

TAKING NOTES ON THE ECONOMY: OUTLOOK FOR MICHIGAN

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During the last three years the U.S. economy withstood a recession, terrorist attacks, numerous corporate scandals, and two ongoing wars. In many respects, the U.S. economy has demonstrated a great deal of resiliency.

The House Fiscal Agency is in the process of generating a forecast of the national economy, state economy, and state revenues that will be part of the Consensus Revenue Estimating Conference on May 18. Although the Agency forecast will not be finalized until just before the conference, I can share some generalities with you.

The national economy is improving, and the House Fiscal Agency expects the state economy to improve. But the job market in Michigan must improve first.

JOBS

The biggest negative for the national economy and the state economy has been the job market recovery—the slowest since WWII. In every other recovery, job growth was stronger and Michigan's job growth outpaced the nation. As shown in the graph below, that has not been the case this time.

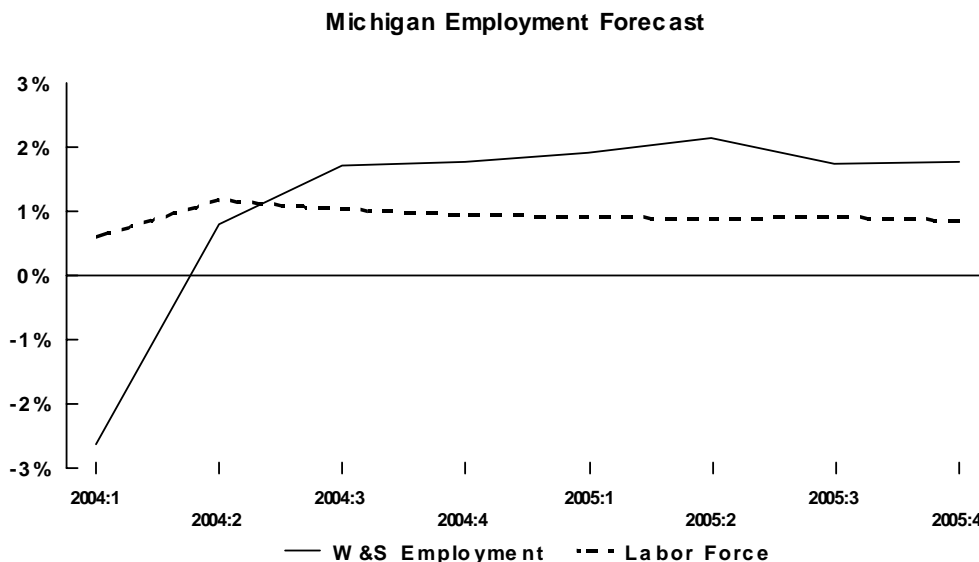


Despite modest gains last month, state employment in March 2004 was still 225,400 below state employment in March 2001. That includes 134,000 manufacturing jobs lost in three years—which represents 60 percent of total lost jobs.

Even though Michigan experienced job losses for the third consecutive year in 2003, there is positive news about the state job market: the rate of job loss now seems to be slowing.

In 2003, payroll employment fell by 70,000, but nearly half of all losses occurred in the first quarter of the year. By the end of the year, the quarterly job loss had slowed to 5,000. Available data indicated that job loss continued in the first quarter of 2004 and the state lost about 29,000 jobs—but this was less than half the rate of job loss in the first quarter of 2003.

The House Fiscal Agency expects the rate of job growth to turn positive in the second quarter of 2004. Job growth over the forecast horizon is reported in the following graph.



The U.S. economy and manufacturing, particularly the automobile industry, are the key drivers of state economic growth. Job losses in manufacturing continued in the first quarter of 2004, but the rate of job loss has slowed significantly.

