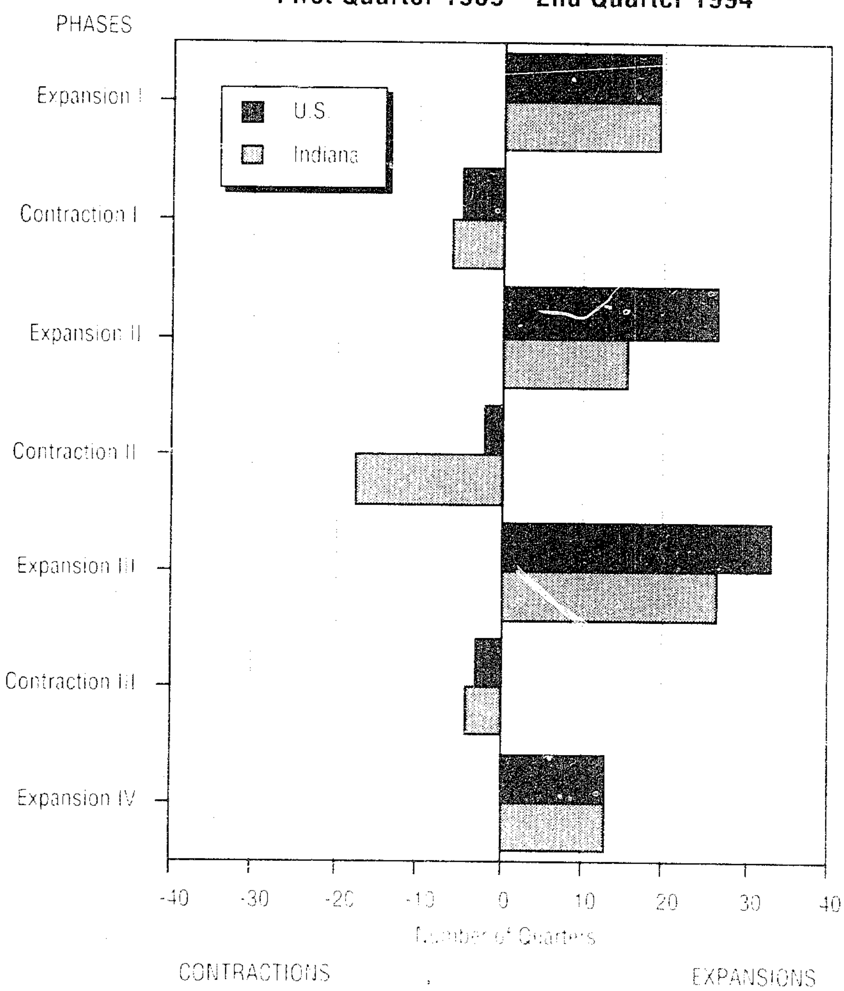
Indiana Business Review

Duration of Expansions and Contractions in Indiana and the United States
First Quarter 1969 – 2nd Quarter 1994



The 1995 Outlook

A publication of the Indiana Business Research Center, Indiana University School of Business

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Please note that this issue completes Volume 69.

The 1995 Outlook

Consumer Spending and Business Investment

R. Jeffery Green

Professor of Business Economics and Public Policy and Co-director, Center for Econometric Model Research, Indiana University School of Business

The total domestic demand for goods and services in the economy is the sum of consumer spending on goods and services and gross private domestic investment. In real terms, after adjusting for inflation, total domestic demand in 1993 amounted to more than 80% of real gross domestic product (real GDP). Over the last four quarters for which we have data, real total domestic demand has risen 5.9% while real GDP has grown by 4.3%. Clearly, the recent strength in the economy is being led by consumer and investment spending. Why the strength? Can it last?

Real Consumer Spending

Real consumer spending has increased by 3.6% in the past 12 months, led by an 8.5% increase in spending on durable consumer goods. Reflecting the strength in the new housing market, real spending on furniture and household appliances has been rising at more than a 10% annual rate. The strength in consumer spending, particularly on durable goods, is the result of good employment and income growth and relatively low interest rates. Employment has increased by more than 3 million jobs in the past year, producing a rise of more than 3% in real disposable personal income. Additional income is the prime determinant of consumer spending. The growth in employment has an added stimulative effect beyond increasing income. As employment expands and the unemployment rate declines, the risk of layoff declines. This reduction in uncertainty encourages consumers to expand their purchases of durable goods.

> *"Clearly, the recent strength in the economy is being led by consumer and investment spending. Why the strength? Can it last?"*

Interest rates have also been favorable for spending on durable consumer goods. While it's true that interest rates rose during 1994, a combination of fairly low but rising rates may be the most stimulative set of circumstances for durable goods spending. This is because interest costs remain moderate and consumers are encouraged to spend now before rates get much higher. As a result, consumer credit has been increasing at double-digit rates over the past year.

We expect the growth in real consumer spending to slow in 1995 for several reasons. Interest rates are expected to continue to increase through 1995; this will both raise borrowing costs for consumers and cool the housing industry, thus reducing additional demand for furniture and appliances. Consumers have been borrowing extensively through 1994, and we expect them to curb borrowing in 1995 as debt loads get larger. The recent spurt in spending on durable goods is classic. Precisely because these goods are durable, once consumers buy them they will not need to replace them for some time, so at least the growth in demand should slow.

Our forecast is for real consumer spending to rise at about 2.2% in 1995. That is a considerable slowdown from its recent performance but still represents a continuation of the recovery. In fact, a slower rate of growth for consumer spending in 1995 will actually increase the likelihood that the recovery will continue for an extended period. Slower growth in consumer expenditures will enable consumers to control borrowing and prevent excessive debt burdens from strangling the recovery.

