District Conditions

Unforeseen events early in 1980 have increased uncertainty about the Ninth District economy over the rest of the year. Farm income fell, interest rates rose to record levels, a credit control program was imposed, and the nation apparently entered the long-awaited recession. While these events have made us less confident than before about the outlook for the district, our forecasting model still predicts that it will avoid a recession, and that prediction still seems plausible.*

Last Forecast: No Recession, High Inflation

Last winter we predicted that, despite the embargo on selling grain to the U.S.S.R., farmers would help the district stay out of a recession. Government programs appeared to be nullifying the embargo's impact, and by late January, grain prices had returned to their preembargo levels. Consequently, we expected farm output and income to be about the same in 1980 as the year before. In addition, various indicators of the national economy looked positive at the time of the last forecast. The homebuilding industry had just received an influx of new mortgage funds, thanks to a new government ruling which allowed financial firms to offer money market certificates to small savers. Besides, output was still growing, and many new jobs were available. Thus, our model forecast 2 percent growth in district employment, accompanied by 13 percent inflation.

This spring our model is still giving us the same prediction. While unexpected recent developments have made a recession seem more likely, the model still could be right.

Farm Income Down, Interest Rates Up

One unexpected development is that farm income has fallen from a year ago. Farmers intend to plant 4 percent more acres this spring than last, but our earlier forecast of farm income nevertheless appears to be optimistic. While the government continued its efforts to nullify the impact of the grain embargo, in April market factors pushed grain prices below their preembargo levels again. In addition, farm production costs increased 6 percent between December and April. With prices decreasing and costs increasing, 56 percent of the rural bankers responding to our April survey reported their areas' farm income down from a year ago, nearly twice as large a share as said that three months earlier.

While the drop in farm income is not encouraging for the regional economy, past history suggests that the government will step in with higher price supports or other help if the drop continues. For this reason, our model's forecast of no recession in the district looks attainable in spite of the decline in farm income.

Another unexpected development is that interest rates have been much higher than predicted. Our forecasting model, along with most experts, expected interest rates to remain at their December levels, but instead they rose to record levels in the first quarter, the prime rate reaching 20 percent. These higher rates have reduced lending. If prices had risen as rapidly as interest rates, lending might not have been affected, for borrowers could have passed on the higher interest costs. But interest costs for many merchants rose faster than the prices of their merchandise, so they cut back on their borrowing to help maintain their profitability. Furthermore, in states where usury ceilings kept interest rates from rising, lending became so unprofitable

*Using employment growth as a proxy for economic growth, our winter *Quarterly Review* forecast no recession for the Ninth District. A commonly used rule of thumb for a national recession is two consecutive quarters of decline in real gross national product (GNP), the total of all goods and services produced by the economy. But a comparable measure of production is not available for the district. To estimate it, we have to use an important input measure—employment—and assume that changes in this measure roughly correspond to changes in output. The Ninth Federal Reserve District consists of Minnesota, Montana, North and South Dakota, northwestern Wisconsin, and the Upper Peninsula of Michigan.

that even the borrowers willing to pay the higher interest rates could not get loans. As a result, usury ceilings, which were already restricting consumer lending late last year, reduced lending even further when interest rates rose sharply in the first quarter.

Like the drop in farm income, this reduction in lending is not encouraging for the district's economic outlook, but fortunately there are signs that it will be short-lived. Interest rates have plummeted in recent weeks, which should help create more normal lending patterns and should allow loans to be made within the limits of the existing usury laws. For this reason, the unexpected fall in lending may not invalidate our model's forecast of no recession in the district.

Credit Controls Imposed—and Loosened

A third unexpected development is the federal government's credit allocation program, begun on March 14. The Federal Reserve System placed voluntary limits on how fast banks could expand their lending and established several new reserve requirements to discourage other types of credit and the use of money market mutual funds.

Considerable uncertainty exists about the program's impact. It may have lowered inflation by reducing people's ability to borrow. If people now want to hold more cash in order to meet their outlays, then with a given amount of money in the economy spending must be lower than it would have been without the program and price increases must be somewhat slower. But the program could easily have lowered output along with spending by making the marketplace less efficient. In our economy interest rates, like other prices, tend to allocate goods and services to their most productive uses. Under credit controls, banks cannot always make loans to the industries and people that can use them in the most profitable way. The economy, therefore, cannot produce the most desirable mix of goods and services. The requirement that bank loans must grow 9 percent or less, even though banks must continue to make normal amounts of credit available to farmers, small businesses, and home buyers, for example, could deprive an efficient large company of funds, while a less efficient small company could get more than it normally would.

We do not know what the program's actual impact has been, so we have no way of adjusting our model's forecast to reflect it. Clearly, this makes the forecast less certain. Credit controls have been reduced recently, however, and some think they may be eliminated soon. Thus the impact of this program on the regional economy should not be substantial enough to produce a recession.

Nationwide Recession Deeper Than Expected

The final unexpected event is the apparent arrival of a deeper nationwide recession than our model had anticipated. The model's original forecast was based on the assumption that, at most, a very mild recession would hit the nation in 1980. But in March the Commerce Department's composite index of leading indicators declined 2.6 percent, the third largest decline in its history. Then, in April, industrial production had its sharpest drop in five years, and the number of housing units started fell to its lowest level in five years. This probably means that the nation's recession has already begun and that it will be more severe than expected.

While a nationwide recession does not help the district's economic growth, it does not necessarily produce a recession in the district. Typically, because of its industrial diversity, the district runs ahead of the national average during a slowdown. During one year in the last recession, for instance, U.S. employment fell more than 1 percent but Ninth District employment was virtually unchanged. Because of that relatively good track record, the model's forecast for the district still appears reasonable.

Our Model's New Forecast: Same as the Old

The drop in farm income, the rise in interest rates, the imposition of credit controls, and the nationwide recession have made our model's forecast more uncertain and have increased the odds of a recession in the district; however, our regional forecasting model has so far given very accurate predictions in spite of the turbulence of the economy. In the first quarter, for instance, compared to a year earlier, district employment increased 2.5 percent and Minneapolis–St. Paul consumer prices increased 12.3 percent, just as the model predicted. When the model was rerun using first-quarter data, it still projected 2 percent growth in employment and 13 percent inflation for 1980. All things considered, this remains a plausible forecast, but the uncertainty about economic activity has, of course, made economic forecasting a very risky venture.

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.