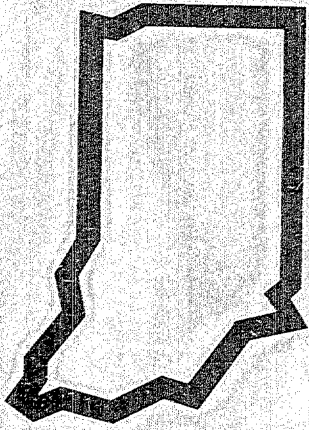

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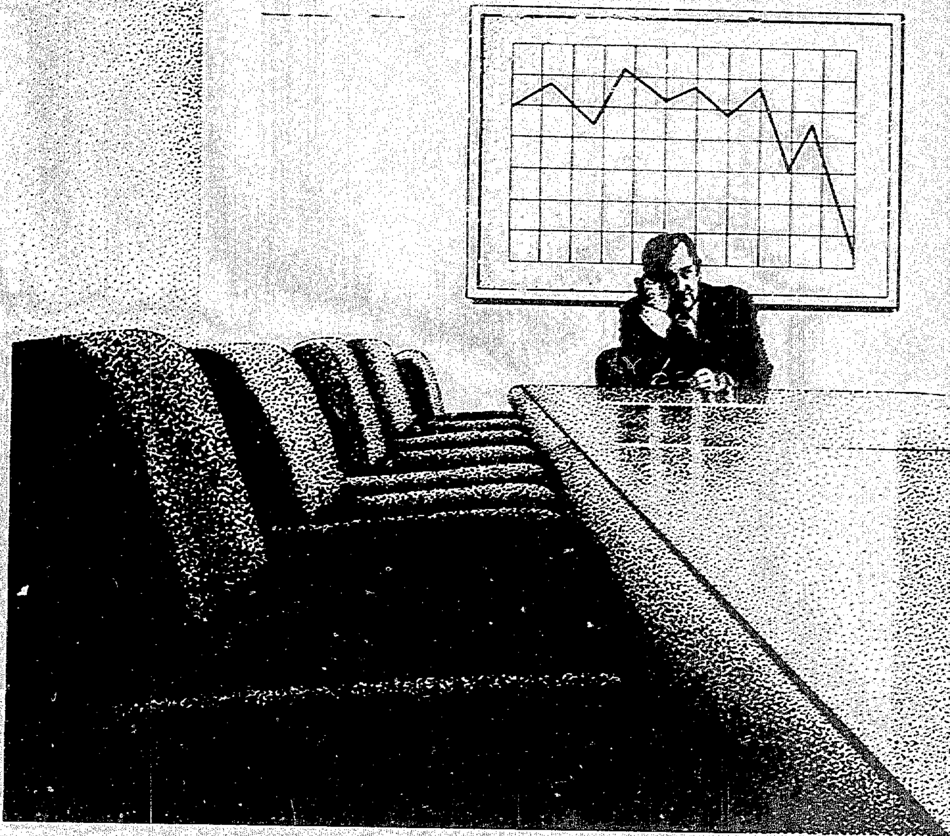

The 1990 Midyear Outlook

July 1990

Contents

1 Bruce L. Jaffee
Midyear Review of the Outlook for 1990

1 R. Jeffery Green
Consumer Expenditures

2 Lawrence S. Davidson
Nonresidential Investment

2 George W. Wilson
Government Monetary and Fiscal Policy, Unemployment, Inflation, and Interest Rates

3 Jürgen von Hagen
The International Economy

4 Donald L. Tuttle
Interest Rates and Financial Markets

5 George H. Lentz
Housing

6 Morton J. Marcus
A Closer Look at Indiana's Economy

9 Robert Kirk
Indianapolis

10 Leslie P. Singer
Northwest Indiana

12 Thomas L. Guthrie
Fort Wayne

12 Patrick M. Rooney
Columbus

14 Marvin Fischbaum
Terre Haute

15 Maurice Tsai
Evansville

17 Dilip Pendse
Kokomo

18 John E. Peck
South Bend/Mishawaka-Elkhart/Goshen

20 Gerald J. Lynch
Lafayette

20 Ashton I. Veramallay
Richmond-Connersville-New Castle

21 Fay Ross Greckel
Jeffersonville-New Albany (Louisville Area)

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Midyear Review of the Outlook for 1990

