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John O. Bornhofen
Grand Valley State University

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From the Bottom Things Always Look Up

By John O. Bornhofen

The recession which began in mid-1981 is probably now over, although that is not obvious to the casual observer. That the upturn has really not started in earnest is obvious, however. For the man in the street, the economist, and the policymaker as well, this has been a painful and frustrating period, perhaps more so than other recessions that have been every bit as deep. This appears to be the case for several reasons. Among these are the high level of unemployment that existed at the outset of the recession, the above-average length of this recession, the structural changes that are taking place in American industry, and the extraordinarily long and drawn-out trough that the economy has been in while getting ready for the upturn. The economy has been bouncing along at the bottom of the cycle since early 1982. This has prompted expectations that the turnaround would soon occur. But it didn't.

A Look at the Recession

Before we look at the likely course of the economy in the near future, it is instructive to review what has happened in this recession and in 1982 so far. Most observers will agree that 1982 has not been a good year, especially in Michigan. The best measure of overall economic activity nationwide—the real Gross National Product (adjusted for inflation)—declined at a 5 percent annual rate from the third quarter of 1981 through the first quarter of 1982. Since then, for two straight quarters, it has risen at an annual rate of slightly less than 2 percent.

The situation is worse, however, in particular sectors of the economy. Industrial production—total production of factories, mines, and utilities—has been declining almost steadily since mid-1981, but it now appears to be bottoming out. The cumulative decline has been over 10 percent. Not surprisingly, capacity utilization is down also—from 80 percent in mid-1981 to less than 70 percent now—and, as everyone in Michigan knows, the automobile industry is still down, although the low point in domestic production appears to have

been reached. Auto production has been on the upturn since early 1982.

The explanation for the discrepancy in the behavior of the GNP compared to industrial production is in two parts. First, the GNP includes the service industries which in total are almost as large as the goods-producing sector. Then there is the government sector, which (not including transfer payments) is about 20 percent of the GNP. Second, there is an additional factor reducing the production of the industrial sector of the economy. A structural transformation is occurring in certain major domestic industries, such as steel, autos, and others as well, which is that they are being transformed into different, and smaller, industries. This is due to a whole host of factors, among them increased foreign competition, high-cost domestic production and high prices, and changing preferences on the part of the public.

Not surprisingly, then, what with structural change combined with recession, unemployment is up. It has risen to its highest level since 1941, in fact. At this writing, the overall rate is 10.1 percent. What is not well known, however, is that the rise in the unemployment rate during this recession has been modest in comparison to what has happened in other recessions. The rate of unemployment has risen only 40 percent from the 7.2 percent level that existed when this recession started. Along with the rise in unemployment, there has been a fall in civilian employment of about one million persons below the mid-1981 level. At this point, slightly under 100 million Americans have jobs.

Also troublesome and discouraging, especially to those who subscribe to the extreme supply-side economics positions, has been the performance of business investment. Instead of rising, as predicted by supply-siders, business fixed investment is behaving as it usually does. Once a recession really gets going, investment declines. That is the case this time. The drop can readily be explained by high interest rates, falling demand for goods and services, excess capacity, and the uncertainties of disinflation. These have been overwhelming the incentives

for investment provided for in the Tax Act of 1981.

While consumption expenditures by the household sector often hold up in recessions, they have not in this one. And retail sales have been very poor, gyrating from month to month. On balance, retail sales have grown very slowly, even more so than in the 1974-75 recession.

The Effect of Interest Rates

A major problem during the recession, and a factor in prolonging it, has been interest rates, which have stayed higher in this recession than in any other. The high interest rates have caused business purchases of new equipment and structures to be postponed or cancelled and have wreaked havoc with the market for houses and "big ticket" consumer durables such as automobiles. In addition, the high rates have kept the value of the dollar high in the foreign exchange markets. This, in turn, has cut exports of American goods and reduced total demand for goods and services in our domestic economy.

Another fact of this recession is the postwar record level of business and personal bankruptcies. However, it should be noted that bankruptcies were already at a high level in 1980 and 1981. And the rise in personal bankruptcy in the last two and a half years has been as much the result of a liberalization of the bankruptcy law in 1979 as it has of the recession.

In recent months, not all the economic news has been bad, however. The *bête noire* of the recession—high interest rates—has eased considerably, especially following the Federal tax hike in August, declines in the Federal Reserve discount rate, and the revised forecasts of two well-known Wall Street economists. Some short-term rates dropped as much as 5 percentage points in July and August, and some long-term rates came down more than 2 percentage points. At this writing, three-month treasury bills were yielding approximately 8 percent, and long-term treasury bonds 11.5 percent. Most interest rates are now lower than at any time since mid-1980, the trough of the last

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recession. As rates have come down, bond prices have jumped, and stock prices have soared. In recent months, many of the major stock-price averages had their biggest increases in decades. This is a very good sign for the whole economy in the near future.