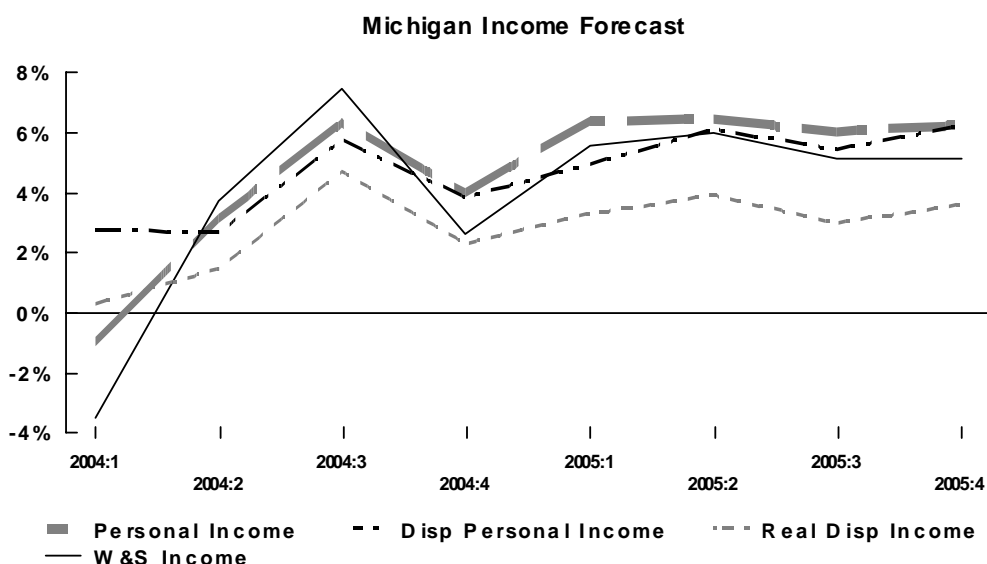
State job losses in the manufacturing sector averaged 12,000 jobs per quarter during the first half of 2003. By the fourth quarter of 2003, job losses slowed to 4,000, and fewer than 2,000 manufacturing jobs were lost in the first quarter of this year.

Another positive sign for the state economy is that the manufacturing workweek seems to be growing. For most of 2003, the average manufacturing workweek varied between 42 and 42½ hours. Since November 2003, the average workweek has increased to 43 hours. Increases in the average workweek are usually followed by increased hiring.

Improvement in manufacturing employment in Michigan in 2004 will be tempered by layoffs of autoworkers in Lansing and stamping workers in Grand Blanc, and by reductions in force at Delphi.

Expected gains in manufacturing employment in 2005 reflect, in part, the addition of a shift at the Lake Orion assembly plant and an increase in the payroll employment count attributable to the laid-off autoworkers in Lansing who shift into protected status programs.

Labor market gains lead to income gains. The House Fiscal Agency expects improvement in income growth over the forecast period as displayed in the next graph.



NATIONAL ECONOMIC OUTLOOK

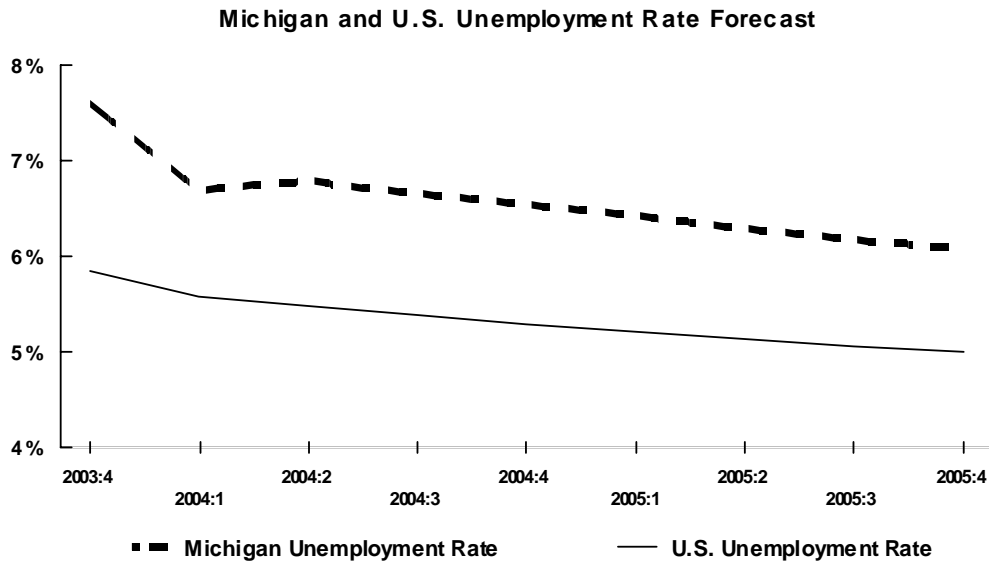
In the national economy, the House Fiscal Agency expects consumer demand, business capital spending, and inventories to contribute to real GDP growth of about 4.6 percent in the first half of 2004.

We expect output to slow somewhat in the second half of 2004 to something less than 4.0 percent. That rate of growth is maintained through the end of 2005 as consumer demand and government spending moderate.

The House Fiscal Agency expects the federal budget to remain expansionary through 2005—but less so than in recent years. Federal expenditures are projected to rise each year, but slow from growing 5.2 percent in FY 2004 to 4.1 percent in FY 2005. Federal receipts are expected to increase only 1.4 percent this year.