Bruce L. Jaffee

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

Last fall the forecast team predicted a slow growth year for 1990, with only a 2% real growth in GNP but with no recession. Fourth quarter 1989 and first quarter 1990 were expected to be especially weak. While the economy has not performed smoothly or consistently in the last six months, the broad outlines of the forecast appear to be on target. Real GNP grew at a 1.1% annual rate in 1989's fourth quarter, and the most recent data indicate first quarter real growth of 1.3%. Both these anemic growth rates are less than half the levels of the previous year. Unemployment rates have moved upward, domestic Big Three automobile sales are down significantly, businesses and consumers have become more cautious about spending on investment goods and big-ticket items, and there is little optimism about improvements in our federal trade and budget deficits.

Yet there are some signs of optimism. Inventory levels, which grew at undesirable rates in the beginning of the year, have now become more moderate. Interest rates have also moderated after rising unexpectedly in the first quarter, although real rates are still quite high. Inflation rates, which were boosted by weather- and energy-related factors in the beginning of the year, now appear to be headed toward a 4% annual rate for the rest of the year.

Many of the economic surprises in the last six months have come in the international sphere. German unification and economic restructuring in Central Europe bode well for domestic and world economic growth. However, most of the effects on the U.S. will occur at the end of this year at the earliest and will be important factors to consider in later years.

The collapse of the Japanese stock market reflects political instability, monetary problems, and personal and financial scandals more than weaknesses in that country's real economy. The declines in the value of the yen and limited real progress in trade barrier negotiations between the U.S. and Japan suggest little substantive improvement will be made in reducing the real bilateral trade deficit.

The cutbacks in U.S. defense spending are likely to be significant, but not until the 1991 fiscal year. Even then, the impacts are likely to be relatively small as adjustments are made to alternative uses of resources except in specific areas of the country, such as Texas, New York, and parts of New England.

In summary, we continue to hold to our forecast of no recession, slow growth, and reasonable balance among all the major sectors of the economy.

Consumer Expenditures

R. Jeffery Green

Professor of Economics, Indiana University

Last winter our forecast for real consumer expenditures was one of weak growth in fourth quarter 1989 followed by moderate growth through 1990. So far, that forecast is right on track. **Table 1** shows the forecast for total real consumer expenditures made last winter together with the actual results for fourth quarter 1989 and first quarter 1990. Because the forecast errors in our November forecast are so small for fourth quarter 1989 and first quarter 1990, our forecast for the remainder of 1990 for total real consumption remains the same as last November. As in November, this forecast is consistent with a fairly constant savings rate of about 5.5% and growth in real disposable personal income of just over 2% at an annual rate.

Despite the lack of revisions in our overall forecast for consumer spending, a number of developments in the last six months warrant discussion. The first is the continued volatility in automobile expenditures. Real purchases of new autos rose at a 50% annual rate in third quarter 1989, spurred by dealer incentives. In fourth quarter 1989, real new auto purchases fell at a 59% rate as dealer incentives were terminated. Renewed dealer incentives produced a 58% annual rate increase in new auto purchases in first quarter 1990, and partial data from early in the second quarter indicate that another decline, though smaller, may be under way. Comparable swings in dealer inventories and auto company profits also occurred. Consumers now apparently wait for inventories to reach excessive levels and force dealers to offer incentives before buying. It looks like volatility in auto purchases will continue for some time.