Investment Spending

Real gross private investment spending can be disaggregated into four major components: real business spending on equipment, real business spending on structures, real residential investment spending, and the real change in business inventories. These four components usually exhibit very different cyclical behaviors, and this year has been no exception. In the last four quarters real gross private domestic investment has increased by an impressive 17.2%. Broken down into the four components, this translates into an increase of 15.5% for real equipment spending, 0.9% for real spending on structures, 8.8% for real residential investment spending, and more than triple the rate of real inventory investment.

More than half of total investment spending goes for nonresidential equipment. Within that sector, by far the fastest growing component is spending for computing and information processing equipment, which increased by almost 20% in the last year. Thus, one major story behind the acceleration of economic activity in the last year is the boom in computer and related spending. Why now, and why is it so strong? Two major factors are the recovery in profits and large declines in computer prices. Corporate profits have risen by more than 15% in the past year, and nonfarm proprietors' income has risen more than 8%, so firms have a growing source of funds with which to finance new capital. And computer prices have been declining sharply for years, with no end in sight. This combination of growing profits and declining prices enables firms to acquire large quantities of new computers and information processing equipment.

The price declines for computers and information processing equipment will likely continue over the next year, but with the economy growing more slowly profit growth will also slow. As a result, real spending on business equipment will grow, but at a slower rate than 1994. We expect that growth to be in the 7–9% range.

Real investment in structures has been weak since the end of the construction boom in the 1980s and the subsequent savings and loan scandal. Although the large declines appear to be over, there is little chance of significant growth in the coming year, particularly in light of our forecast of rising interest rates. We predict real investment in structures to show little or no growth. Residential investment has been very strong this past year, but with rising interest rates and slower income growth we expect the housing sector to show little or no growth in 1995.

Inventory accumulation has been spectacular this year. We have not seen this rate of stock building since the early days of the recovery from the 1981-82 recession. This rate is not sustainable, so we expect inventory accumulation to be lower this year.

Putting all these component forecasts together yields a picture of continuing growth in total real domestic demand to average 2–2.5% this year, but at a rate that is considerably slower than we saw last year. Nevertheless, this is a very favorable forecast because the economy is currently very near full employment. Consequently, a slowdown in growth next year will lower the likelihood of higher inflation rates while allowing economic recovery to continue.

A final note of caution is in order: Spending on durable consumer goods, business plants and equipment, and housing is interest-sensitive. If the Federal Reserve decides it must raise interest rates even higher than we expect in order to slow the economy and prevent a rise in inflation, it is precisely these interest-sensitive sectors that will feel the pinch. In that case, the rate of growth of total real domestic demand may be lower than we forecast.

Monetary and Fiscal Policy

Carol A. Lehr

Assistant Professor of Business Economics and Public Policy, Indiana University School of Business

Current trends in output growth, unemployment, and inflation are quite favorable. Since 1992, output growth has averaged 3.4%, compared to a disappointing 1.1% coming out of the 1990-91 recession. Moreover, the unemployment rate, after hitting a peak of 7.7% in mid-1992, has dropped steadily and is now below the 6% rate.

It should be noted that there was a break in the unemployment series in January 1994 due to changes in the survey technique. The alterations raised the measured unemployment rate by 0.5%, so current unemployment may be even lower relative to 1993 rates. Typical estimates for the "natural rate" of unemployment (that is, the rate of unemployment below which inflationary pressures accelerate) fall into the 6% range. The dip in the unemployment rate below this level, along with rising factory orders, increasing incomes, strong retail sales, relatively high-capacity utilization numbers, and a myriad of other strong signals, has made market participants nervous that inflation will soon pick up.

However, the most recent inflation numbers show no current tendency toward accelerating inflation. In fact, the CPI inflation rate for third quarter 1994 was 3.2%—virtually unchanged from the previous quarter. But the markets look forward and current third quarter numbers only reflect activity prior to September 30. Future inflationary pressures will depend on the Federal Reserve's decisions concerning interest rate movements as well as the economy's ability to increase productivity and capacity.

Monetary Policy

With this scenario in mind, the Fed made several moves this year to raise short-term interest rates. As is usually the case, the rate changes have been small and gradual as monetary policy attempts to balance possible future inflation costs against a slowdown in current growth arising from a higher cost of funds. At the last meeting of the Federal Open Market Committee (FOMC) in November, the committee voted to raise short-term interest rates yet again, by three quarters of a percentage point.

Although the Fed does not directly control nominal long-term interest rates, it can influence them indirectly through the yield curve and, more important, through its effects on expected inflation. The recently improved output growth rates are undoubtedly linked to lower long-term interest rates, which encouraged the investment-led growth spurt. Moreover, net investment in new machinery and equipment adds to capacity, which in turn helps keep inflationary pressures low in the long run.

Therefore, in an effort to keep currency spending within current capacity and to restrain expectations of inflation, the Federal Reserve will probably continue to raise short-term interest rates gradually into 1995. The outlook projection is that short-term rates, such as the three-month Treasury bill rate, will increase nearly 1%.

Fiscal Policy

As of March 1994, the federal debt totaled close to $4.6 trillion, which is 68% of GDP. In 1989 the federal debt was 55% of GDP. The 1992 elections brought the issue of the federal budget deficit and debt to the forefront of popular debate. High levels of government spending relative to revenue have limited fiscal authorities in their ability to manipulate spending and taxes to influence the business cycle. Therefore, the thrust of fiscal policy in this decade has not been to use the budget deficit to smooth out business cycle fluctuations. Instead, emphasis has been placed on budget reduction. The implementation of the 1993 budget plan reduces the deficit by $500 billion over a five-year period. These measures—along with a growing economy and, hence, growing tax revenues—helped bring down the deficit in 1993 and 1994. The government's fiscal year ended on September 30, and reports show that the deficit declined from the previous fiscal year, which is the second year-to-year drop.

The outlook for calendar year 1995 is for the deficit to increase slightly. The projection is based on slowing economic growth. However, the failure of health care reform this year helped keep the projected deficit lower than otherwise thought. If health care reform returns to the agenda, it is again unlikely that major initiatives could be put into place next year, thus delaying the initial increased cost to government. On the other hand, one of the major reasons for the explosion of the deficit in the 1980s was the sharp increase in health care costs. This drove spending on Medicare and Medicaid to unprecedented levels, and reductions in the deficit are inextricably tied to lowering the growth of health care expenditures.

