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The Recession: Is It Over?

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In our last analysis, which appeared in the February issue of *West Michigan Magazine,* we speculated that the recession, which began last summer, would soon end. At this time, however, there are still conflicting signs concerning the timing of the turnaround. While there are some indications that the bottom has been reached, there are other signs that the recession is continuing but the decline is at a much slower pace. While it will take several months to verify whether or not turnaround is actually in progress, the odds are that if the recession is not already over, it soon will be.

In March, part of the uncertainty about the timing of the turnaround revolved around the extent to which economic activity had been unduly depressed by the weather in January and the extent to which all or some of the improved performance in February represented a "bounceback" from that. While a number of economic indicators have improved recently, others continue to deteriorate. Among those that are behaving consistent with a turnaround are retail sales, construction spending, prices of sensitive commodities at the wholesale level, along with some measures of durable goods orders and unfilled orders. Other series, however, continue to deteriorate, indicating that the recovery is still in the distance. Among these are leading indicators, personal and business bankruptcies, help-wanted advertising, and the unemployment rate. The last two of these lag behind overall activity, however, and would be expected to deteriorate even in the face of a turnaround.

So far, the recession has had most, but not all, of the trappings of the classic downturn. The exception has been interest rates. Real Gross National Product (GNP after adjustment for inflation) fell sharply (about 4% seasonally adjusted annual rate) during the last two quarters. Unemployment has risen from 7% in July, 1981, to 9%. Real final sales (GNP less the increase in business inventories) has fallen 2+% since the first quarter of 1981. Industrial production has declined sharply as has the rate of utilization of manufacturing capacity. Last, and worse for Michigan, the housing and auto industries are still in their own depression, and new housing starts are near rock-bottom levels, as are automobile assemblies and sales.

These are the painful effects of the recession. The benefit is the precipitous rate at which inflation has declined. The Consumer Price Index (CPI) has been rising at about 1% so far this year, compared with almost 9% last year. And prices actually dropped, for the first time in 17 years in March. Although inflation will not continue at this low rate indefinitely, it appears that the cycle of ever-increasing inflation has been stopped. The recent contract concessions in the auto industry are symptomatic of the fact that the back of inflation has finally been broken.

At this point, with the exception of interest rates, the fundamentals should be in place for an upturn. Monetary policy has been stimulative for almost six months, and fiscal policy (federal tax and expenditure policy) is becoming stimulative after being contractionary through most of 1981. Also, business inventories are coming under control, setting the stage for increased production.

The "fly in the ointment," so to speak, is high interest rates which, although much lower than they were last summer, are still very high for a recession. The major problem with interest rates is the demand-depressing effect of the high "real" (inflation-adjusted) interest rates. Technically, real rates are nominal interest rates minus the inflation expected to occur over the time period the rate is to cover. For instance, if the rate on a one-year treasury bill is 13% and the markets expect inflation of 9% over the next year, the real rate is 4%. In computing real rates, however, some observers had compared the short-term interest rates of 13% to 15% around the first of the year with the inflation rate of about 4% on the CPI at that time and had concluded that the real short-term rate is a backbreaking 9-11%.

This analysis is wrong and misleading for the following reasons. First, 4% is too low a rate for future inflation. The recent inflation rate on the CPI has been unsustainably low in recent months. Before too long, the recorded rate will move back up to the basic rate, which is now around 8%. Also, the CPI is not a comprehensive enough measure of inflation for the whole economy. The GNP deflator is a better measure, and it rose at 9% in 1981, before temporarily slowing down in the first quarter of 1982. In addition, as indicated above, the appropriate inflation rate to use in computing the real interest rate is the forward-looking expected inflation rate, not the past rate. Thus, the real rate of interest is still very high—about 4-5%—but much lower than some observers have claimed.

One last note about the recession. It is not only unfortunate because it is taking such a terrible toll, but it was probably unnecessary! It was the almost inadvertent result of a combination of a monetary policy and a Federal fiscal policy which were simultaneously tight (contractionary), because of their timing. Originally, the Reagan Administration had planned that fiscal policy would be neutral. But after the enactment of the tax cut in 1981, fiscal policy was thought to be stimulative. So far, however, the stimulative effects of the federal income tax cuts have been offset by other tax increases and by expenditure cuts. Thus, it is a misconception that fiscal policy has been stimulative. This misconception arose out of the notion that a tax cut program had been passed and that would produce large budget deficits in the future.

The real key to the fiscal-policy effect on the demand for goods and services has been the timing of the cuts in Federal expenditures and of the tax rate cuts that have actually occurred. The expenditure cuts had their effects first, reducing total demand, starting in 1981. Contrary to popular belief, the tax cuts did not occur in mid-1981 and, for the most part, have not occurred yet. When they do, they will have their impacts gradually. Thus, fiscal policy has actually been contractionary at the same time as the Federal Reserve pursued a tight monetary policy. Unfortunately, monetary policy has alternated between tightness and ease within the year, while achieving its (appropriate) targets for the year as a whole. The effects of the timing of these policies have been combined with the expectation of large federal deficits in the future, which have produced high interest rates in advance. Those high rates have crushed the housing market, contributed to depression in the auto industry, and cut into other areas of demand as well. Thus, we have had the "crowding out" of private demand, by Federal government actions that were thought to be stimulative, in advance of their actual occurrence. The result has been the worst of both worlds.

