Deficits and Tight Money Hold the Economy Down

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Enrichment Fund Activities

We are pleased to present an Enrichment Fund report for the fiscal year July 1, 1980, to June 30, 1981, in this issue. Several programs and activities have been made possible with the earnings from the Endowment. A financial statement is given on page 4 of this issue.

Five Seidman College graduate students attended our special program in Washington this summer (see article on the Washington Campus Program). One student, Deborah Edwards, spent eight weeks with Amway Corporation’s office in Washington on an internship after completing the special Washington Campus Program.

Several Seidman faculty received support for research projects on corporate governance and management-worker relations in the west Michigan area. Future issues of the Memo will contain brief reports of the findings of this research.

A special lecture in the community by Dr. Michael Novak and the business strategic planning lectures on our campus by top corporate leaders were reported in the last issue of the Memo. Additional lectures are being scheduled for this academic year. Such lectures add an important dimension to the students’ learning experiences.

The high school Economic Essay Contest sponsored by Seidman College in conjunction with the Economic Club of Grand Rapids was very successful this year. As reported in the last issue of the Memo, more than 80 essays were received on the topic, “How Can We Improve Productivity in the United States?” Many of the essays were well written. We are very pleased to publish the first- and second-place winners in this issue. We believe readers of the Memo will be interested in reading what area high school students are writing about our economic system.

The next Enrichment Fund Dinner is set for Tuesday, June 15, 1982. Mark Russell, noted political satirist, will be the featured speaker. In addition, a new colored-slide presentation will highlight some of the programs and activities made possible by the Enrichment Fund.

Deficits and Tight Money Hold the Economy Down

“Interest rates, interest rates, interest rates!” the Congressman said. That’s all his constituents talked (or complained) about. Indeed, the talk about economics in late summer revolved around record and near-record interest rates and what they were doing to the economy and to the Reagan economic game plan. This article will take a look at what brought these interest rates about and the prospects for their decline.

As indicated in the graph, the Grand Valley index shows that growth in the Kent, Ottawa, and Muskegon county area has been erratic in 1981 and somewhat out of sync with the rest of the country on a month-by-month basis. The behavior of the Grand Valley index for the U.S. economy, however, is consistent with the path of the real Gross National Product so far this year. After rising strongly in the first quarter, the real GNP fell in the second quarter and will probably be no more than flat in the third and fourth quarters. This is consistent with the notion of an economy with a strong upward thrust being throttled by high interest rates. While some industries are doing well, others, such as autos and construction, remain in a depression due at least partly to high interest rates. On balance, the current situation could end up being labeled as a recession, and much of the problem stems from the economic policy that has been carried out in Washington this summer.

At last writing, the question was whether Congress would go along with the President’s request for a 25 percent “across-the-board” personal income tax cut and acceleration of business depreciation allowances, or whether it would play politics as usual and weigh the tax cuts more heavily toward the lower-income levels (which would have been more expansionary in terms of total demand) and pass its own menu of favored tax cuts and reforms.

Now the deed has been done, and it turns out that Congress did play politics as usual but a different version. It did give the President what he wanted, but it also did what it wanted. Congress passed the Reagan tax plan and its own! On top of the Administration’s cuts, Congress piled its

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own—and the result is a veritable “Christmas tree” of tax relief. The so-called “marriage penalty” was reduced, the “all-savers certificate” (for high-tax individuals) was invented, and the list goes on. Most of the changes are probably worthwhile by themselves, but taken together with the Administration’s cuts, the package is clearly excessive and very expansionary.

Tax Cuts Outweigh Expenditure Cuts

No one really knows how big the actual reductions will turn out to be, but the most common estimate is that the Federal taxes will be about $750 billion lower over the next five years than they would have been without the latest cuts. The expenditure cuts, enacted earlier and already taking effect, will total somewhere around $300-$350 billion through 1985. Thus, extensive as these cuts will be, they will be outweighed by tax cuts, and by a wide margin. The Federal government’s deficits—the difference between Federal revenue and expenditures—will be huge if the newly passed tax and expenditure programs remain in effect through the mid-1980s. The Federal debt will rise by a cumulative $400-$450 billion or so through 1986. The financial markets, projecting these deficits and believing that the Federal Reserve will be unwilling to monetize enough of this debt to hold interest rates down, expect sky-high rates in the future.

