West Michigan Management Memo

Volume 1 | Issue 2 Article 6

4-1-1981

Economic Commentary

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The Grand Valley Economic Index

The Grand Valley Index of Economic Activity declined in January to 102.6 from its December, 1980, level of 102.9. This is a slight upturn from a low reached in 1980, when the index value was 100.6. The retail sales and nonresidential construction components of the composite index exerted the greatest negative influence during 1980. The substantial decline in the residential construction component of the index, which began in 1979, appears to have turned upward somewhat. There is also some evidence of an upturn in the use of industrial electric power. Employment also increased slightly at the end of 1980. In Muskegon County, both residential and nonresidential construction activity has declined significantly since 1978.

The composite index is made up of a weighted average of five economic indicators: bank debits, retail sales, residential and nonresidential construction, industrial power consumption, and employment, all of which are adjusted for seasonal variations and for the effects of inflation.

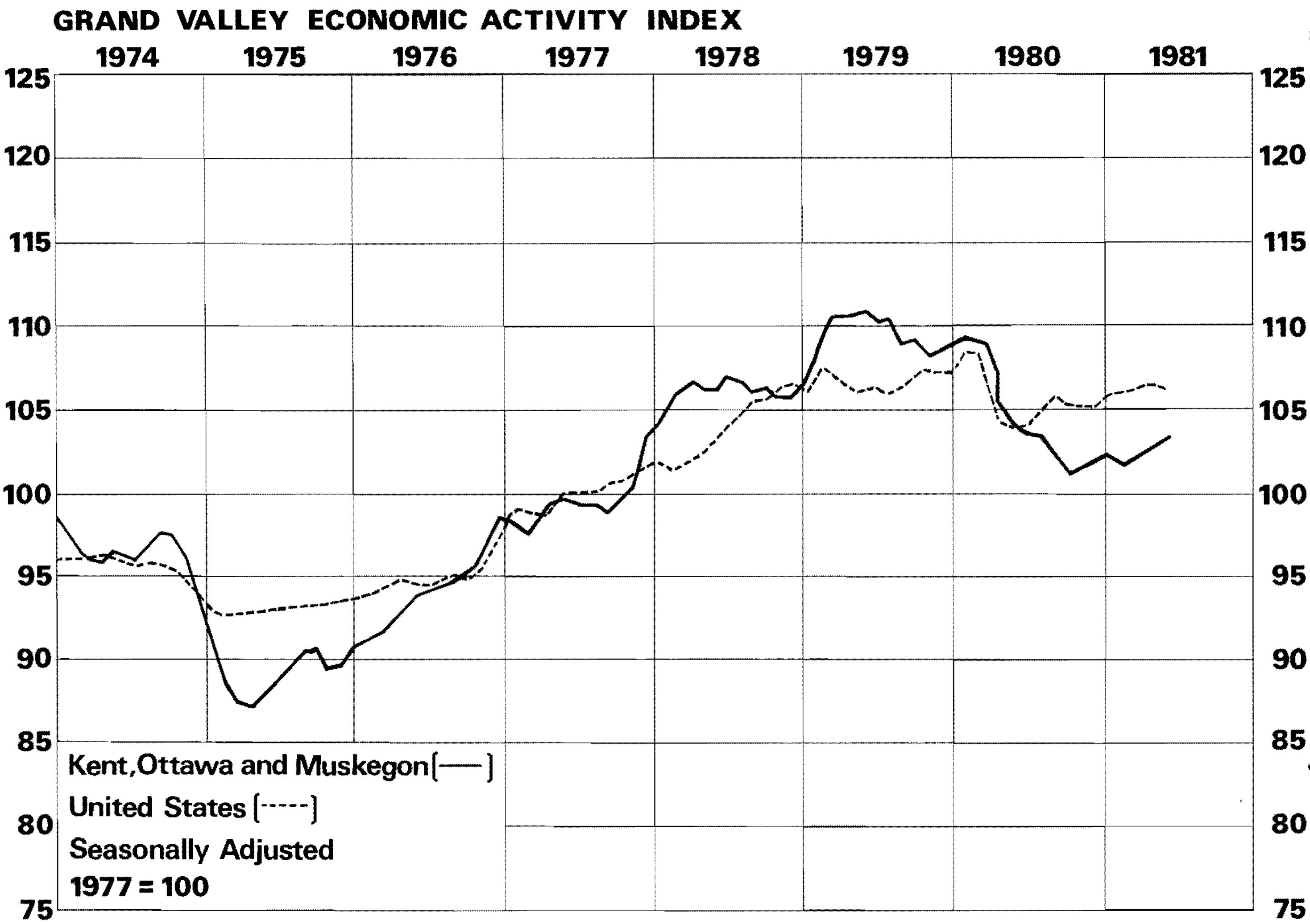
An index has been prepared for the United States which makes use of approximately the same components that make up the index for Kent, Ottawa, and Muskegon Counties. The movements of this index are shown by a broken line on the accompanying graph, which gives some evidence of how local economic activity compares with national economic activity.

Inquiries about the detailed facts of the index can be obtained by writing to Dr. Marvin DeVries, Dean, F. E. Seidman College.

Economic Commentary

The Grand Valley Economic Activity Index shows that the 1980 recession in the tri-county area ended as fast as it started, with a remarkably sharp bounceback. That pattern is quite similar to the national experience, but it occurred several months later. Now the regional economy appears to be in the same sluggish growth pattern as the national, which is still burdened by high inflation and high interest rates holding down certain components of demand, such as spending on durables and construction.