Consumer purchases of clothing and shoes have been very weak over the past six months, declining at an average annual rate of 2.9% from third quarter 1989 through first quarter 1990. A major reason for this decline is the rapid rise—9.1% at an annual rate—in clothing prices over the same period. The depreciation of the dollar may have played a role in

Table 1
Forecast and Actual Values, 4th Quarter 1989 through 4th Quarter 1990
(Billions of 1982 dollars)

	4th Quarter 1989	*1st Quarter 1990*	*2nd Quarter 1990*	*3rd Quarter 1990*	*4th Quarter 1990*
Total Real Consumer Expenditures					
November Forecast	2694.0	2710.0	2725.0	2740.0	2755.0
Actual	2693.7	2710.1	n/a	n/a	n/a
Percent Change (AR)					
November Forecast	0.4	2.4	2.2	2.2	2.2
Actual	0.5	2.5	n/a	n/a	n/a

these price increases because a large percentage of clothing and shoes are imported. As a result, there has been a major decline in imports of clothing and shoes in first quarter 1990.

Consumption of energy products is often volatile and has been especially so over the last several months. Very cold weather in December 1989 raised the consumption of fuel oil, electricity, and natural gas. Warmer than usual weather in January and February 1990 had the opposite effect. The result was to make consumer spending larger than it otherwise would have been in fourth quarter 1989 and smaller than it would have been in first quarter 1990. Real consumption of gasoline in first quarter 1990 fell to the lowest level since the end of 1985 as gasoline prices rose sharply.

The recent volatility in several consumption categories suggests that, although our forecast of total real consumer expenditures is for a smooth increase of about 2.2% for the rest of 1990, the total will mask swings in many components as they adjust to short-run changes in prices and weather-related shocks.

Nonresidential Investment

Lawrence S. Davidson

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

Nonresidential investment includes business fixed investment (BFI) and inventory change. After leading the country's economic growth since 1982, mostly through strong equipment sales, BFI began to slow in 1989. Last December we predicted a continuation of this sluggish growth in 1990, so when coupled with modest inventory accumulation, nonresidential investment would grow by around 4%.

Since that writing we have received data on fourth quarter 1989 and first quarter 1990. The level of BFI fell from its third quarter value and then picked up again in first quarter 1990, growing by more than 4% per annum during the first quarter. Inventories piled up in fourth quarter 1989 and then fell dramatically, to a seasonally adjusted accumulation of only $2.6 billion in first quarter 1990. The increases in BFI, as throughout most of the recovery, have largely come through the equipment sector. Growth in business structures continues to be weak. The upshot is that while first quarter numbers were somewhat rosy, the slow growth scenario envisioned last December is hardly changed by recent events. In addition, the volatile weather of early 1990 played havoc with construction activity, so the numbers for the first quarter offer at best an opaque window for future prognostication.

If anything, there may be reason to pare down our 4% forecast a notch. First, the auto industry has problems. First quarter profits for the Big Three showed big reductions. The inventory numbers for the first quarter show how the industry reacted—by producing less. Although the inventory numbers may return to normal by midyear, we predict caution on the production side. And less output means less demand for tools and equipment. Second, cost factors do not bode well for more investment spending. Economy-wide wage and unit labor costs accelerated in 1989, growing at a rate of about 4.5%. Then unit labor costs rose another 4.9% at an annual rate in first quarter 1990. Demand for industrial goods is climbing rapidly and there is a growing potential for price increases from this sector. These rising costs of labor and materials may lead to a more widespread profit and liquidity squeeze as the year progresses.

Finally, macroeconomic policy continues to send warning signals to managers. Interest rates crept up until the second quarter even though the Fed has allowed M2 to grow at the top of its range for almost a year. With inflation not subsiding, this leaves less doubt about the future course of interest rates. The government seems hamstrung by politics, but business can't help but worry a little about which taxes will be raised as part of the new fiscal package. And as the savings and loan bailout numbers get scarier, the wait-and-see attitude about plant and equipment spending may be strengthened. Taken together, these recent events suggest that we revise our previous prediction for nonresidential investment downward. We expect no higher than a 3% rate of growth.