With the current high rates, the prophecy becomes somewhat fulfilled as the Treasury’s interest payments on existing debt rise to unforeseen levels, increasing the deficit even more. Thus, the Administration’s entire program of stimulating real economic investment, construction, and auto purchases is already being thrown off track by the excessive tax reduction and consequent high interest rates, and the depressing effect on autos and construction in contributing to continued stagnation in Michigan. As in early September, the real rates of interest—the difference between nominal rates and the inflation rate—were at near-record levels. This reflected the expected massive Federal deficits, continued inflation, and a tight money policy in the face of a growing demand for credit from the private sector.

In its original intent, the Reagan economic policy was to hold aggregate demand for goods and services constant with fiscal (Federal tax and budget) policy and expand total supply. This was to bring inflation down and promote general prosperity and a rising standard of living. As the policy has actually been carried out, however, it is one of “easy” fiscal policy (because the tax cuts will expand total demand more than expenditure cuts will contract it) and tight monetary policy. With heavy Treasury borrowing and the Federal Reserve left in the position of having to fight inflation alone, the inevitable result was high interest rates and a bloodbath in the securities markets. One problem is that as the growth of the money supply is slowed by the Federal Reserve, inflationary expectations, which took years to build up, recede only slowly.

The Federal Reserve has left money tight for several months prior to this writing, but has started to ease up a bit recently. The most relevant measure of the stock of money M1-B, which includes currency, checking accounts and other transaction accounts of the public, was essentially unchanged between early April and early September, as the demand for money rose.

Large deficits and credit demand, along with tight money policies and expectations of inflation, produce high interest rates

So far, Wall Street and the media seem to have pegged the expected deficits as the culprit bringing about the high interest rates. But, in all due regard to the people who hold these sentiments, it is a fact that the existence of Federal deficits does not necessarily mean that interest rates will be high. The reverse has often been true. It is true, however, that large deficits together with strong demand for credit from the private (and state and local) sectors, along with a tight money policy and expectations of continued, although reduced, inflation, do produce high interest rates. And private credit demand has been strong. Witness the very strong growth of business borrowing from banks and in the commercial paper market in the summer in the face of astronomical interest rates.

At this writing, the Reagan Administration, being fully aware of the concerns (panic?) of the financial markets while not fully sharing those concerns, is preparing even further steps to hold down future deficits and bring the Federal budget into balance by 1984. A number of possible actions are being considered and will probably fall into three general areas: reductions in military spending, more reductions in non-defense spending and, later, tightening up the tax code, perhaps delaying some of the reductions just passed by Congress and signed by the President. At this writing, there is also discussion of trimming some of the heretofore sacrosanct programs such as Social Security. However, the financial community is rightfully doubtful that Congress will go along with more large budget reductions. Hence the pessimism on Wall Street.

Federal Reserve to Ease Tight Money Policy

By the time this article is published, the threat of renewed recession and widespread bankruptcies along with Congressional pressure will have prompted the Federal Reserve to ease its tight monetary policy somewhat. But as one works through the possible economic scenarios for the future, one is struck by the normally high rise in the velocity (turnover) of money that will be required for the Reagan scenario to occur. For it to come about, interest rates will have to be high, although not necessarily as high as in the summer.

The near-term outlook is for inflation to remain just below the double-digit level, while unemployment rises in the near term. Real GNP growth will probably resume after the beginning of next year, and will probably progress in fits and starts after that. The current sluggish situation is deteriorating rapidly and is moving in the direction of recession.

Inflation will continue into the future although at rates below those of the last two years. It cannot and will not “go away.” The underlying rate is still at low double digits. It will take more than temporary gluts of oil and ephemeral declines in food prices to unwind our inflation. It will take either smaller percentage increases in wages, on the average, or a sharp and sustained growth in productivity, both of which are unlikely. Although the Reagan program promises to increase productivity, any increase that we can reasonably expect will be too small to do the job alone. Unless total demand is restrained at the Federal level, inflation will build up again in the future, if and when we move toward full employment over the next few years.

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