The International Economy

Michele Fratianni

AMOCO Professor of Business Economics and Public Policy, Indiana University School of Business

Economic growth around the world improved in 1994. **Table 1**, based on data available in May 1994, indicates that world output is growing at 3%—still below the long-term trend. This performance, in turn, reflects the fact that several industrial countries are in a down phase of the business cycle. Over the period of 1975-1989, world output of goods and services grew at an average annual rate of 3.5 %. Industrial countries, which account for the lion's share of world output, grew at an average of 2.8 %. Of the so-called G7 countries—the elite of the industrial countries grouping—only Japan and Canada grew faster than the industrial average. Developing countries, which account for a relatively small share of world output, grew almost twice as fast as industrial countries. Asian countries grew faster than that, and Pacific Basin countries even faster.

Table 1
Growth of World Output, 1975–1994 (%)

	1975–89 Average	*1990*	*1991*	*1992*	*1993*	*1994 (est.)*
World	3.5	2.0	0.6	1.8	2.2	3.0
Industrial Countries	2.8	2.1	0.2	1.5	1.2	2.4
US	2.7	0.8	−1.2	2.6	3.0	3.9
Japan	4.2	4.8	4.0	1.3	0.1	0.7
Germany	2.0	5.1	1.0	2.0	−1.2	0.9
France	2.4	2.2	1.1	1.8	−0.7	1.2
Italy	2.7	2.1	1.3	0.9	−0.7	1.1
UK	2.3	0.5	−2.2	−0.6	1.9	2.5
Canada	3.4	−0.5	−1.7	0.9	2.4	3.5
Developing Countries	4.7	3.7	4.2	6.1	6.1	5.5
Asia	6.7	5.7	5.8	7.9	8.4	7.5

Source: International Monetary Fund, May 1994

In 1990 the United States went into a recession that lasted through part of 1991. During that year the growth of U.S. gross domestic product was approximately 4 percentage points below trend. Canada and the United Kingdom mimicked quite closely the U.S. business downturn. Continental Western Europe slid into hard times in 1991 and Japan in 1992.

Germany paid the front-loaded costs of German monetary unification. The policy goal of raising almost overnight the standards of living of the former East Germany put pressure on government spending and real rates of interest in the country. The Bundesbank, the German central bank, tightened monetary policy to offset the inflationary effect of the higher expenditures. Interest rates rose and stayed high as a consequence.

Countries participating in the European Monetary System had a choice of either maintaining existing exchange rate parities and thus importing the high interest rates, or adjusting the parities. Political leaders and central bankers opted for the credibility of the European Monetary System and had to tighten monetary policy. This was not a good choice, because of its deflationary implications.

In mid-September 1992 there was a currency crisis, the result of which was forced parity adjustments by some countries and the decision of Italy and the United Kingdom to abandon the exchange rate mechanism that kept exchange rates within a narrow band of fluctuations. Neither of these two countries has returned to the system. At the end of August 1993 a second currency crisis centered around the French franc. The French authorities were unwilling to adjust the par value of their currency and the collapse of the exchange-rate mechanism was averted by a compromise of widening the bands from plus or minus 2.5% to plus or minus 15%.

The September 1992 and August 1993 events provided the impetus for a more expansionary policy in Western Europe. Short and long-term interest rates fell and stock market prices boomed in anticipation of the business recovery. Germany, France, and Italy were at the bottom of the recession; in contrast, the United States, Canada, and the United Kingdom were enjoying business expansion. Most recent data suggest that economic activity has picked up considerably in Germany (estimates of real GDP growth are around 2.5% on an annual basis), France (2.0%), and Italy. Thus, business cycles are converging among the G7 countries.

Japan continues to experience its worst economic performance since World War II, with the exception of 1973. The factors at work are the deflation of the real estate price bubble; the deterioration of the quality of bank assets, which has led to a credit crunch; the sharp slowdown of Japanese exports following an appreciating yen; declining output growth rates in the rest of the world; and pressures on Japan to reduce its current-account surplus. In February 1994, the Japanese government announced its fourth fiscal stimulus package since 1992. Despite these measures, economic performance so far remains very disappointing. Economic growth, on the other hand, is proceeding at a "booming" pace in the Pacific Basin countries.

Matters have turned around in Central Europe which as a whole is now recording the first positive economic growth rates since the breakdown of communism. Official output continues to decline in the former USSR, although at a declining rate. It should be noted that official output understates the true but unknown output because of underground activities.

Average inflation rates in the industrial countries remain at historically low levels—below 3% (see **Table 2**). Inflation rates in the developing world, which have been much higher historically, are coming down. In the fast-growing Asian countries inflation averages approximately 7%.

Market rates of interest are rising in the United States, both in absolute value and in relation to interest rates in the G7 countries. Whether U.S. real rates of interest are also rising depends on expected inflation rates. The U.S. bond market is jittery and does not seem to believe that low inflation rates will persist in the future. We shall assume in the forecast that monetary policy in the United States will tighten relative to monetary policy elsewhere in the G7 group.

Forecast

The forecast for the current-account balances of selected countries is shown in **Table 3**. Beginning with 1989, U.S. trade and current-account balances have been improving markedly in response to the declining value of the U.S. dollar in the exchange markets and lower economic growth in the U.S. relative to that of our trading partners. This trend seems to have stopped in second quarter 1992, when both trade and current-account deficits rose relative to the values in the first quarter. The reason lies in the slowdown of output growth abroad relative to output growth in the U.S.—thus reducing the growth of our exports while raising that of our imports. The noted higher economic growth abroad will mean higher growth of U.S. exports. Our assumption is that U.S. exports and imports in 1987 dollars will be rising at an average rate of 8% per annum. Despite these developments, net exports in 1987 dollars will go from –$106 billion in 1994 to –$133 billion in 1995.