Government Monetary and Fiscal Policy, Unemployment, Inflation, and Interest Rates

George W. Wilson

Distinguished Professor of Business Economics and Public Policy and Professor of Economics, Indiana University

As noted here last December, the absence of a sensible fiscal policy won't make much difference for the real economy during 1990. The most recent bout of deficit mania, including discussions between the White House and Congressional leaders in May, probably won't amount to much either, though one hopes that sooner or later a real policy reflecting legitimate priorities will be forthcoming. The S&L bailouts have

put more pressure on the participants to "do something" about the deficit, but in itself the bailout is an income transfer whose real effects are not especially consequential. The real damage to the economy has already been done in the form of wasted and misdirected investment in construction. Furthermore, attempts are now going forward to make the S&L transfer payments exempt from GRH deficit calculations. So much for the relevance of the size and meaning of the "official" deficit! Politically the deficit issues, from "read-my-lips" nonsense to fussing about which additional taxes to raise, which party will get the blame, and how much further to cut military spending, will be very important. Fortunately for the economy, these are mostly smoke, although they will restrain productive expenditures in many needed areas and create more anxiety and pessimism throughout the system than is necessary. However, we've seen it all before.

Monetary policy remains poised to prevent any further inflationary outbreaks following unacceptably high first quarter rates, which were largely weather related. Further inflation rates promise to be far lower over the rest of the year because the unemployment rate is up to 5.4% (the highest in more than a year), overall real growth of spending remains well below the system's capacity, industrial raw materials prices are far below last year's levels, and the higher value of the dollar has reduced import price increases, to mention only some of the more obvious deflationary pressures. The slow turnaround in real output growth, apparent from more recent data on factory orders and leading indicators, is not expected to sustain inflation rates already experienced during the first quarter. The Fed should resume a policy of moderate ease to encourage the tepid turnaround and prevent a recession.

The revolutionary events in Eastern Europe and the ending of the Cold War in 1989 will translate into demand for U.S. exports as the nations seek to modernize their industries, improve infrastructure, clean up the environmental disasters left by an unprincipled industrialization process, and otherwise struggle to achieve sustainable growth rates well above population growth. The detente dividend is also real and substantial. Not much stimulus to the U.S. economy will be felt by year's end, but many domestic industries will be gearing up before that time. The investment needs for Eastern Europe and the Soviet Union will be enormous over the next decade, and the U.S. will provide a substantial share. But for the rest of 1990, additional demands from this source will be meager. Growth rates of the other GNP components are envisaged to be small enough to average barely 2% for the year as a whole, as previously forecast.

Unemployment rates may rise even higher, partly in response to reductions in military outlays and personnel needs, but they should end up averaging about 5.5% for all of 1990. Interest rates should fall slightly in the next several months, depending of course upon inflation expectations (already down) and Fed policy (always vigilant), then drift up modestly.

It thus seems that in macroeconomic terms, the economy should be rather well positioned to reach a higher growth plateau. This will be triggered by a more buoyant world economy and more substantial investments and technological improvements as U.S. business and government respond to the continuing economic threat of Japan, the Asian "gang of four," a resurgent Western and Eastern Europe, and a sea-change in the world investment climate that will progressively substitute economic competition for military in most areas. But this is a scenario for another occasion.

The International Economy

Jürgen von Hagen

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

Since our last forecast, the international economy has been shaped by two dramatic, unforeseen developments, both spurred by political change. The first is the revolutionary change in the political and economic systems of Central Europe, especially in East Germany. The second is the financial crisis currently shaking Japan's business sector.

The political changes in Central Europe have started a process of modernization and liberalization in these countries that is necessary to revitalize the economies after four decades of socialist mismanagement. Only as Western businesses have started to consider investment in these countries as a promising alternative have the size and severity of their economic problems become clear: chronic pollution, outdated and obsolete capital stocks, and a lack of necessary infrastructure. The need for capital, both private and public, is therefore immense. However, as the political risks appear to become more tolerable, investment opportunities also promise good profitability. The economies' biggest asset is probably their relatively well-educated work force.

