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News and Information Services

News Release

412 Maynard Ann Arbor, Michigan 48109-1399

March 15, 2002 (27)

As U.S. economy recovers, interest rates and inflation will increase

ANN ARBOR---While America's economic recovery from the recent recession will bring accelerated growth, greater employment and higher corporate profits, it will also signal increased interest rates and growing inflation in the year ahead, say University of Michigan economists.

"If our forecast is correct that the economic recovery will gain momentum as the year progresses, it becomes increasingly likely that the Federal Reserve will begin to move interest rates up," says Saul H. Hymans, U-M professor of economics.

"Once the recovery is firmly in place, the Fed has two choices---either begin to raise short-term interest rates in a series of steps that will not jeopardize the vigor of the expansion, or wait until inflation is clearly on the radar screen and then move to a restrictive policy to pre-empt the inflation. The former seems to be the lower risk policy and the one we expect the Fed to choose."

In their annual forecast update of the national economy, Hymans and colleagues Joan P. Crary and Janet C. Wolfe expect the Federal Funds Rate (interest charged by banks when banks borrow "overnight" from each other, and which, in turn, affect consumer interest rates) to increase by 100 basis points in the second half of this year and by 200 basis points over the course of the next year to close 2003 at a level of 4.75 percent.

Short-term interest rates (3-month Treasury bills) are expected to rise above 2.5 percent by the end of this year (up from a current rate of 1.7 percent) and should be at or above 4.25 percent by the end of 2003, the economists say.

Long-term interest rates (10-year Treasury bonds and conventional mortgages) also are expected to increase over the next two years. Mortgage rates are predicted to climb from a current level of about 7 percent to 7.25 percent by the end of 2002 and to 7.75 percent by the end of next year.

"Over most of the next year-and-a-half-to-two years, we expect the Fed to raise short-term rates preemptively, in other words, before financial markets begin to sniff any serious excess demand inflation," Hymans says. "Under those circumstances, the rise in long rates can be expected to lag behind the upward movement in short rates."

Although it will remain well under control, consumer price inflation is expected to rise from a low 1 percent this year to nearly 3 percent in 2003, the forecast shows.

"The weak U.S. economy has led to reduced wage pressures and, with weak economies abroad, to declining energy and other raw materials prices," Hymans says. "In addition, the strong dollar has helped hold import prices down. Inflation accelerates in 2003 as many of these factors are reversed—the dollar weakens and more rapid growth worldwide puts upward pressure on prices."

Despite higher interest rates and inflation, the national economy will register real Gross Domestic Product (GDP) growth of 2.5 percent overall in 2002 and 3.3 percent next year, compared with last year's rate of 1.2 percent—but still below the 4.1 percent growth rate posted in 2000.

The unemployment rate will steadily improve throughout this year and next, but will still be at 5.5 percent overall for 2002 and 5.3 percent for 2003, compared with rates of 4.8 percent last year and 4 percent in 2000.

The return to healthy output growth will not only spur higher employment, but will help generate a rebound in corporate profits this year and next, the economists say. Profits after tax will rise from about $503 billion last year to $592 billion this year and to $610 billion in 2003.

The U-M forecast (which is based on the Michigan Quarterly Econometric Model of the U.S. Economy and compiled by the U-M Research Seminar in Quantitative Economics) also predicts that:

- **Real disposable income will rise by 3.5 percent this year, but only by 3 percent in 2003.**

- **Annual sales of light vehicles will decline from last year's mark of 17 million units to a still-strong 16.6 million this year and 16.5 million next year.**

- **Private housing starts will increase to about 1.62 million units this year, up from last year's 1.61 million units, before falling back to 1.56 million units**

in 2003.

The federal budget balance will drop sharply from a surplus of about $150 billion in 2001 to deficits of a little more than $6 billion this year and nearly $41 billion next year.

Contact Bernie DeGroat
Phone: (734) 647-1847
E-mail: bernied@umich.edu