It now appears that we have made it through the end-of-the year scare, when interest rates hit record levels, without plunging us back into recession. Up to that time, economic activity was advancing smartly and credit demands were rising even more rapidly. Interest rates were rising sharply, to the point where there was concern that the recovery would be choked off in its infancy. There was concern that the Federal Reserve had tightened up hard on monetary policy and might be bearing down too hard on money and credit. At the



time, this was difficult to assess because the Fed was holding back money-supply data because of problems with new types of deposits, shifting deposits, and financial-institution reporting arising out of the implementation of the Monetary Control Act.

Now that the smoke has cleared, it is apparent that the Fed has indeed tightened up on money and credit over the last few months. Total reserves and the monetary base were essentially constant from October through February. Since banks and other depository institutions must maintain reserves behind their checking-type deposits, zero growth in reserves makes it difficult, although not impossible, to achieve growth in money and credit. Thus, the most meaningful measures of the money supply show very slow growth during the period.

Since the beginning of 1981 the situation has eased, and short-term interest rates have receded substantially from their highs. This time around, however, the Fed seems determined, at least for the time being, not to repeat the mistakes of the past, when a sharp tightening was followed by significant and prolonged easing and all of the benefits of the tightening were lost. The monetary authorities have recently lowered their 1981 target growth rates for the money supply and seem determined not to let it grow too fast or let interest rates fall too rapidly.

Toward the end of 1980, economic activity on the national level was strong, and the real Gross National Product increased at a 4 percent annual rate in the fourth quarter. In real terms (after adjustment for inflation), personal consumption expenditures, residential construction, and Federal government expenditures all strengthened in the fourth quarter. These increases easily offset the major new area of weakness—real net exports of goods and services (exports over imports), which declined, reflecting the upturn in U.S. imports associated with our recovery along with a decline in U.S. exports as our international trading partners experience weakening activities in their own economies.

While real economic activity was up, so was inflation. Both the Consumer Price Index (CPI) and the GNP price deflator show a worsening of inflation, but this could reflect a rebound from the slowdown in mid-1980. It is small consolation to note that the inflation rate as measured by the CPI is less now than it was at this time last year, since the CPI overstated the actual inflation at that time. A good omen, possibly, is that prices of producers' finished goods are rising more slowly than at any time in the last several years, with the exception of the 1980 recession period. It is far too early to say, however, that real progress is being or will be made against inflation. The underlying rate is still in the low "double-digits."

The job situation has continued to improve, but very slowly. The national unemployment rate has fallen slightly from its recession high to about 7.3 percent. Civilian employment has finally climbed back up to its pre-recession level of almost 98 million people, having gained back almost all of the one million jobs lost in the recession. However, it should be noted that the 7 plus percent unemployment rate (and the capacity utilization ratio of 80 percent) greatly overstate the amount of "slack" in the economy.

Much of the economic outlook, especially after mid-year, depends on the Federal Reserve's monetary policy and the new Administration's fiscal policy. President Reagan has put forth a new Federal budget which is unprecedented in recent decades in terms of expenditure and tax cuts, and in the general direction of the Federal government. But as large as the proposed expenditures cuts ($48.6 billion) and tax cuts ($40 billion) are, they do not really amount to very much more than reducing the Federal budget to where it would have been, based on projections of just a few years ago.

The growth in Federal spending in recent years has been far faster than had earlier been anticipated. For instance, from the second quarter of 1979 to the fourth quarter of 1980, Federal expenditures grew at an 18.8 percent annual rate while the Gross National Product grew only one-half as fast—9.8 percent. State and local government expenditures grew even less—9.3 percent. In January, 1980, the 1981 Federal budget was planned at outlays of $616 billion and receipts of $600 billion, with a deficit of almost $16 billion. The actual 1981 budget, however, will have outlays of over $663 billion and receipts of approximately $607 billion, with a resulting deficit of almost $60 billion!

The 1982 budget that President Reagan inherited had planned outlays of $739 billion and receipts of $712 billion, with a planned deficit of $27 billion. Recent events indicate this too is too optimistic and that the 1982 deficit could be as high as $70 billion. The size and growth of the Federal government are what the new President is trying to change. Aside from defense expenditures, which have the largest dollar increases and are being increased for national defense reasons, the Federal budget is out of control. The other areas with very high expenditure increases are spending on transfer-payment programs and interest on a Federal debt which now approaches $1 trillion.

The questions about the Federal budget revolve around how much of the program Congress adopts, how much gets modified in the legislative process, the timing of the proposed changes, and their impacts on the economy. At this time, it appears that the President will get most of what he is asking for in terms of budget reductions (from projected outlays). Reductions in tax rates are also virtually assured, but Congress will probably bias them more toward business and less toward individuals than would the President. This reflects widespread skepticism about the "supply-side" effectiveness of the President's program and the belief that the effects of the tax cuts will primarily be on demand. While these reservations are well-founded, the Congress must not lose sight of the fact that massive tax increases are already programmed into the system because of "bracket creep," increased social security taxes, and the so-called windfall-profits tax. These tax increases themselves are the major reasons why Federal taxes were originally expected to increase by over $90 billion from fiscal year 1981 to fiscal year 1982. The Reagan proposal only reduces the planned tax increase by about half.

Because of the likely timing and effects of the Federal tax and expenditure cuts, the promised course of monetary policy, and the other developments in the private sector such as weak household discretionary income and the faltering leading indicator index, the near-term outlook is for slow economic growth with continued high unemployment and inflation, and high but falling interest rates. This should continue until the latter half of 1981 when more solid economic growth can resume.

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