It is instructive to reflect on the prospects of the United States for eliminating its trade deficits. Since 1985, the U.S. government, both alone and in cooperation with the other members of the G7 group, has pursued a policy of dollar depreciation with the aim of correcting its external imbalance. Furthermore, the U.S. government has progressively engaged in an active trade policy, particularly with respect to Japan. The motivation underlying this policy is the belief that the U.S. has a trade deficit because other countries, especially Japan, do not play "fairly." This is a misguided concept. Our trade deficit has little to do with unfair trade practices and a great deal to do with the fact that the United States saves too little relative to its investment needs. For example, in 1993 the private sector saved $1 trillion and made gross private domestic investments of $882 billion, whereas the federal, state, and local governments dissaved $215 billion. The result was an excess of investment over total savings of $95 billion, which was financed by the rest of the world. This external financing implies a net capital inflow or a deficit in the current account of the U.S. balance of payments. Trade deficits will persist as long as the saving-investment imbalance remains. Further devaluations of the dollar and a more aggressive trade policy are a minor force in rectifying our trade deficit.

As to the value of the U.S. dollar in the exchange markets, the fundamental factors move in opposite directions. The expected improvement in the German cyclical position relative to that in the U.S. favors an appreciation of the German mark, or a depreciation of the dollar. The more restrictive monetary policy in the

Table 2
Inflation Rates (%)

	CPI (Estimated) 1994	1995
Industrial Countries	2.5	2.6
US	2.8	3.2
Japan	0.9	0.9
Germany	3.0	2.2
France	1.9	2.1
Italy	3.8	3.1
UK	3.2	3.0
Canada	0.5	1.7

Source: IMF, May 1994

Table 3
Current-account Balances
(In billions of dollars)

	1993 (Actual)	1994 (Est.)	1995 (Est.)
US	–109.2	–140.3	–165.9
Japan	131.4	133.4	125.7
Germany	–21.9	–13.0	–10.6
France	10.5	10.3	13.4
Italy	10.6	26.2	30.7
UK	–16.0	–19.4	–19.7
Canada	–19.5	–14.5	–13.8

Source: IMF, May 1994

Table 4
Summary of the International Economic Forecast
(In billions of 1987 dollars, NIA)

	1994 Estimated	1995 Forecast
Exports (avg)	643	697
Imports	759	830
Net exports	-106	-133
Yen/dollar	Unchanged	
Mark/dollar	Unchanged	

U.S. relative to monetary policy in Germany and Japan favors an appreciation of the dollar. The large Japanese trade surplus favors an appreciation of the yen. It is beyond our knowledge to determine which of these forces will prevail. Hence, we call for an approximately constant value of the dollar.

The summary of our international forecast is shown in **Table 4**.

Corporate Profits, Interest Rates, and the Stock Market

Michael Simkowitz

Professor of Finance, Indiana University School of Business

Another year is passed and my mother's foolish son is again sitting down to make a forecast of the financial markets. The past year has been characterized by a number of surprises. The economy was much stronger than expected at the end of 1993, interest rates went up much more than expected at the beginning of 1994, and the economy stayed stronger than expected in the face of this rise in interest rates. The short-term financial scene is dominated by two stubborn forces: Chairman Greenspan's insistence on getting inflation down under 2.5%, and the economy's stubborn refusal to slow down significantly in the face of rising interest rates. This tug of war will continue at least into the first part of 1995. I'm betting my money on Greenspan. Anybody who can spend as much time as he does in front of Senate committees without cracking a smile has got more than enough fortitude to defeat inflation. After all, I keep getting confused between C-Span and the Comedy Channel.

Corporate profits began to expand rapidly as 1993 progressed, and continued to expand in 1994 at a reasonably good rate of approximately 10%. This kind of profit expansion is expected to continue at a high single-digit rate. My estimates for the operating earnings on the S&P 500 are shown in **Table 1**. These earnings will be above what are reported, because reported earnings include write-offs whereas operating earnings reflect the profitability of current operations.

Dividends have begun to increase. After remaining nearly constant from 1990 to 1993, they expanded by about 5% in 1994 (see **Table 2**). Similar growth in 1995 should be expected.

Autos, metals, and computer equipment should be the relatively stronger sectors. Tobacco, beverage, and personal product firms are beginning to benefit from the expanding economies in Europe. A new conservative Congress in Washington indicates that if health care is revisited, any resulting legislation will be more benign to the health care sector than what was envisioned about a year ago.

Interest rates have risen dramatically in the past year. On the short end of the yield curve, another 50 to 100 basis point rise is to be expected. This will bring the 90-day T-bill rate to about 6%. Most of the damage on the long end has been done, and as I write this, the 30-year treasury bond is yielding 8.05% and most likely doesn't have much more than another 20 to 40 basis points to go. Our expectation is that the long rate will most likely peak out sometime in second quarter 1995. In fact, long rates may be on their way down by the end of 1995.

The equity markets present a dilemma. As I mentioned a year ago, since World War II the tops of bull markets have been extended plateaus, and this one appears to be no exception. By any reasonable measure the stock market is currently at least fully valued. The current dividend yield on the S&P 500 is around 2.83%. This is a rather lofty level from which to expect a significant upward price movement. This past year has been characterized by an equity market in which the S&P 500 has been bounded by 440 on

Table 1
S&P 500 Operating Earnings

Year	Earning	% Change
1990	$24.75	---
1991	22.50	−10.3%
1992	24.65	11.0%
1993	28.50	15.6%
1994 (est.)	32.00	12.3%
1995 (est.)	34.50	7.8%

Table 2
S&P 500 Dividends

Year	Dividend	% Change
1990	$12.10	---
1991	12.20	0.8%
1992	12.38	1.5%
1993	12.58	1.6%
1994 (est.)	13.20	4.9%
1995 (est.)	13.90	5.3%

the low side and 490 on the high side. It is a rare year in which the total swing of the market is less than 10%. It would be extraordinary if we had two such years back to back. The concern we should have for the market is that by the time interest rates top out, investors may be looking ahead into late 1995 and 1996 and seeing a weakening economy.