With German monetary union a reality, and with a virtual certainty of German political unification, East and West Germany are in key strategic positions. German monetary union went into effect on July 1, following agreement on an exchange rate of 1:1 for a limited amount of East German marks for West German DM, and 1:2 for the remainder. West German companies have already started to move into the country, and several U.S. companies have participated

in the move through their West German subsidiaries. These changes find West Germany in the middle of a booming economic expansion fueled by the large inflow of immigrants from East German and other Eastern countries during the last two years.

Apart from rising West German real growth, which will spill over to Germany's main trading partners, a notable consequence of these changes has been a distinct rise in German interest rates, which are now above U.S. rates for the first time in 20 years. High German interest rates reflect two factors: the expected high real rate of return on investment in East Germany and other Central European countries financed through West Germany's capital market, and increased uncertainty about inflation, as the West German Bundesbank embarks on the difficult task of managing monetary policy for both countries. The Bundesbank's reputation and historical performance indicate little reason to fear that monetary union will increase Germany's trend inflation rate in the long run; yet the variability of inflation is likely to rise as very little is known about the demand for money in East Germany.

The international repercussions of these developments are twofold. In the near future, high interest rates will attract capital to Germany and Central Europe and push up interest rates in the U.S. and elsewhere. The U.S. will find it more difficult to attract the capital necessary to finance its current account deficit. The higher attractiveness of investment in Germany will also be reflected in a stronger DM, which has already appreciated about 10% against the dollar since fall. More than the U.S., the developing countries will feel the increased burden of higher world interest rates. This may damage their financial stability and reduce their growth prospects in the near future. On the other hand, a weaker dollar and growing demand for investment and consumer goods from Central Europe will improve the export opportunities of the U.S. and the developing countries.

The current economic developments of Japan are of a very different nature. Japan is now paying the price for participating in an ill-conceived effort of international monetary policy coordination between 1985 and 1988. Japan's policy of cheap money aimed at supporting the dollar caused stock and property prices to soar. These tendencies have been reversed as Japanese monetary policy has become more restrictive to fight the revival of inflation. The underlying real economy remains healthy, but the Japanese business sector has suffered a significant financial downturn—reflected in a drastic decline in the Tokyo stock market, with the result of a weakening yen and a fall in the current account surplus to an estimated $40 billion in 1990. Japan is likely to cut back the supply of capital to the world's financial markets, which contributed largely to the financing of the U.S. current account deficits of the past decade.

The dollar is thus torn between two tendencies: depreciation against the DM and other European currencies, and appreciation against the yen. Given the predominance of U.S. trade with Asia and Canada and the current weakness of the Canadian dollar, we foresee a slight to moderate appreciation in the trade-weighted value of the dollar. At the same time, however, the reorientation of international capital flows away from the U.S. should lead to a stagnation if not a slight improvement of the U.S. current account.

Interest Rates and Financial Markets

Donald L. Tuttle

Professor of Finance, Indiana University School of Business

The easing of interest rates for 1990 that was forecast last December had not materialized by the end of May for a number of reasons. They include the Federal Reserve's continued concern with inflation, the large supply of debt coming to market, the continued overhang of junk bonds, and the concern over financing both a larger-than-forecast federal government deficit and an expanding S&L bailout. Long-term government bond yields rose from about 8.0% to 8.6% in the first five months of 1990. The steepening of the yield curve that had been projected did materialize during these same months, with the spread between short- and long-term government rates moving from zero to 100 basis points by late May.

The most likely scenario for the remainder of 1990 is no change—relatively moderate and stable real growth, inflation, and monetary policy. The only exception would be if the economy shows signs of significant weakness toward the end of the year, in which case rates will fall as monetary policy eases. A possible cause of such a scenario would be a continuation of the constraints on lending imposed by banks, which have caused credit growth over the last several months to be the lowest in decades.

The forecast for a relatively lackluster equity market and a total return in the 10-13% range still holds. In 1990 the stock market has been characterized by two phenomena. One is the sharp decline in some overseas markets, especially the Japanese market, followed by sizeable recoveries. The other is the large difference in performance between large-capitalization U.S. stocks and small-capitalization issues, accentuating a trend that began in 1983. The differ-