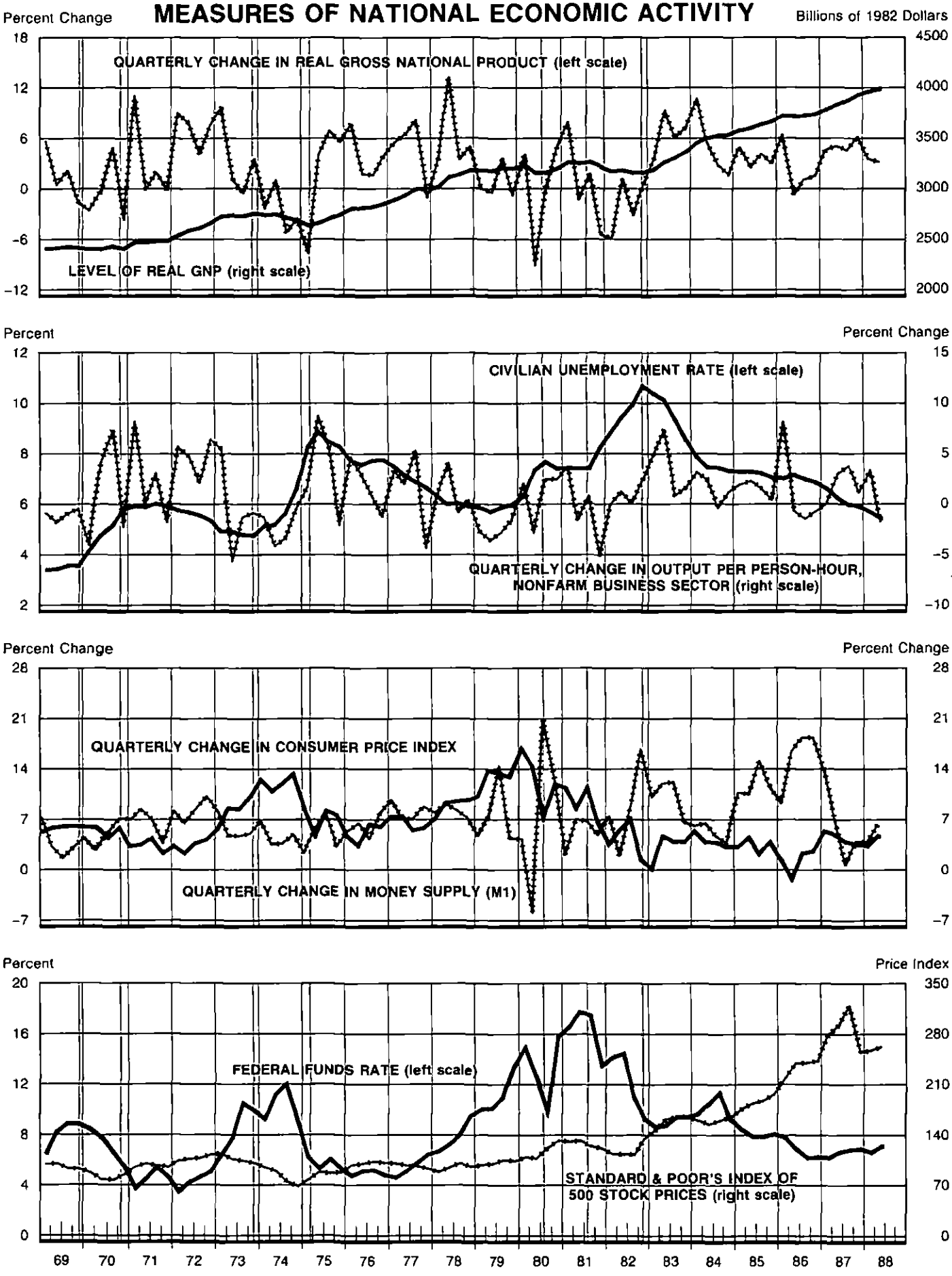
Note: Shaded areas indicate recession periods as designated by the National Bureau of Economic Research, Inc.

MEASURES OF NATIONAL ECONOMIC ACTIVITY



Note: Shaded areas indicate recession periods as designated by NBER; percent changes are at annual rates.

MEASURES OF NATIONAL ECONOMIC ACTIVITY



Note: Shaded areas indicate recession periods as designated by NBER; percent changes are at annual rates.

Announcing a new volume from the Institute for Social Research...

REVIVAL IN THE RUST BELT:

Tracking the Evolution of an Urban Industrial Region

by Daniel Denison and Stuart Hart

Understanding the evolution of regional economies and the growth or decline of business organizations within them is an important step in the formulation of state and local economic development policies. Such an understanding is also central to the progress of academic research on business strategy and on the population ecology of organizations, as well as to the creation and development of new business.

This new ISR volume describes the research design and preliminary findings of one of the first comprehensive studies of the factors influencing the development of business activity within a specific regional economy–southeastern Michigan's Oakland County. Heavily tied to the economic ebbs and flows of the auto industry, southeastern Michigan is an area often associated with decline and deindustrialization, yet Oakland County is one of the most rapidly growing areas in the nation; it is a region that offers an extremely interesting set of dynamics for the study of business organizations and their evolution.

The research described in this volume covers the first year of a five-year longitudinal study. A representative sample of firms was drawn from the population of all businesses operating in the county, using state unemployment insurance records; this data source provided a particularly effective sampling frame for new and small firms–precisely those firms that conventional data bases such as Dun & Bradstreet's are poorest at capturing.

The study measures a variety of firm characteristics such as industrial sector, size, origin and stage of development, level of technology, level of dependence on the automobile industry, sourcing activity, business strategy, and performance (new product development, sales growth, market share, profitability, etc.). Distinctions among the firms on this first set of measures facilitate further comparisons based on responses to a second set of measures: perceptions of major operating problems; expected use of business services; factors affecting the decision to locate in the region; and several variables measuring each firm's expected outlook for employment and growth or expansion over the coming months and years.

The results of the study reveal a number of important features about the evolution of the region as whole, as well as some particularly interesting differences among the various types of firms within the region. Among the first-year results, for example, is the finding that traditional "smokestack" criteria such as utility costs, wage rates, transportation, and taxes once central to the location decision now seem to be of lesser importance than factors related to the perceived quality of life in the region.

ISR Research Report Series / 224 pages
ISBN 0-87944-322-7 / $15.00 paperbound

Order from:

ISR Book Sales, Dept. E
Institute for Social Research
The University of Michigan
P.O. Box 1248
Ann Arbor, MI 48106-1248

All orders from individuals must be prepaid.

ECONOMIC OUTLOOK USA
SRC–P.O. Box 1248
Ann Arbor, MI 48106

Second Class Postage
Paid at Ann Arbor, MI