It would appear that the equity markets will have real difficulty appreciating by more than the 5–6% growth in dividends. The current yield of 2.83% plus a hopeful 6% appreciation totals to less than 9%. With U.S. treasury bonds at 8.05%, it is a sanguine observer who views equities as the dominant risk-adjusted investment vehicle. I still believe that in the short run the downside risk is greater than the upside potential in the market. But for the long-term investor, selling equities can be a trap: it takes quite a bit of courage to get back in the market.

In summary, short-term investors may want to be nimble, reducing their equity exposure as the S&P index climbs over 480 and increasing it if the S&P index falls below 450. For longer-term investors, I am hesitant to recommend heavy selling of equities because of the difficulty of getting back in at the right time. Still, for long-term investors who are quite nervous in this market it may be time to reduce their equity exposure by 20 or 30%.

Housing

Jeffrey D. Fisher

Associate Professor of Finance and Real Estate and Director, Center for Real Estate Studies, Indiana University School of Business

The rise in mortgage interest rates during 1994 (about 200 basis points higher than a year ago, when mortgage rates hit a 28-year low) has had a dampening effect on housing activity. Pent-up demand from the recession of the early 1990s had helped propel single-family housing over the million-unit mark during 1993-94, but it will have only a negligible presence in 1995's more restrained economic climate. The good news is that the principal home-buying age group—those 35 to 54 years old—has expanded by 10 million people during the first half of the 1990s, implying continued demographic support for this market.

On balance, single-family construction should remain fairly flat during 1995, and may even experience a slight decline. Multifamily housing is likely to continue to benefit from the increased availability of capital from banks and other sources for new construction. Total housing starts (single and multifamily) are likely to remain flat during 1995 at an annual rate of about 1.4 million units. Housing starts peaked at 1,972,000 in January 1972 and reached a low of 837,000 units in November 1981.

To mitigate the rise in the rate for fixed-rate mortgages, many borrowers have taken advantage of the steep yield curve by choosing adjustable-rate mortgages (ARMs) rather than fixed-rate mortgages in recent months. About 43% of loans closed in recent months were ARMs, compared to 16% a year ago. This is the highest share since June 1989. Of course, the price these people must pay is increased uncertainty as to what their payments will be in the future if interest rates, especially short-term rates used to index the ARMs, continue to rise.

Sales of existing homes rose unexpectedly in recent months despite the climbing interest rates. In the Midwest, sales rose about 8% in August. The National Association of Realtors expects 3.97 million existing homes to sell this year—almost as high as the record level of 3.98 million sold in 1978. This pace will probably not continue on into 1995, however, because of the rising interest rates.

The median home price in Indiana was $75,000 during second quarter 1994, which was an increase of 2.88% from second quarter 1993. The median home price is still considerably less than that for the rest of the nation, which was $109,800 for second quarter 1994. The gap between home prices in Indiana and those of the rest of the nation suggests much room for growth, especially if the Midwest economy remains strong compared to the rest of the country.

Indiana

Morton J. Marcus

Editor; Director, Indiana Business Research Center; Co-director, Indiana Center for Econometric Model Research, Indiana University School of Business

When one examines the record of change in personal income in our economy since 1969, it is clear that Indiana has had two dramatic recessions. It is more difficult to observe that same distress in the national economy (see **Figure 1**). In the mid-1970s, Indiana experienced a sharp drop in real personal income associated with the first Oil Shock; the second decline began in the late 1970s and extended well into the 1980s. This was Oil Shock II, followed by a major restructuring of industry, particularly steel.

An examination of the data shows seven alternating phases of expansion and contraction in the Indiana and U.S. economies from first quarter 1969 through second quarter 1994. In **Figure 2** the number of quarters for each of these phases is represented. The most obvious feature of these phases is that Indiana has experienced longer contractions and shorter expansions than the nation. Hence, if we try to date these contractions and expansions, a question arises: Should they be dated in terms of Indiana's experiences or in terms of the nation's?

Table 1 offers both interpretations. But first, note that in the period from first quarter 1969 through second quarter 1994—just over a quarter of this century—Indiana has had an average annualized growth rate of 1.99% in real personal income. This is three-quarters of a percentage point below the nation's growth rate for the same period. Among the 50 states, plus the District of Columbia, Indiana ranked 44th in the nation in growth.

This comparatively poor record is the result of the first two contractions found in Table 1. Whether measured in terms of Indiana or the nation, contractions have been stronger in this state, as well as longer, than in the nation as a whole.

Figure 1
Real Personal Income in Indiana and the U.S.: 1Q69–2Q94

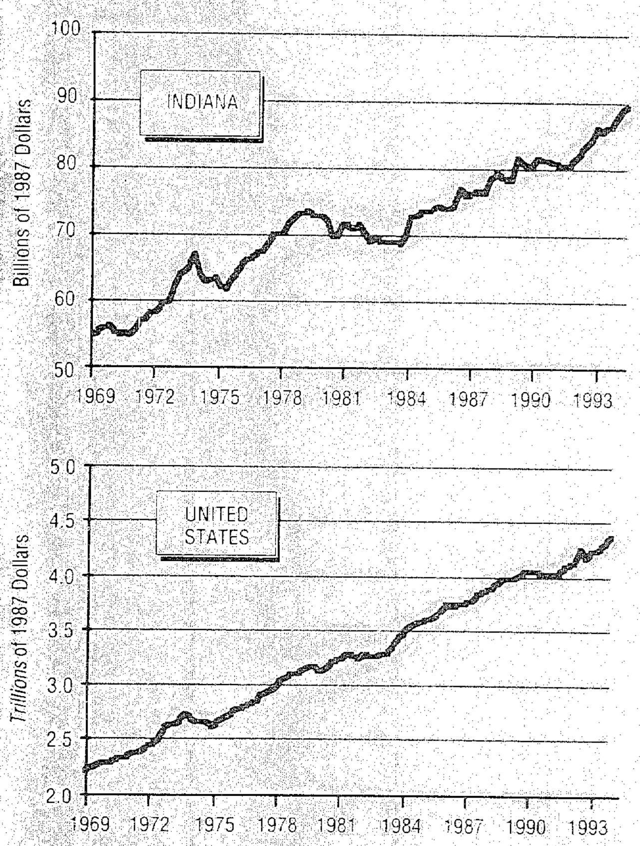


Figure 2
Duration of Expansions and Contractions in Indiana and the U.S.: 1Q69–2Q94

