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## It's a New Ball Game: The Economy Gets New Life

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# It's a New Ball Game: The Economy Gets New Life

By John O. Bórnhofen

*"Economy Picks Up Steam"; "Economy Fired-Up: New Fuel On Way"; "Falling Prices Lift Consumers"; "Prime Rate at 8-Year Low."*

These were just some of the headlines in the nation's newspapers during the second weekend in March. In spite of a recent spate of other negative economic announcements, optimism about the economy was rampant due to the recent declines in oil and gasoline prices and interest rates and the expectations they engender for the economy. In addition, the stock market was skyrocketing. These were some of the positive developments during a period of economic turmoil in which the near term outlook has changed from one of uncertainty to one of ebullience.

The U.S. economy has now emerged from its growth recession of 1985. Although 1985 was a fair year, 1986 should be a good one. A number of factors have contributed to this outlook. Among these are the precipitous decline in world oil prices and the attendant declines in gasoline prices, the continued moderation in inflation that these portend, the sharply falling interest rates, the rising stock market, the falling dollar in the international markets, and the likely probability that the Federal budget deficit will be reduced somewhat in the near term.

The U.S. economy grew only approximately 2 percent last year, a snail's pace compared with the 5.5 percent growth of the previous two years. For a while, it looked as if the economy was suffering from old age, and there were concerns that the expansion was petering out.

## Expansion Has New Life

That is no longer the case. The expansion has a new life, which is good for almost everyone. The catalyst for this is the cataclysmic drop in oil prices that has occurred since November. Indeed, price of oil for future delivery has dropped recently to \$10.00 a barrel, a far cry from over \$30.00 a barrel of last November. And as prices in the cash or spot market have followed, gasoline prices declined to levels we hadn't expected to see again, prompting speculation of 60-cent gas

down the road. Since oil is such a pervasive commodity—it goes into just about all other goods and services—the price cut acts like a big increase in productivity for the overall economy.

Although the short-run effects of this are negative—witness the rise in unemployment and the fall in industrial production in February—the longer term result should be to hold down inflationary pressures and to increase the economy's capacity to produce goods and services. In short, it is a shot in the arm that increases the pie. To be sure, someone will be hurt by the price drops—oil producers and drillers will see their incomes shrink, and some individuals will lose their jobs—but, on balance and on average, most people will be better off. The disinflationary implications of the oil price break come at the very same time that we would otherwise expect to see inflation increasing due to the falling dollar and the longevity of the expansion, coupled with the effects of stimulative monetary policy on otherwise stagnating productivity.

There were several pronounced short-term "trends" in 1985, but some of these will be altered substantially by recent events such as the oil price decline, the falling dollar, and plummeting interest rates. The growth of consumer spending slowed significantly, but that should speed up this year. Fixed investment by business in plant and equipment also slowed sharply in 1985, relative to the previous two years. Although it grew 6 percent, that was well below the torrid 16 percent growth previously. The falling interest rates and expected pickup in the economy could stimulate investment, but uncertainty over possible tax reform and its negative consequences for investment still remains.

One factor tending to hold down economic growth last year was absence of inventory accumulation in the second half. Although business accumulated inventory at a record rate in 1984, there was zero growth after mid-1985. This should be reversed this year as business rebuilds stocks in anticipation of higher sales.

The latest figures on our foreign trade balance show it worsening at a slower rate than last year. This reflects the falling

dollar, which makes foreign goods and travel more expensive to Americans and domestic goods cheaper to foreigners.

Housing construction picked up last year as interest rates came down, and we should see another good year in 1986. In fact, we are very close to a housing boom at this point.

The growth in the economy and the decline in the dollar have provided stimuli for industrial production, which, after stagnating for most of 1985, was moving upward until the reduced activity in the oil patch knocked it down in February. After drifting downward in late 1985, the capacity utilization ratio in manufacturing is now back to where it was in early 1985. Even employment in manufacturing has risen in recent months, after sliding during most of 1985. Indeed, a survey of purchasing agents in manufacturing indicates the economy is expanding and that shortages are non-existent and price pressures minimal.

Employment growth in the overall economy remained strong, with 2 million new jobs being added in 1985 and another strong surge in January. After holding steady for most of 1985, the overall unemployment rate declined in January to 6.7 percent—a level not seen since early 1980. A surprising jump in February to 7.3 percent, however, has taken the unemployment rate back to its 1985 high. This development could be partly a statistical fluke, but it reflects the onset of recession in the oil drilling industry.

The other recent event with negative connotations is the announcement that productivity as measured by output per worker stagnated last year in the U.S. economy. Combined with the subdued growth in the previous two years, this expansion has seen the weakest improvement in productivity in any business cycle in many a year.

