

Seidman School Management Memo

Volume 4 | Issue 1

Article 3

10-1-1983

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Recommended Citation

Bornhofen, John O. (1983) "The Recovery Continues," *Seidman School Management Memo*: Vol. 4: Iss. 1, Article 3.
Available at: <http://scholarworks.gvsu.edu/ssmm/vol4/iss1/3>

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The Recovery Continues

By John O. Bornhofen

As of mid-September, the recovery, which began in late 1982, was proceeding nicely. The exceedingly strong second and third quarters have brought the strength of this recovery, in the first nine months of 1983, almost in line with that of its predecessors. The middle of 1983 saw a virtual explosion in economic activity as the recovery really picked up steam. Real GNP (Gross National Product adjusted for inflation) grew at a strong 8.4% annual rate in the second and third quarters. Sales, production, and orders of almost all kinds soared as the recovery finally took hold. As a result, employment climbed and unemployment fell sharply, as workers went back to work in droves. The business sector has now ended its long period of inventory reduction, and firms are now trying to add inventories. Additional inventories mean more workers to produce them and more jobs.

There is no doubt that the recovery is real and stronger than previously anticipated. It appears to be almost as strong as the average of the postwar recoveries. However, it is still unbalanced, with consumer spending, autos, and new housing being the major sectors which are showing the most strength. Business investment and government demand continue to be weak, while net exports (the excess of what we sell to the rest of the world over what we buy from them) continue to decline. This imbalance is not surprising given the incipient stage of the cycle and the high value of the dollar in the foreign exchange markets. The latter will continue to hold exports down, while encouraging imports. The strength in consumer spending reflects an acceleration of personal income growth, rising consumer confidence, lower rates of inflation, the Federal income tax cuts, lower interest rates, and huge capital gains in stocks and bonds over the past year.

The rise in economic activity is reflected in the employment picture which has improved markedly, both nationally and in the State of Michigan. The national unemployment rate is down sharply, to 9.5%, from 10.4% in the first quarter, and the rise in total civilian em-

ployment is equally impressive. The number of people with jobs rose to 101,560,000, up two million from May. In addition, the average workweek in manufacturing is now above 40 hours per week.

Thus, it is obvious that the job-generating capability of a strong recovery swamps even the inflated number of new jobs that are claimed for the so-called "jobs bills." Moreover, the number of new jobs actually created by these bills is generally much lower than the number intended.

Along with this improvement in employment, other measures of economic activity are also advancing smartly. Industrial production is up at an annual rate of approximately 16% over December, and capacity utilization in manufacturing is now above 76%, up from 68.8% in November. In this regard, it should be noted that actual capacity is well below 100%, and the gap in unused capacity is much smaller than it appears. At this point, though, we are well short of the situation where "bottlenecks" show up and push up costs and prices. Indeed, the improvement in the economy has been so rapid that business expenditures on new plants and equipment, normally a laggard in the business cycle, have already started to turn around and are increasing for the first time since mid-1981.

As indicated, the recovery has meant more jobs and more hours worked. This is reflected in a rise in personal income of the household sector of almost 7% (annual rate) in the first half of 1983. This increase has led to increased consumer buying power and to increases in retail sales.

Although economic activity has picked up sharply, inflation has continued to slow. The Consumer Price Index has increased at less than a 3% annual rate since December, and producer's prices of finished goods have risen only slightly since their sharp decline in January. This is certainly good news, but it is now behind us. Further moderation in prices is not in the cards. The rate of inflation will probably increase slowly from now on, because of increased demand, crop shortfalls due to summer drought, and the sharp increases in the stock of money in the recent past.

In the financial sector, most interest rates have risen since May, because of increased Treasury borrowing and a slower growth in the stock of money. From this point on, however, neither a sharp rise nor a significant fall in rates is likely, and rates could drift for several months. Although aggregate corporate profits are improving, the rising interest rates and the uncertainty concerning Federal Reserve policy have combined to stall the stock market. Between May and September, most of the major stock price indices fluctuated in a narrow trading pattern, essentially "making lines."

On the economic policy front, Federal fiscal policy has remained stimulative as the Federal budget continues to hemorrhage "red ink." The actual deficits for 1983 and 1984 are still expected to average \$200 billion plus, and the "structural" deficit is still around \$100 billion. The structural deficit is a euphemism for the Federal deficit that would probably occur if the economy were operating at a high level of activity and employment. In that case, the economy would be generating a higher level of income and taxes, and transfer payments, such as unemployment benefits, would be lower.

Since May, it appears that the Federal Reserve has shifted to a new phase in its monetary policy. The Fed's policy has become noticeably less stimulative in recent months, perhaps heeding the cries of private economists, the financial markets, and others that were warning that the very stimulative policy, adopted in mid-1982, was being overstayed. Accordingly, the growth of the basic money stock, M_1 , (currency, checking accounts, and other transaction accounts) has slowed from the 14% annual growth rate between August of 1982 and June 1983 to about 4% in recent months. This is a positive sign that the Fed will not continue to pour additional money into the economy so as to regenerate inflation as it has so often done in past recoveries.