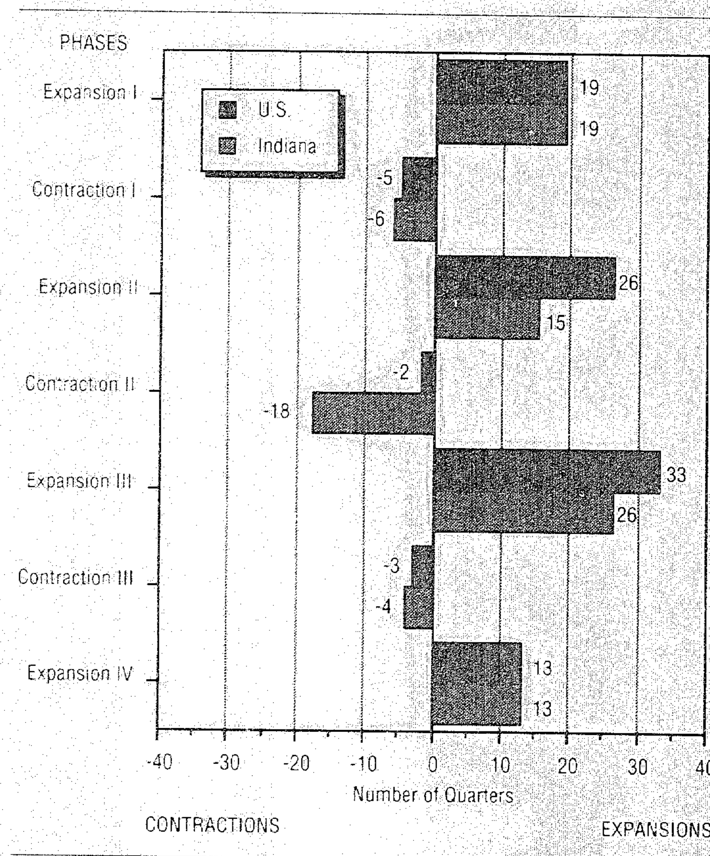


Table 1
Average Annual Rates of Change in Real Personal Income During Expansion/Contraction Phases, Indiana and the U.S.: 1Q69–2Q94

			RATE OF CHANGE			
Quarter/Year	*Phase of Cycle*	*Number of Quarters*	*Indiana*	*Rank in U.S.**	*U.S.*	*Difference (IN–US)*
1Q69–2Q94		101	1.99	44	2.74	–0.75
INDIANA–BASED CYCLES						
1Q69–4Q73	Expansion I	19	4.46	35	4.42	0.04
4Q73–2Q75	Contraction I	6	–5.66	45	–1.68	–3.99
2Q75–1Q79	Expansion II	15	4.89	24	4.35	0.55
1Q79–3Q83	Contraction II	18	–1.60	48	1.45	–3.05
3Q83–1Q90	Expansion III	26	2.77	27	3.15	–0.38
1Q90–1Q91	Contraction III	4	–1.52	36	–0.64	–0.89
1Q91–2Q94	Expansion IV	13	3.39	17	2.59	0.80
U.S.–BASED–CYCLES						
1Q69–4Q73	Expansion I	19	4.46	35	4.42	0.04
1Q69–4Q73	Contraction I	5	–6.43	43	–2.86	–3.58
2Q75–1Q79	Expansion II	26	2.29	40	3.48	–1.20
1Q79–3Q83	Contraction II	2	–7.17	49	–1.88	–5.29
3Q83–1Q90	Expansion III	33	2.01	33	2.77	–0.77
1Q90–1Q91	Contraction III	3	–1.23	34	–1.15	–0.08
1Q91–2Q94	Expansion IV	13	3.39	17	2.59	0.80

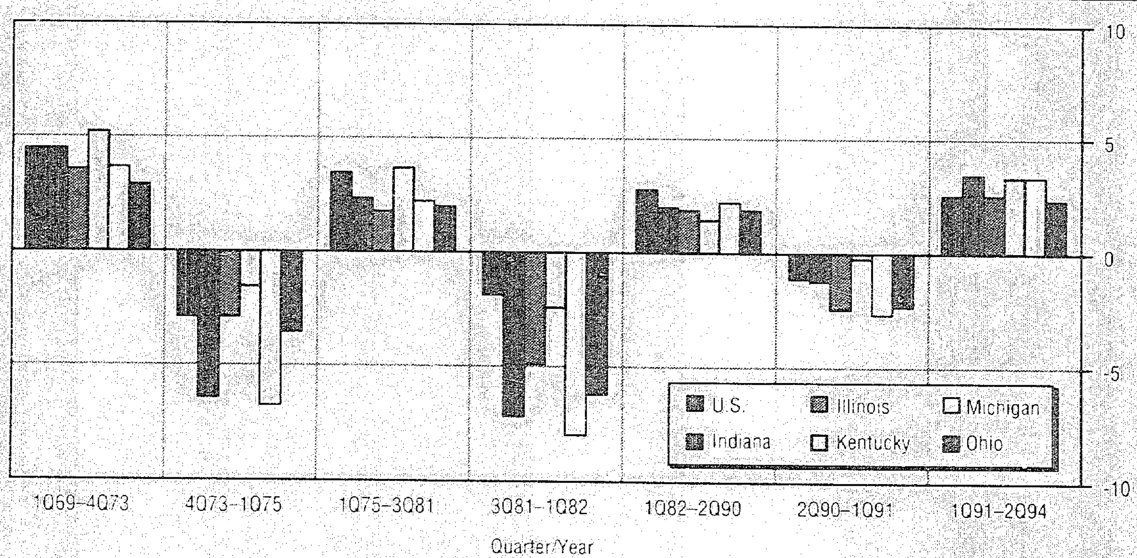
**50 states plus the District of Columbia*