## Moderate Inflation Ahead

Regardless of labor productivity growth or lack thereof, inflation is still behaving nicely. Just a few months ago the author was preparing to forecast an acceleration of inflation in coming months. Now, happily, that has changed. The recent plunge in oil prices means that inflation will con-

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continue to be moderate for at least six to nine months and could actually decline below last year's rates.

Due mainly to the huge influx of imports and the "growth" recession, inflation in 1985 was quite mild on all three major indicators. On the Consumer Price Index, the inflation rate of 3.8 percent was in line with that of the 1982-84 period. Producers' (wholesale) prices rose less than 2 percent during 1985, essentially the same as in 1984. And there was a marked improvement in the GNP deflator price index, sometimes called the "general" price index. It rose only 2.2 percent during 1985, a sharp decline from 4.7 percent during 1984. So far in 1986, the situation is remarkably improved with both consumer and producers' prices falling dramatically—their sharpest declines in over three decades.

The bond and stock markets have also taken notice that inflation should continue to be moderate, maybe even decline a bit. Longer-term interest rates, which had been stalled for several months in mid-1985, fell sharply after the September 22 meeting of the Group of Five in which coordinated reductions in the interest rates of the industrial nations were

American manufacturers, along with the prospects that the expansion will continue and inflation will moderate, has sent the stock market through the roof. The Dow-Jones Industrial Average, an imperfect and narrow but widely watched measure of stock prices, has hit 1800. As recently as September, it was below 1300. That amounts to an annual rate of return of approximately 80 percent for the period. Other indices are up somewhat less. So far, it has been a rally of big stocks but the lesser stocks can be expected to follow suit.

One reason why interest rates have declined in recent months has been the passage of the Gramm-Rudman bill, which mandates a balanced Federal budget by 1991. Although a recent court decision has struck down a key enforcement provision, and there is increasing skepticism that Gramm-Rudman will stay in place long enough to make meaningful reductions in the Federal deficit, the fall in interest rates hasn't been affected as yet.

Meanwhile, the Congressional Budget Office has projected the Federal deficit to decline to \$120 billion by 1990, mainly due to a slowdown in the growth of de-

The current target—which is likely to be exceeded—is between 3 and 8 percent.  $M_2$ , which contains  $M_1$  plus the time and savings account balances of the household sector, rose 8 percent last year and has a 6 to 9 percent target this year. Monetary growth can slow a bit now because of the stimulative effects of the falling dollar and falling interest rates, and because a recession has become so unlikely in the near-term

## Outlook Is Good . . . But

The outlook for the year is quite positive but there are some contingencies that are impossible to forecast in terms of timing and impact. What could still go wrong? Probably the major uncertainty hanging over the whole scenario is the fate of petroleum producing firms and countries that have big bank loans outstanding, and the ramifications to the banking system of defaults on those loans. Although some Third World debtors such as Brazil will be helped by declining oil prices, others such as Mexico could argue that they have been hurt enough to default. The eventual outcome of this situation is not clear at this time.

On the assumption that the damage from these defaults, if they occur, will be contained, the outlook is very positive. It is for renewed economic growth, probably between 4 and 5 percent this year. Inflation will be held down by the recent decline in oil prices and might even decline a bit for the year. Interest rates could decline a bit over the near term but could rise somewhat by year end. Unemployment should improve slightly over the year and could approach 6.5 percent by year end.

It should be a good year for the economy in general, and this should carry over into the Michigan and Grand Rapids economies. The Michigan economy should also benefit from falling oil prices and the falling dollar as they help auto sales and tourism in the state. It should be a good year for Michigan. The expansion that we have been enjoying has a new lease on life now.

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discussed. But this was only one factor bringing rates down. The moderation of expected future inflation was another. The continued ease of the Federal Reserve's monetary policy was another, and the passage of the Gramm-Rudman Deficit Reduction bill was still another reason.

For a combination of reasons, then, interest rates on all but short-term securities plummeted in late 1985 and early this year, and short-term rates have been falling so far in March. Rates on five-year treasuries dropped almost two and a half percentage points since September, and long-term treasuries continued their long slide. They have dropped more than five percentage points since mid-1984.

## Stock Market Rallies

The actuality of declining interest rates and the falling dollar, which will help

fense expenditures and continued growth in the economy.

If there is additional deficit reduction in 1986, the direct effect would be to reduce demand for goods and services, but this should be offset by the stimulative effect of falling interest rates and the falling value of the dollar. Although Gramm-Rudman will probably not bring about a balanced budget in 1991, or ever, for that matter, it will help in reducing the Federal deficit. Thus, fiscal policy will become less stimulative over time in the direct sense. The deficit is now expected to drop from \$203 billion in fiscal year 1986 to \$164 billion in fiscal year 1987.

Monetary policy continues to be stimulative, however, although less so in the near future than in the recent past.  $M_1$ , the stock of currency and transactions balances, rose almost 12 percent last year.