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Economic Growth Resumes

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By John O. Bornhofen

As we look backward and forward in early March, we see a healthy and growing economy. Last year, the economy, as measured by inflation—adjusted Gross National Product (real GNP)—grew 6.8 percent on a year-over-year basis. This was the strongest performance in over 30 years. Not only that, the inflation rate remained constant, employment rose strongly, the unemployment rate declined, and most interest rates were lower at year-end than at the beginning. And there was more—a pretty good year indeed.

So far, 1985 is starting out on the right foot, and the rest of the year looks pretty good also. The economy will not grow as fast this year as last—that would be excessive—but growth should be quite respectable.

1984 in Retrospect

Toward the end of last year, there was concern that the economy was slowing down very rapidly and might be heading into recession. Real growth declined from an 8.6 percent seasonably adjusted annual rate (SAAR) in the first half (IH) to 3.2 percent SAAR in the IIH. This slower growth, most of which was in the third quarter, accompanied the sharp slowdown in the growth of stock of money and the rapid rise in our foreign trade deficit. Both of these reduced the growth of the demand for goods and services in the domestic economy in the second half of the year.

While the trade deficit might continue to widen, the Federal Reserve has seen to it that money growth has turned around. Fed policy has been quite stimulative in recent months, perhaps too much so. Whatever the case, fears of imminent recession have faded, at least for now.

Nineteen eighty-four was a strong year for consumer buying and for business investment. Expenditures by households on durable and nondurable goods and services rose 5.3 percent from 1983 to 1984. But business investment in plant and equipment was even stronger, and investment in additional inventories by business was stronger yet. Business invested almost 20 percent more in plant and equipment in 1984 than in 1983 and added a total of $28.4 billion more to inventories of finished goods, raw materials, etc.

Again, the weakest sector of aggregate demand was net exports—the difference between exports and imports of goods and services. Imports exceeded exports in real terms by $14 billion in 1984 compared with positive net exports of $12.6 billion in 1983. In nominal terms, that is, before adjustment for inflation, net exports were a negative $62.5 billion in 1984 compared with only $8.3 billion in 1983. Both of the 1984 numbers dwarf any other year's performance in the history of our National Income Accounts. The major culprit, although not the only one, in this situation is the phenomenal strength of the U.S. dollar—and it keeps rising. Since the dollar buys more units of foreign currencies than in the past, it is cheaper now for Americans to buy foreign goods and travel abroad. Conversely, it is more expensive for foreigners to buy American goods and services. This holds our exports down, while our imports are skyrocketing. It also holds domestic demand and the inflation rate down. Real GNP, employment, and inflation would all be higher if Americans weren't buying cheap foreign goods, but our standard of living might be lower, too, on the average.

With the growth in production and sales comes growth in incomes. Wages, salaries, and fringe benefits increased at a faster rate than did the overall economy in 1984. Other sources of income to households that also grew rapidly were the income of unincorporated businesses, also known as proprietor's income, along with dividend income, and interest income. For the first time in five years, however, transfer payments grew more slowly than the overall economy. Transfer payments consist of income people receive from the Government for which there is nothing in return in the same period. Examples are Social Security, welfare, unemployment benefits, veteran's pensions, etc.

Output of the nation's factories, mines, and utilities has stalled after rising very rapidly in the first half of 1984. It was up 6.7 percent during 1984. Factories are now working at over 82 percent of capacity. This is a bit lower than last summer but well above the end of 1983.

Because of the rise in economic activity, sales, and production, the labor market improved substantially in 1984. The number of people with jobs rose to a record 106.4 million, an increase of over 3.5 million jobs during the year. The proportion of the adult population in the labor market also increased —to 64.8 percent—also a record. The overall unemployment rate dropped almost continually throughout the year but temporarily stalled at 7.3 percent in February.

As we would expect, Michigan has shared in the economic expansion. Real personal income in the state increased strongly in 1984, as it did in 1983 after four straight years of decline. The increase is reflected in the strength in total employment, which rose 190,000, to over 3.9 million in January. This is a 5.1 percent increase over January, 1984, much higher than the national rate of gain (3 percent). Unemployment, however, is still troublesome and uncomfortably high. Although slow and gradual progress is being made, 466,000 people still are counted as unemployed in the state.

The overall unemployment rate in Michigan declined each quarter in 1984 and stood at 11 percent seasonably adjusted (SA) in January. One year before, it was at 11.5 percent SA. Progress in reducing unemployment was slow last year, and that will probably continue.

Inflation has not improved, but we wouldn't expect it to at this stage of the business cycle. The Consumer Price Index increased 4 percent in 1984, a performance not much different from the two previous years. The GNP deflator—a general price index—was also remarkably behaved for the second year in a row. It rose 3.6 percent during both 1983 and 1984. With both indexes, the rates were not significantly different in the second half of 1984 than in the first.

The Producer's Price Index, however, does show more inflation, but it is still well under control at this time. The PPI rose 1.8 percent in 1984 compared with only .8 percent in 1983. Even more remarkable, the Index remained constant or declined in seven of the last ten months. Given the current strength of the dollar and the moderate growth in economic activity, inflation should remain under control throughout this year. A return to "double-digits" is not on the immediate horizon.