A positive feature of this analysis is found in the most recent phase of the business cycle. Both the nation and our state have had 13 quarters of expansion between first quarter 1991 and second quarter 1994. During that period, Indiana has ranked higher in its growth rate (17th in the country) than in any other expansion period. In addition, the positive difference between Indiana and the rest of the nation is greater than in any previous expansion period.

Figure 3 illustrates the rates of growth for the U.S., Indiana, and our neighboring states during the phases of recent business cycles (measured in national terms). In all but the current expansion, Michigan has had stronger responses to expansions and contractions than Indiana. Kentucky shows less response on the down side than the nation in each contraction.

One reason we would expect to see strong responses in the Indiana, Michigan, and Ohio economies is the dependence of these states on earnings from the manufacture of durable goods. These three states occupy the top three positions in the nation in percent of earnings derived from durable goods (see **Table 2**). Thus, when interest rates rise and consumers and businesses cut back on goods financed by borrowed funds, these states tend to feel the effects. This year is expected to be that kind of year.

Figure 3
Average Annual Percent Change in Real Personal Income During National Expansions and Contractions: 1Q69–2Q94



Indiana's real personal income, which is expected to increase by nearly 3.5% in 1994, could have difficulty realizing a 2% growth in 1995. This is not a recession, but a definite slowing of the state's growth rate. Employment gains, strong in 1994, should be trimmed in 1995. Where the state will probably record a gain of 50,000 jobs in 1994, that advance could be reduced to about 40,000 jobs gained in 1995.

Just as the differences among the states are particularly strong, so too within Indiana. Each area has a different set of expectations for 1995, as the following articles demonstrate.

Table 2
1993 Earnings in Durable Goods Manufacturing as a Percent of Total Earnings, and Rank in U.S.

	Percent	*Rank*
NORTHEAST	9.87	---
New England	13.79	---
Maine	9.14	30
New Hampshire	16.42	5
Vermont	15.32	7
Massachusetts	12.70	17
Rhode Island	14.01	10
Connecticut	15.84	6
Mid-Atlantic	8.49	---
New Jersey	6.36	40
New York	7.25	37
Pennsylvania	12.54	18
SOUTH	8.56	---
South Atlantic	7.25	---
Delaware	7.48	34
Maryland	5.43	43
Dist of Col	0.30	51
Virginia	7.01	38
West Virginia	9.00	31
North Carolina	11.72	21
South Carolina	10.05	28
Georgia	7.36	35
Florida	5.97	41
East South Central	12.98	---
Kentucky	12.73	16
Tennessee	13.00	14
Alabama	12.02	20
Mississippi	15.16	8
West South Central	8.55	---
Arkansas	12.49	19
Louisiana	5.46	42
Oklahoma	9.71	29
Texas	8.55	32
MIDWEST	16.46	---
Great Lakes	18.52	---
Ohio	19.09	3
Indiana	**22.84**	**2**
Illinois	11.71	22
Michigan	25.43	1
Wisconsin	17.33	4
Plains	11.29	---
Minnesota	13.05	12
Iowa	13.54	11
Missouri	11.34	23
North Dakota	3.96	46
South Dakota	7.34	36
Nebraska	6.60	39
Kansas	11.08	25
WEST	10.24	---
Mountain	8.27	---
Montana	5.20	45
Idaho	12.74	15
Wyoming	2.15	48
Colorado	8.00	33
New Mexico	5.25	44
Arizona	11.19	24
Utah	10.96	26
Nevada	2.81	47
Pacific	10.85	---
Washington	13.03	13
Oregon	14.23	9
California	10.83	27
Alaska	1.53	49
Hawaii	1.05	50
UNITED STATES	11.07	---

Indianapolis

Bob Kirk

Professor of Economics, Indiana University-Purdue University at Indianapolis

Employment for the economy of the Indianapolis metropolitan area (Marion County and the surrounding eight counties) is expected to increase 1.25–1.75% in 1995. This is down from the slightly more than 2% rate of increase for 1994. Nominal personal income is expected to increase 4–5%, or 1–2% adjusted for inflation.

Uncertainties

The Federal Reserve is using higher interest rates to slow the rate of growth. The interest rate-sensitive sectors expected to be most affected are consumer durable goods (autos and appliances), residential construction, and business equipment spending. Historically, increases in short-term interest rates have resulted in small increases in the ten-year treasury yield and flattened the yield curve. However, since 1985 the ten-year yield has responded more strongly to increases in the federal funds rate with less flattening occurring. If this pattern continues, the rise in longer-term interest rates could be greater than expected and the forecast may be optimistic.

Comparative Performance

The **Table** shows how Indianapolis has performed compared to other metropolitan areas in the Midwest in terms of employment. The Midwest has been highlighted nationally for its relative strength in this recovery. However, as the Table indicates, there have been differences in employment growth within the region.

Table
Percent Change in Employment for Selected Metropolitan Area, 3Q93–3Q94

Area	*Total Employment*	*Manufacturing Only*
St. Louis	2.7	−0.1
Detroit*	2.1	3.0
INDIANAPOLIS	2.1	1.3
Chicago	1.9	0.0
Cincinnati	1.6	−0.1
Columbus, OH	0.5	1.0

Source: Establishment data from state departments of employment.
**July and August only.*

At the metropolitan level, specific events have stimulated employment growth, such as the construction of a new downtown football stadium and the arrival of TWA's corporate headquarters in St. Louis. The strength in the automotive sector benefited Detroit. In the 1980s, Indianapolis and Columbus competed neck and neck; recently, however, Indianapolis has been the stronger economy.