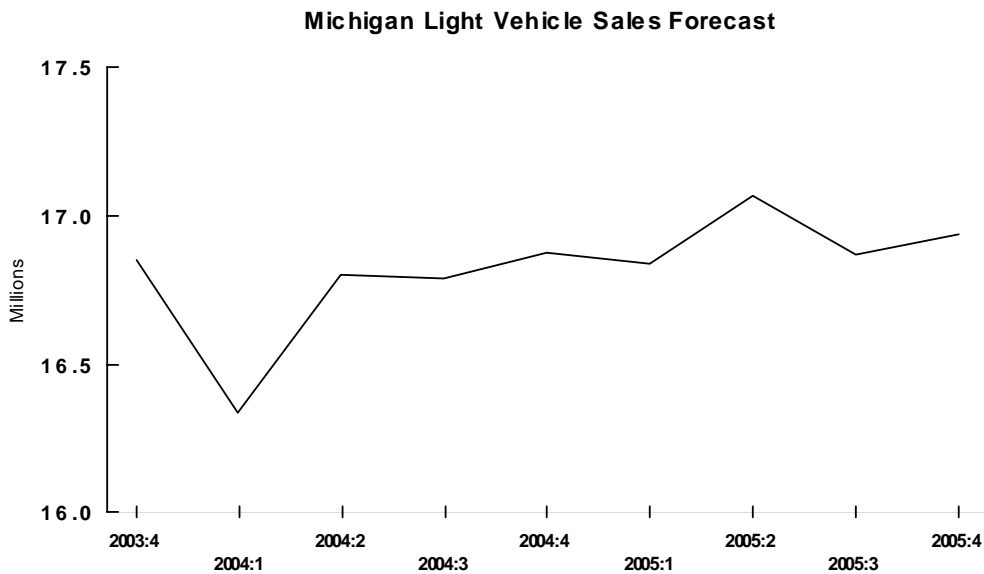
We expect the Federal Reserve to raise the federal funds rate by about 50 basis points this summer, followed by an additional increase of about 25 basis points after the election. We also expect increases of 150 to 175 basis points in 2005. Increases in the federal funds rate lead to increases in the 3-month Treasury bill rate, which hits about 3 percent by the end of 2005. The 30-year mortgage rate is also expected to increase—to about 5.8 percent in late 2004 and 6.0 percent in late 2005.

As demonstrated in the following graph, U.S. unemployment rates are expected to improve.



The House Fiscal Agency expects modest increases in inflation in 2005.

Light vehicle sales are expected to average 16.7 to 16.9 million units in 2004 and 2005. The exchange value of the dollar is expected to decline somewhat, which slows the loss in the domestic share of light vehicle sales.



We also expect a growing world economy and a relatively weak dollar to stimulate the U.S. market for exports.

OTHER STATES

The recession and an extremely weak recovery in the job market have had a negative impact on state budgets around the country. Fred Giertz, an economist at the Institute of Government and Public Affairs, UI Urbana, and Seth Gierth, CBO, analyzed national and state level data for all the states. Their findings are published in the March 2004 National Tax Journal. One of their conclusions was that “. . . states were indeed hit with an unprecedented downturn in revenues—unlike anything that had been experienced in the preceding half century.”

These findings are consistent with recent NCSL reports on state revenues and should not be surprising. State revenues are directly impacted by job growth, which has also been weaker in the current recovery.

RISKS

The labor market in Michigan is showing some improvement, but has not yet recovered. If the state labor market does not improve as predicted, the state budget will still be under pressure.

The U.S. economy could be negatively affected by external factors completely beyond the ability of forecasters to predict—such as terrorism or the impact of additional corporate scandals on the equity markets.

STATE BUDGET ISSUES

In recent years, state revenue growth has been particularly weak—and at times negative—while spending pressures have increased. One of the most significant budget problems facing the states is funding Medicaid.

In Michigan, Medicaid is a \$7.1 billion program. About 25 percent of General Fund/General Purpose and tens of millions in state restricted revenue are appropriated for Medicaid this year. In four years, Medicaid caseload increased over 27 percent and costs increased over 40 percent. As of December 2003:

- One in eight Michigan residents are receiving Medicaid
- Over one-third of births are paid for by Medicaid
- Over 70 percent of nursing home costs are financed through Medicaid

As we move forward, the biggest risks for the national economy are unpredictable external shocks. The health of the state economy is predicated on the health of the U.S. economy and improvement in the state job market. Barring unpredictable external shocks, we expect the U.S. economy to continue to expand and the state economy to expand this year, but continue to lag the U.S.