The economy appears to have been responding closely to changes in the growth of money put into the economy by the Federal Reserve System, our central bank. In mid-1984, when M_1—currency and checking account balances of all kinds—was almost flat (no growth), the economy began to stall. As money growth subsequently picked up, the economy resumed growing. For a while, money growth was excessive. At this writing, M_1 has been growing almost 10 percent SAAR since the end of last October. Apparently, the Federal Reserve has still not found the will or the way to stabilize monetary growth as so many economists, bankers, and the Administration believe they should, for the sake of long-run stability in the economy. Fluctuations in the stock of money and in its growth over time contribute to the boom-and-bust situations we have too often experienced in the past.

Responding to the changes in monetary growth, a slowing economy, and the growing belief that the federal deficit would be reduced, interest rates dropped sharply in mid-1984 after rising since the onset of the recovery in late 1982. Most rates dropped 2 to 3.5 percentage points from mid-1984 through January. Now, with progress of the deficit reduction slow and special interest groups becoming very vocal about reductions in Federal expenditures, there is growing pessimism that meaningful action will be taken soon on the deficit. Consequently, rates have been moving back up since January. Roughly one-third of the previous drop has been erased. Undoubtedly, steps will be taken to reduce, but not eliminate, the deficit which

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The difference between transaction prices and the true, or equilibrium, prices could also distort resource allocation by giving off false signals about the values of goods and services traded. When scarce resources are misallocated, and some other goods and services are forgone, there is waste. This waste is known as "allocational inefficiency."

Avoiding Taxes

One reason buyers might submit to these inferior prices is tax evasion. They might be willing to pay the higher prices if the percentage price differential is smaller than the tax rate and if the trades can be concealed from the tax man. Thus, people might be willing to pay up to 50 percent more for goods or services if their marginal tax rate is 50 percent.

Barter organizations do reduce the original problems of double coincidence of wants and high transactions costs but substitute in their place default risk, an inferior type of money. But the basic inefficiency associated with barter still exists and causes a suboptimal allocation of scarce resources in the overall economy.

Why then do we waste resources this way? To answer that, we must go back to tax evasion. People are attempting to escape high marginal tax rates on income through the confidentiality of barter transactions. Presumably, the reduced tax load to an individual barterer offsets the additional transactions costs, inferior prices, and/or default risk incurred. Even though this makes sense on the microeconomic level, there is waste and inefficiency on the macro, or social, level. Costs are higher to conduct a given amount of production and trade through barter or barter organizations than with money. Resources used to carry out barter and cope with increased default risk are resources that don't produce other goods and services. Thus, the economic well-being of people is reduced.

Can Barter Be Eliminated?

What can be done to rectify this misallocation of scarce resources? There are several possible approaches. First, marginal tax rates could be reduced to make barter less appealing. However, it is unlikely that rates can or will be reduced enough to discourage this practice. Second, enhanced knowledge of the costs and risks of barter and barter clubs on the part of potential barterers would reduce some of the practice. If people have a general idea of the search costs involved in overcoming the double coincidence of wants, the possibility of inferior prices, and the risk of default by other traders or barter clubs, the incidence of barter should be reduced. Barter will not be eliminated, however, as long as high marginal income tax rates exist.

Third, having the authorities make sure they tax barter transactions that produce income for the barterers would also reduce the incidence of barter and its attendant waste. In this regard, the IRS has recently required that each barter exchange report the gross transactions for each member on Form 1099's.

If barter clubs were required to record the name of each person who makes a trade, the type and amount of goods and services traded, and the amount of credits awarded in return, the value of the income-producing transactions could be determined.[3] This disclosure would be expected to raise the cost of operating the clubs and to reduce their attractiveness as tax-evasion devices.

In conclusion, resort to barter and barter organizations amounts to high transactions costs, inefficiency in the use of our scarce resources and increased risk, throughout the economic system. While barter organizations convey benefits, they also involve costs and risks that, at the macro level, outweigh the benefits.

The root cause of all this appears to be high marginal tax rates on income. But even if trading through barter organizations is recorded, taxed, and reduced, individuals can still revert to straight barter, which is even more inefficient.

[1] The difference between barter clubs and exchanges appears to be that the former are made up of individuals whereas business firms comprise the latter. Barter exchanges are sometimes called trade exchanges.

[2] All costs represent what is given up to pursue one alternative rather than others. Costs are usually measured in money terms, but an out-of-pocket payment in money is not necessary for a cost to occur.

[3] Not all barter transactions are taxable income-producing transactions. Many are non-taxable because they involve personal (as opposed to capital) assets or personal expenditures.

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is currently running at about $220 billion per year. The uncertainty is about when, which, and how much. Clearly the deficit will not go away—not with growth nor with any of the deficit reduction schemes being discussed in Washington.

Outlook

The outlook is for continual but erratic economic growth in 1985. Real GNP is expected to grow 3.5 to 4 percent. Unemployment could fall a bit more, but that will happen much more gradually than in the past two years. We should go below 7 percent. Inflation may begin to creep up somewhat, but it should remain at 5 percent or under throughout the first half of this year.

Although the near term looks rosy for the national economy, the situation for Michigan is more uncertain. While a buoyant economy will support an even more buoyant automobile market, car production in Michigan will be held down as the Japanese increase the number of cars they sell in the U.S. market following our lifting of the "voluntary" import quotas on Japanese cars. While this will hurt the domestic auto industry and Michigan somewhat, it won't throw the state back into recession. And the American consumer will reap noticeable benefits.

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