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and Shinplasters*

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District Conditions

Contrary to expectations, a general U.S. economic recovery did not appear in late 1982, but many forecasters now find reasons to expect it in early 1983. If they're right this time, the district's recovery is likely to begin then too, though it will probably be somewhat weaker than the nation's.*

No Recovery in Late 1982. . .

Around midyear, the U.S. economy was expected to begin to recover during the last half of 1982. Most national forecasters expected gross national product, adjusted for inflation (real GNP) to increase a modest 4 percent in both the third and fourth quarters. Based on that forecast, we expected a late 1982 recovery for the district economy as well, but a somewhat slower one than the nation's. That difference was because the recession has been particularly severe on farming, metal mining, and lumbering, and proportionally, these industries contribute more to the district's economy than to the nation's. Since they were not expected to be significantly strengthened in 1982, they would somewhat restrain activity in the district.

The consensus forecast was wrong, however. Real GNP was essentially unchanged between the second and third quarters of 1982, as were national levels of employment and retail sales. Unfortunately, our assessment that the district economy would perform less well than the national economy was correct. While employment in the nation didn't change between the second and third quarters, for example, employment locally fell 1 percent. (There are no regional production counterparts to the GNP data.)

. . . But Financial Conditions Improved. . .

Since midyear, however, financial developments have signaled that a recovery might not be far away.

Interest rates, for instance, have dropped sharply. The prime rate paid by businesses at banks in the district and elsewhere in the nation dropped from 16.5 percent in July to 11.5 percent in late November. The corporate AAA bond rate also dropped during this period, from 14.6

percent to 11.8 percent. Along with the decline in business borrowing costs has come a substantial decline in consumer borrowing costs. Rates on mortgage and consumer installment loans at banks and S&Ls in the district and elsewhere dropped about 2 or 3 percentage points between July and late November.

Accompanying the sharp decline in interest rates has been a dramatic rise in stock prices. Nationally, the Standard & Poor's 500-stock index rose 26 percent between July and late November. In the district, the Dain Bosworth regional stock price index rose 33 percent during that time.

Economic activity generally responds to such financial developments with some lag. As a rule, businesses and consumers don't react instantaneously to changing financial conditions. When interest rates drop sharply and stock prices rise dramatically, businesses and consumers hesitate to change strategy until they determine where interest rates and stock prices are going. Consumers, for example, put off buying houses until they are convinced that mortgage interest rates have stopped falling. Also, re-financing typically involves significant transaction costs, such as the underwriting costs for stock and bond issues and the closing and moving costs of homebuying. Furthermore, businesses and consumers must commit themselves for several years when financing large purchases. Therefore, even after businesses and consumers have reformed their expectations for interest rate and stock price trends, they need time to ponder large purchases.

Thus, the failure of the district and national economies to recover in the third quarter, when financial conditions were starting to improve, is not surprising. In fact, it is consistent with historical evidence, which suggests that it takes several quarters for financial market adjustments to have a major impact on the rest of the economy.

What has been happening in late 1982 is that busi-

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