Interest rates were not the only factor driving stock prices up though; in addition, corporate profits have now bottomed out after a long slide that started in early 1980. As of the second quarter of this year, gross corporate profits, after adjustment for inventory profits and inadequate depreciation allowances, had fallen 23 percent below their 1979 level. And that was before the effects of inflation! That slide is now over, and a cyclical upturn in business profitability is imminent.

In late September, however, it appears that the sharp decline in interest rates of the last few months has ended. We may see some increases, certainly some fluctuations, and, on balance, slow gradual decline is possible. But another precipitous drop in rates is not in the cards.

Since home mortgage rates tend to lag behind other interest rates, we should see more improvement in the home mortgage market in the near future. That will be an enormous boost to the housing industry, which has been in sad shape for the last two and a half years. It now appears that the corner has been turned in housing, and when the sharp month-to-month fluctuations are netted out, it can be seen that the industry has been improving, albeit slowly, since last winter (on a seasonably adjusted basis).

Another positive development stemming at least partly from the recession is the reduced rate of inflation. So far in 1982, the Consumer Price Index has increased at only slightly more than a 5 percent, seasonally adjusted annual rate. And the general price index of all goods and services and the producer's price index have gone up even more slowly.

There are several plausible reasons why the upturn has been delayed. One is the erratic behavior of the stock of money in recent months. Another is the effect of federal deficits and high interest rates. Still another is the lack of confidence and uncertainty on the part of consumers and business alike. This lack of confidence reflects the highest unem-

ployment rate in 40 years and the reports of actual and anticipated bankruptcies of large firms and banks, and even foreign governments. It seems that the public pays more attention to the bad news than to the good news, such as it has been.

The Impact of Government Policy

Although one can make a case that the Federal Reserve's monetary policy has not changed in almost a year, the stock of money has behaved erratically. The sharp decline in M_1 (the best measure of money as a medium of exchange) in mid-1981 was not made up until late 1981. That decline was a major, if not the major, contributor to the recession. Then in late 1981 and early 1982, there was a spurt in money growth which helped stop the recession temporarily. Then the money stock stopped growing again, which has delayed the recovery. At the end of June, M_1 was no higher than it was at the end of December! Thus, another part of the Reagan program—steady growth in the stock of money—has been thwarted, with predictable effects on the economy. Although the effects were predictable, the behavior of M_1 was not.

The erratic behavior of the money stock has not been the only factor contributing to high interest rates, however. The high actual and even-higher Federal deficits projected for the future have also been keeping interest rates up. In addition, there has been substantial doubt in the financial markets that inflation is finally being brought under control, and interest rates have continued to reflect the premium for expected future inflation. Having said all this, we must still recognize that even though rates have been high during the recession, they are a lot lower now than they were at the outset. Then we were looking at a prime rate of 20 percent and mortgage rates of over 18 percent. That was followed by a sharp drop in the second half of 1981. That was reversed somewhat in early 1982, but rates have been falling since.

Federal fiscal policy remains stimulative and will continue to be so—in varying degrees—for years to come. Despite the tax increase passed in August, the Federal government will continue to run deficits, and therefore put more spend-

ing into the economy through expenditures than it takes out in taxes, for several years. Although much of the current deficit is due to the recession, the Federal budget would still be unbalanced and stimulative even if the economy were operating at a high-employment level.

But at long last, progress is being made in curtailing Federal expenditures and reducing Federal taxes, the August tax bill notwithstanding. Latest data show that Federal spending has grown only 2.5 percent (annual rate) from the fourth quarter of 1981 through the second quarter of 1982. Meanwhile, Federal tax receipts have actually fallen at an annual rate of 5.5 percent from the third quarter of 1981 to the second quarter of 1982. Personal income tax payments are lower, reflecting lower tax rates and slower growth in personal income, and excise taxes are also down. The biggest drop is in corporate profits taxes, and that reflects reduced profitability of business corporations as well as the tax cuts and credits in the 1981 Tax Act. Social Security taxes continue to increase, however. The drop in tax collections and the slow growth in Federal spending have combined to raise the Federal deficit to almost \$120 billion in fiscal 1982, and it will be higher in 1983.

The Near Term Outlook

This, then, is what has been happening in the economy; but there are a number of hopeful signs. The leading indicators have been increasing for several months. Interest rates are down, the stock market is up, and the stock of money is growing again.

The near term outlook is quite optimistic for a change. We can look forward to solid growth in economic activity, incomes, and real GNP in the near future. Inflation should continue to be modest compared to the recent past, and interest rates should stay down. The auto industry should continue to improve, but overall unemployment will recede only slowly and will stay high by historical standards. All of this, of course, presumes either that there will be no rash of major bankruptcies or that they will be handled adeptly to keep the damage from spreading.

John O. Bornhofen, Ph.D., is an associate professor of economics and finance at Seidman College.