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District Conditions / Recovery Likely to Be Stronger Than Expected

Since our last "District Conditions" was prepared in the fall of 1982, economic analysts have stopped asking, "When will the recovery begin?" and have begun to ask, "How strong will the recovery be?" The evidence indicates that a recovery in the Ninth District was underway in early 1983, much as we expected last fall.* Only time will reveal its strength, but developments so far in 1983 suggest that it will be stronger than we anticipated last fall. Then we thought that the district's recovery would be modest by historical standards and weaker than the nation's because of lingering weaknesses in agriculture and metal mining. Now improved prospects for the national recovery, which in part have been fueled by falling oil prices, suggest that the district's recovery will be faster than anticipated. Although serious problems persist in agriculture and metal mining, the new Payment-In-Kind Program suggests agriculture will exert somewhat less drag on the district than we anticipated in our last report.

Expected and Unexpected Strength

The long-awaited recovery in the district is underway. Last fall we argued that the decline in mortgage rates last summer and early fall would soon lead the recovery by resulting in a pickup in real estate sales and home-building. It did. Ninth District building permits for housing units, seasonally adjusted, rose 32 percent between the third and fourth quarters. Moreover, the recovery began spreading to other sectors of the economy in early 1983. Employers stepped up their hiring. The Conference Board's Minneapolis help-wanted advertising index, seasonally adjusted, rose 6 percent between December and January, with an associated increase in employment. Preliminary estimates now indicate that district employment, seasonally adjusted, rose 0.9 percent between December and January.

Concurrent with the beginning of a district recovery, prospects for the national recovery also improved. Forecasters are now anticipating that real gross national product (GNP) will increase around 4.7 percent between the fourth quarters of 1982 and 1983, instead of the 4.2 percent that they were predicting in December. This faster growth in real GNP suggests that nationwide demand for district goods and services will be stronger than expected.

This more upbeat outlook stems in large part from the national economy's surprisingly strong performance in January. Unemployment was not expected to decline until the last half of 1983, but in January the national unemployment rate, seasonally adjusted, fell to 10.4 percent from 10.8 percent in December. In addition, forecasters had been anticipating that 1.41 million housing units would be started in 1983; in January, however, housing starts were unexpectedly high, reaching 1.72 million units at a seasonally adjusted annual rate. The 4.5 percent jump in durable goods orders, seasonally adjusted, between December and January was also surprising because much of the recent strength in durable goods orders had been from defense orders, and in January defense orders declined 22 percent. These increases in starts and orders gave a substantial boost to industrial production, which, seasonally adjusted, rose 0.9 percent in January, its first sharp rise in 11 months. Admittedly, these gains could be transitory, and normally forecasters are hesitant to revise forecasts in response to one month's data. The magnitude of these unexpected changes, however, makes the upward revision in the forecast of GNP plausible.

Oil Price Cut Improves Outlook. . .

Giving further credence to the prospects for a stronger-than-expected national and district recovery is the recent drop in petroleum prices, which will increase petroleum

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

users' spendable income. The Organization of Petroleum Exporting Countries (OPEC) in March cut its official crude oil price \$5 per barrel, from \$34 to \$29, and many oil industry analysts expect it to fall further. The district currently uses about 179 million barrels of petroleum per year. At this rate, a \$5 per barrel price cut, if passed on to petroleum users, would amount to an annual saving of \$895 million for district consumers, businesses, and governments. This approximates the amount district residents will receive from the 10 percent federal personal income tax cut scheduled for July.

This increase in spendable income, along with petroleum sensitive prices becoming more attractive relative to other prices, should benefit the district in several ways. More spendable income in the hands of consumers should boost retail sales. The district's tourist industry should benefit too, both from consumers having more spendable income and from the transportation component of vacation costs declining relative to other costs. Given that petroleum accounts for approximately 6 percent of farm production expenses, a cut in petroleum prices should provide some relief to the district's hard-pressed farmers as well. Lower petroleum prices should also cut state and local government expenditures while a faster recovery generated by the cut in petroleum prices should increase state and local tax revenues.

