District Conditions

Contrary to expectations, a general U.S. economic recovery did not appear in late 1982, but many forecasters now find reasons to expect it in early 1983. If they're right this time, the district's recovery is likely to begin then too, though it will probably be somewhat weaker than the nation's.*

No Recovery in Late 1982. . .

Around midyear, the U.S. economy was expected to begin to recover during the last half of 1982. Most national forecasters expected gross national product, adjusted for inflation (real GNP) to increase a modest 4 percent in both the third and fourth quarters. Based on that forecast, we expected a late 1982 recovery for the district economy as well, but a somewhat slower one than the nation's. That difference was because the recession has been particularly severe on farming, metal mining, and lumbering, and proportionally, these industries contribute more to the district's economy than to the nation's. Since they were not expected to be significantly strengthened in 1982, they would somewhat restrain activity in the district.

The consensus forecast was wrong, however. Real GNP was essentially unchanged between the second and third quarters of 1982, as were national levels of employment and retail sales. Unfortunately, our assessment that the district economy would perform less well than the national economy was correct. While employment in the nation didn't change between the second and third quarters, for example, employment locally fell 1 percent. (There are no regional production counterparts to the GNP data.)

. . .But Financial Conditions Improved. . .

Since midyear, however, financial developments have signaled that a recovery might not be far away.

Interest rates, for instance, have dropped sharply. The prime rate paid by businesses at banks in the district and elsewhere in the nation dropped from 16.5 percent in July to 11.5 percent in late November. The corporate AAA bond rate also dropped during this period, from 14.6 percent to 11.8 percent. Along with the decline in business borrowing costs has come a substantial decline in consumer borrowing costs. Rates on mortgage and consumer installment loans at banks and S&Ls in the district and elsewhere dropped about 2 or 3 percentage points between July and late November.

Accompanying the sharp decline in interest rates has been a dramatic rise in stock prices. Nationally, the Standard & Poor's 500-stock index rose 26 percent between July and late November. In the district, the Dain Bosworth regional stock price index rose 33 percent during that time.

Economic activity generally responds to such financial developments with some lag. As a rule, businesses and consumers don't react instantaneously to changing financial conditions. When interest rates drop sharply and stock prices rise dramatically, businesses and consumers hesitate to change strategy until they determine where interest rates and stock prices are going. Consumers, for example, put off buying houses until they are convinced that mortgage interest rates have stopped falling. Also, refinancing typically involves significant transaction costs, such as the underwriting costs for stock and bond issues and the closing and moving costs of homebuying. Furthermore, businesses and consumers must commit themselves for several years when financing large purchases. Therefore, even after businesses and consumers have reformed their expectations for interest rate and stock price trends, they need time to ponder large purchases.

Thus, the failure of the district and national economies to recover in the third quarter, when financial conditions were starting to improve, is not surprising. In fact, it is consistent with historical evidence, which suggests that it takes several quarters for financial market adjustments to have a major impact on the rest of the economy.

What has been happening in late 1982 is that busi-

*The Ninth Federal Reserve District consists of Minnesota, Montana, North and South Dakota, northwestern Wisconsin, and the Upper Peninsula of Michigan.

nesses and households have been taking advantage of improved market conditions by refinancing their borrowings at lower cost, or *restructuring their balance sheets,* as it is sometimes termed. The principal reaction of corporations to improved financial conditions has been to step up borrowings in the long-term debt and equity markets. They have used the proceeds primarily to reduce bank debt and other short-term borrowing, not for plant and equipment spending. With substantial excess capacity in many industries, there is little incentive for capital spending. But refinancing short-term debt increases corporate liquidity, reduces risk due to interest rate variations, and sets the stage for capital spending to occur if the economy recovers.

Some consumers, too, have been taking advantage of lower interest rates, in their case, to refinance existing mortgage debt or to convert contracts for deed into conventional mortgages. Their motives are similar to those of corporations, that is, to reduce interest costs and lock them in so as to reduce risk due to future interest rate variations.

At the same time, rising stock prices have made consumers wealthier. It has been estimated that the recent stock market boom produced aggregate capital gains in the neighborhood of $250 billion. This increased wealth may have made consumers more inclined to spend on big-ticket items like homes and autos.

. . .And May Lead to Recovery in Early 1983

Financial developments are not alone in signaling a national recovery. The leading indicators of business activity rose in six of the seven months ending in October. Based on past patterns, that would suggest that a recovery is about to start. According to most forecasters, it will begin in early 1983. Many economists believe that real GNP will increase at a 3 or 4 percent rate in the first two quarters of 1983, which would be modest postrecession growth by historical standards.

Of course, these forecasts must be viewed cautiously. Economic prediction is dangerous; the fact that most forecasts for the second half of 1982 proved overly optimistic is evidence of that. Admittedly, the same thing could happen to forecasts for the first half of 1983.

However, weak signs of increased economic activity add to the credibility of the leading indicators. The housing industry has often been among the first sectors of the economy to respond positively to lower interest rates, and this pattern may be repeated once more. Nationally, home sales in September and October were 33 percent greater than sales in the previous two months. In the second half of 1982, domestic auto manufacturers were offering attractive financing terms, and nationally in October and November their sales were up 7 percent from sales in the preceding two months. We do not have comparable information at the district level, but anecdotal evidence indicates that district consumers have begun to be more interested in purchasing homes and autos too. Our reports suggest that more people are out shopping and a few, at least, are buying.

Weakness in the District

While the district economy should recover if the national economy does, we still believe that it won't recover as strongly, at least for a few quarters. That is for basically the same reason explained earlier. Three of the industries particularly important to the district economy have been among those hurt worst in this recession: farming, metal mining, and lumbering. And only one of these industries is likely to be helped much in 1983 by the expected moderate general recovery.

Lumbering is the fortunate industry. With financial conditions continuing to boost home sales, industry analysts forecast a 34 percent increase in housing starts between 1982 and 1983. This should provide a welcome boost to the district lumbering industry, which has been operating at about 65 percent of capacity.

But if the forecasts for metal mining and agriculture are correct, these industries should moderate the strength of the local recovery. Although industry analysts predict that auto sales will increase 16 percent between 1982 and 1983, this won't be enough to substantially revive metal mining in the district. Capacity utilization in district iron mining is expected to increase, but only from a catastrophic 10 percent this fall to a still depressed 55 percent in 1983. The outlook for district copper mining is little better; substantive recovery of this industry will also require more than a few quarters of sustained growth. Perhaps most important for the district economy are the continuing poor prospects for farm income. The U.S. Department of Agriculture has estimated that 1983 farm income will just match its 1982 level, which was badly depressed by any standard.

The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.