A Look Back at the Recession

In our last article, we promised a look at the 1981-1982 recession to see why it occurred and why it lasted so long. The recession started in mid-1981 after both fiscal and monetary policies tightened in early 1981. The tightening of fiscal policy can be seen in the reduced rate of

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growth of Federal spending in early 1981. After growing at 12% per year through the four years of the Carter presidency, Federal spending growth was slowed to 9% by President Reagan in the first half of 1981. Taxes, however, were not cut until later. These actions reduced the actual Federal deficits and the Federal stimulus to the economy so much that the high-employment Federal budget actually showed a surplus in the first half of 1981.

At the same time, the Federal Reserve was implementing a tight money policy to combat inflation. The result was that the basic money stock, M_1 , actually declined from April to October, 1981, following a growth rate of 10% from early 1980. This was a significant tightening. But there was still more. The Administration's policy was to slow the rate of growth of Federal taxes as well as the money stock and Federal spending. Accordingly, the Economic Recovery Tax Act (ERTA) was passed in mid-1981, and it called for massive reductions in Federal taxes. Unfortunately, the tax cuts took effect gradually over time, and some of ERTA's major impacts were delayed until future years.

Coupled with the minor slowdown in aggregate Federal spending, the huge tax cuts triggered red flags, warning of skyrocketing Federal deficits in the future. Expecting the deficits to drive up interest rates in later periods, the financial markets responded and rates rose immediately. Coupled with a tight-money policy, the expectation of ballooning out-year deficits drove the high and rising interest rates even higher. Long-term rates reached record levels in late 1981 and early 1982. By then, the recession was on. Real GNP was dropping and unemployment was rising.

In early 1982, it appeared that the economy was about to turn around and resume an expansion, but two more policy developments squelched it. The Fed tightened the monetary screws again, holding the stock of money flat from January, 1982, until August, and Congress passed a new tax act, this time raising taxes. This was TEFRA, the Tax Equity and Fiscal Responsibility Act.

By mid-1982, the recession itself was bringing interest rates down, and TEFRA helped by reducing the deficits expected

in future years. Then, in August 1982, the Federal Reserve switched to a very stimulative monetary policy. Subsequently, M_1 grew faster than in almost any comparable period in the past. Interest rates, which had been drifting downward, now broke sharply, the stock and bond markets took off, and in November, 1982, the economy bottomed out. The recession was over.

The Administration's economic policy is now more or less in place, at least as much as the political process will allow. Money growth has been slowed relative to that of the Carter years, but stable growth has yet to be achieved. The growth in Federal taxes has been slowed sharply, but the slowdown in Federal expenditures growth has been much more modest. Hence the huge deficits. In fact, Federal tax collections are now lower than they were in mid-1981, although this is partly due to the depressed level of economic activity. However, even if the economy had been operating at a high-employment level since early 1981, Federal taxes would only have risen about 6% per year, compared to over 13.5% from 1976 through 1980.

But the recent tax reductions were relative to "what would have been" under the then existing tax structure. Because of inflation, "bracket creep," and rising social security taxes, however, Federal average and marginal tax rates on personal income are now essentially the same as before the 1981 Act. There has, in fact, been very little tax relief at the Federal level.

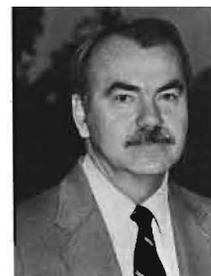
The Outlook

The recovery is now on track and has good strength. This should continue into 1985. Real GNP could rise 6% in the rest of 1983 and perhaps 4% to 4½% in 1984. Incomes and employment should continue to rise smartly and the unemployment rate should drift downward to around 9% by early 1984. Although inflation will speed up, incomes should increase even faster, and people should experience an increase in their standards of living.

In Michigan, this is already evident as the auto industry is bouncing back from the recession. The state should experience higher incomes, production, and

employment, along with less unemployment, and an improved state budget in the rest of 1983 and in 1984. This period should stand in marked contrast to the experience of the last three years.

New Seidman Professor



Dr. Ken DeYoung has been appointed Professor of Management. He was a visiting part-time professor in Seidman for the last two years. Dr. DeYoung received

his B.A. and M.A. degrees in psychology from Michigan State University and his Ph.D. in psychology from the University of Minnesota. He taught at that university for eight years. From 1969 to 1976 he was with the firm of Rohrer, Hibler and Replogle, Inc., as a management consultant. From 1976 to 1981 he was a partner in Dallis, DeYoung and Student, consultants in organizational development, personal and professional development, and management of people.

Faculty and Staff Notes

Dr. Richard A. Gonce, Professor of Economics, will participate in a seminar entitled "Human Freedom and Social Order: Recurring Themes in the Thought of Frank H. Knight," sponsored by Liberty Fund, Inc., in Indianapolis, on November 10 and 11.

Rita Grant, Associate Professor of Accounting, presented a paper, "Fund Accounting: Uses and Misuses," at the American Society of Women Accountants National Spring Conference on June 10 at Boyne Mountain.

Robert Vrancken, Associate Professor of Management and Director of the Facilities Management Program, was the subject of an interview entitled "A Ride on the Office Horizon," that appeared in the September, 1983, issue of *Construction Dimensions*.