The cut in petroleum prices, however, will not benefit everyone in the district, as it will hold down the already depressed level of oil exploration in the western half. In February, the number of active oil rigs in Montana and North Dakota was 64, as compared with 159 a year earlier and 175 in 1981. The fall in petroleum prices and resulting cutback in exploration have not only reduced spending in these states; they have also reduced the tax revenues these states receive from petroleum exploration and production. The prospect of declining oil prices, for example, recently resulted in Montana reducing its revenue estimates for the next biennium by \$24 million.

. . .and So Does PIK

The prospects for a faster national recovery will probably benefit the district about as much as the rest of the country, but the U.S. Department of Agriculture's (USDA) Payment-In-Kind (PIK) Program, announced in January, should improve the district's recovery relative to the nation's. In our last "District Conditions," we discussed the poor prospects for agriculture and metal mining, which are four to five times more important to the district's economy than to the nation's. These conditions, we argued, might lead to the district's economy experiencing a recovery somewhat weaker than the nation's. The prospects for district metal mining are still relatively poor, but PIK has brightened prospects for district agriculture.

The district's two largest crops are corn and wheat, and nationally supplies of these grains are expected to exceed consumption in the current marketing year (1982–83). As a result, inventories of these grains are expected to rise and prices to fall. According to the USDA, corn inventories on September 30, 1983, the end of the current marketing year, are expected to be 3.4 billion bushels. This is a 1.1 billion bushel (or 48 percent) increase from last year. Corn prices, prior to PIK, were expected to decline from \$2.45 per bushel in the 1981–82 marketing year to \$2.25 per bushel in the current marketing year. Wheat inventories on May 31, 1983, the end of the current marketing year, are expected to be 1.6 billion bushels. This is a 0.4 billion bushel (or 33 percent) increase from a year ago. Wheat prices, prior to PIK, were expected to decline from \$3.65 per bushel in the 1981–82 marketing year to \$3.45 per bushel in the current marketing year.

The USDA can do little to reduce the large corn and wheat inventories expected at the end of September and May this year, but PIK, by reducing planting this year, will lower corn and wheat supplies in the next marketing years. Under the USDA's acreage reduction programs, farmers can idle up to 20 percent of their corn and wheat acreage in return for cash payments and price support loans. Farmers who agreed to participate in these programs in 1983 were also eligible to sign up for PIK. It permitted them to idle another 10 to 30 percent of their corn or wheat acreage, and they could also submit bids to idle an even higher percentage. Instead of being paid in cash for these additional idled acres, however, they will receive, at harvesttime, 80 percent of the corn that they normally could be expected to grow on that land and 95 percent of the wheat. Farmers' response to PIK and the USDA's other acreage reduction programs has been strong. Nationally, 39 percent of the normal corn acreage and 35 percent of the normal wheat acreage have been enrolled in these programs.

Because fewer acres than normal will be planted in corn and wheat, production of these grains is expected to decline, and inventories are expected to fall below the levels they would have reached without PIK (see the accompanying figures). According to USDA projections, corn inventories will decline 1.5 billion bushels (or 44 percent) between the ends of the 1982–83 and 1983–84 marketing years, and wheat inventories will decline 0.2 billion bushels (or 13 percent) during the same period.

As a result of this anticipated drop in inventories, corn and wheat prices are expected to be higher than they would have been without PIK. The USDA now estimates that corn prices will average $2.55 per bushel in the 1982–83 marketing year (instead of the $2.25 per bushel that they would have averaged without PIK) and then will rise to average between $2.70 and $3.10 per bushel in the 1983–84 marketing year. The USDA now expects average wheat prices of $3.45 per bushel in the 1982–83 marketing year (the same as without PIK) with an increase to the $3.50 to $3.90 per bushel range in the 1983–84 marketing year.