A closer examination of the Indianapolis employment data indicates that the leading sectors this past year were general construction, primary metals, chemicals, wholesale, and retail (building materials and general merchandise). Construction and primary metals reflect the strength in residential housing and the automobile industry. However, these sectors are sensitive to interest rates. In 1995, housing permits issued are expected to decline from a very high 1994 level.

Many new members of Congress and the state legislature have been elected to reduce the size of government. If financial markets see significant federal deficit-reducing efforts, then long-term interest rates may fall, with the housing industry being a primary beneficiary. In 1994 there have been small reductions in federal, state, and local government employment in Indianapolis due to cost containment efforts.

The employment growth in general merchandise and building materials reflects the entry of new retailers during the year. With factory outlets, warehouse clubs, category killers, home centers, discount stores, catalogues, and TV shopping networks, the retail sector has become increasingly competitive.

Big Employment Impacts

There will be some major employment impacts in 1995. Functions of Fort Benjamin Harrison are being shifted to other sites, so 1,350 people will no longer be employed there. At this time, an undetermined number may remain in the Indianapolis area as they take jobs with other government agencies or the private sector. An additional 1,000 United Airlines employees will be employed at the UAL maintenance center by the end of 1995. This should give some support to the housing sector, although the mechanics will come in with a 15.7% pay cut due to the new UAL employee ownership arrangement. With the opening of the Circle Centre Mall in September, approximately 1,500 retail jobs will be created—though at the same time many of the construction workers on the project will have completed their work.

How will the Circle Centre Mall be different from suburban malls? According to the marketing people, it will be "upscale" with a mix of goods and services not found in other shopping locations, and it will be architecturally unique with a "European" ambience.

narrower walkways, and a sense of the vertical dimension.

Market analyses of the mall call for it to capture 4.6% of the metropolitan retail market. Downtown hotels, which are expecting a strong 1995 convention schedule, won't have to use buses to take their convention guests to suburban malls. Downtown office workers will have a place to spend their money during the lunch hour. For others who live in the metropolitan area and throughout Indiana, the Circle Centre Mall will become a shopping and entertainment center that will complement other downtown attractions, such as the professional football, basketball, and baseball venues, the symphony, the zoo, Eiteljorg Museum, White River Park, Union Station, and the Children's Museum. In other words, the mall is another element in achieving the "critical mass" for reviving the downtown area. New downtown housing is being built; other investment is expected to be stimulated too.

The financing of the mall involves the Circle Centre Development Corporation, a group of 17 local firms that have shown their support via a $65 million equity investment that includes the developer, Melvin Simon and Associates, Inc., a couple of European bank loans totaling $45 million, and $187 million of City of Indianapolis Tax Increment Revenue Bonds.

On the supply side, then, a lot of new retailers have been entering the marketplace. What about the demand side? Retailing has been supported by relatively strong employment and income growth, housing starts, and the benefits from mortgage refinancing. These stimuli are expected to weaken somewhat in 1995.

In the longer run, what are the implications of the baby boom generation for consumption and saving? Average annual household income is highest for the 35–44 and 45–54 age groups. Much has been written about the low saving rate; the new Congress will pay attention to ways of increasing saving. Because high-income households account for a disproportionate share of total savings, the "typical" household is better represented by the *median* personal saving rate. This rate increases by about 1 percentage point for the 45–54 age group compared to the 35–44 age group. In 1990, the baby boomers (25–44 age group) headed 50% more households than did the preceding generation (those who were 25–44 in 1970). As they age, there will be some increase in the aggregate savings, but it will be modest because of the growing importance demographically of two older generations that have lower saving rates.

Spatially, Indianapolis promotes its many interstates that pass through the city. They have made Indy an attractive wholesale distribution center (as evidenced by the employment growth in wholesaling mentioned above), but they have also made it easy for households to live in lower-population-density communities (the suburbs). Many of the residents of these recently constructed communities are baby boomers who experienced their adolescence by jumping into a car and traveling to the nearby suburban mall located near an interstate. One such place is The Fashion Mall/Keystone at the Crossing—another "upscale" mall on the north side. In addition, with two-earner households, time has become increasingly valued, which means that people have become more focused in their shopping trips by patronizing specialized stores that provide a wide range of choices—Office Depot, Toys R Us, and the like. A reading on the success of the Circle Centre Mall will not come until after we see how competing malls respond to try to maintain market share, and whether the mall can continue to attract customers after its first birthday.

Automobile Industry

Indianapolis has benefited from the strong sales in automobiles, light trucks, and sports utility vehicles. How will the industry do in 1995? Leading indicators can be classified into two categories: *ability* to buy, as measured by disposable income, household debt burden, interest rates, and price pressures; and *willingness* to buy, as measured by consumer attitudes, unemployment claims, length of work week, and the stock market. Higher interest rates, reduced overtime, and stock market uncertainties are three cautionary flags waving for 1995. In addition, this year we will see if leased cars coming back to dealers could make leasing more costly and reduce the value of used cars. If the return of these cars puts downward pressure on used-car values, then payments on future leases could be forced upward because the monthly lease payment is based on the difference between the car's selling price and its projected value at the end of the lease. The maintenance of high resale value is particularly critical in the luxury car end of the market.

Health Care

The Indianapolis health care industry began making adjustments prior to last year's health care debate in Congress. With changes in Medicare and Medicaid reimbursement schemes, hospitals have downsized, shifted to outpatient care, and formed cooperative relationships. Health care was a major source of employment growth for Indianapolis in the 1980s; in the past year, its contribution was very small.

Productivity

We have heard much about the rate of growth in labor productivity being higher in the manufacturing sector than in the service sector. Some have expressed concern because if more of the labor force is shifting to