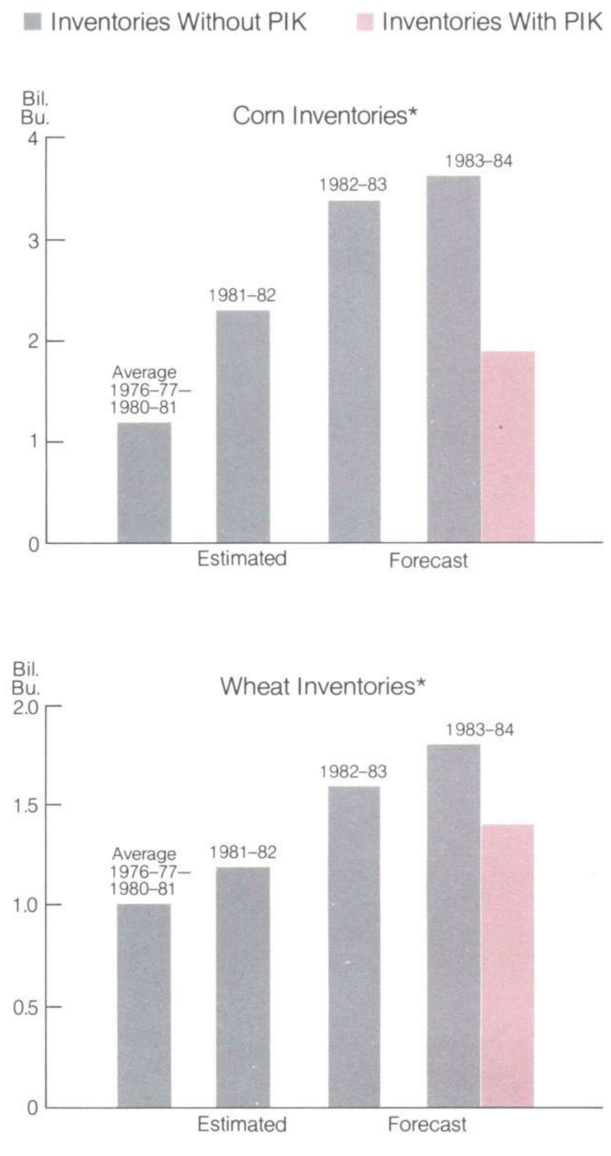
Both farmers' gross sales and net income are expected to rise as a result of PIK. Thanks to the grain that they will receive from the USDA for reducing their planted acreage, farmers who enroll in PIK will have almost as much grain to market at harvesttime as if they had planted normally. Along with the higher grain prices now expected, this will boost farmers' gross sales. At the same time, operating expenses for farmers who enroll in the program will decline because, with fewer acres to plant, they will be able to decrease their purchases of seed, fuel, machinery, fertilizer, and other inputs. In fact, according to the USDA, PIK will probably lower farm production expenses about 4 percent this year. If these predictions of higher gross sales and lower operating expenses prove to be correct, farmers' net income will rise.

It is important to remember, however, that corn and wheat inventories will still be large by historical standards and no marked increase in the demand for these commodities is foreseen. Thus, while PIK suggests that agriculture will exert somewhat less drag on the district than we anticipated earlier, serious problems persist in the agricultural sector that could keep the district from growing as fast as the nation.

Conclusion

The district's recovery has finally started, and it should be somewhat stronger than we anticipated last fall. This improved outlook is attributable to three developments: a faster-than-anticipated national recovery, an unexpected decline in petroleum prices, and the implementation of the new PIK program. Just as these developments have resulted in our revising last fall's forecast, unanticipated

Though PIK should reduce corn and wheat inventories in 1983–84, they will remain high by historical standards.



*Inventories at the end of the marketing year: September 30, for corn; May 31, for wheat.

Source: U.S. Department of Agriculture

developments could alter our current forecast. For the present, however, recent developments suggest the district's outlook has improved substantially. It still seems likely, in our view, that the district's recovery in 1983 may be slightly less robust than the 4.7 percent consensus forecast for real GNP—for exactly the reasons that we outlined in our last "District Conditions." Lingering weaknesses in agriculture and metal mining are still likely to hold back the district's recovery.