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The reasons for the high interest rates are still the Federal government's deficits, which are very high and expected to be higher in the future, plus continued high borrowing by business, along with the increased risk of lending. Current business borrowing is more involuntary than planned in that firms are often borrowing to finance unsold inventories and to make interest and dividend payments, rather than expand in a planned way.

Another reason for the high interest rates is the enormous risk of holding bonds. When interest rates rise, bond prices fall and holders can incur capital losses (along with reduced buying power due to inflation). In recent years, interest rates and bond prices have been far more volatile than in the past, and this has increased the risk of holding bonds. Add to all of this the increased risk of default associated with loans and debt securities these days, and the result is high real interest rates. Economic recovery, smaller federal deficits, and higher saving by the private sector will solve most of the interest-rate problem, if they can be brought about more or less simultaneously.

The issue now becomes what, if anything, to do about the current situation. At this point, stimulative actions by the Federal government to effect a turnaround should be out of the question, because the economy will be improving before those actions would have their impact. Thus, the effects of these actions would occur only after they are needed. But even worse than the prospect of policy actions that are too late is the prospect of counterproductive actions. Washington does not appear to be dominated by people who understand aggregate-demand management. The current mood is to cut the Federal deficit to bring interest rates down. To do this, Federal fiscal policy will turn more contractionary than it is now programmed to be. Very probably, then, when the Congress finishes its attempts to control the deficits and interest rates, effective tax rates will have been raised again, one way or the other, and some of the defense buildup aborted.

These, of course, are the "easy" ways to attempt to get the Federal deficit under control. The opportunities to make the really tough decisions that would get Federal spending under control, and which must be faced sooner if not later, could well have been lost again as they have so many times in the past. Raising tax rates directly, or letting inflation do it, and cutting defense spending are, of course, the old game of "politics as usual," and Federal spending will still be out of control.

But these comments are addressed to the priorities of fiscal policy. The timing is something else. Only the recent stalemate over what to do has kept Congress from engaging in 1930's Depression-style economics of tightening fiscal policy and reducing total demand for goods and services while the recession is still in progress. It is probably just fortuitous, then, that actions to correct the deficit will be taken at a future time so that their effects will not be felt until such time as fiscal policy finally becomes stimulative and the economy is well on its way to recovery. What, then, should we do now?

The way some politicians talk, the personal income tax cut that President Reagan asked for and got was the cause of our current troubles. This is not true. The cuts in the personal tax rates have only succeeded in offsetting recent and expected near term "bracket creep." Bracket creep is the situation in which your real income goes down but your Federal personal income taxes go up! The enormous deficits expected to occur in the future are part of the problem. The deficits are the result of a number of factors. Among these are the excess tax concessions that Congress added to the Economic Recovery Tax Act of 1981 which were over and above the President's requests, the underruns in expenditure cuts, overruns in other expenditures, the reduction in income and tax collections due to the recession, and revisions in the overly optimistic and unrealistic projections upon which much of the economic program had originally been based. Except for a few specific programs, the Federal budget has not been cut as much as we have been led to believe. Even with all of the talk of expenditure cuts and associated tales of woe, the Federal budget is running well above President Reagan's target. In fact, at approximately $730 billion for fiscal 1982, it is much closer to Jimmy Carter's projection than to Ronald Reagan's. Federal spending is up about $70 billion this year, and that amounts to a rate of growth in excess of the growth of the overall economy, again!

The major concern now is not that the recession will not end. It will, and there will be no "depression." The concern now is for the strained financial position of some American families and business firms. Business liquidity is at low levels and is deteriorating, and business and personal bankruptcies will continue at high levels until after the recession is over. As things now stand, it appears a certainty that the recession will have ended by late summer. By then, the second stage of the Administration's personal income tax cut will be in effect. This will give households an enormous boost in buying power. The 10% reduction in tax rates is expected to increase personal disposable income by about 2% per month. This should be large enough to offset the effects on the households of the high interest rates, higher state and local government tax rates, and the reduction in government support for college students, for middle income taxpayers, at least. The recovery will probably not be as strong as recoveries usually are, because interest rates will still be high by historical standards, although they could be a good bit lower then than they are now.

As for Michigan, none of our readers need be reminded of the economic plight of the state. Unemployment is over 16%—the highest in the country—and the real disposable income of the people is still dropping. Since the state economy is still auto-related, and the domestic auto industry is still cyclical, the state's recovery must wait for the national recovery. Thus, improvement in the Michigan economy is several months off.

This does not address the structural situation in the auto industry, however. There, fundamental changes in demand and supply conditions have occurred and will continue for some time. Although the industry will never regain the employment levels of the past, there can be cautious optimism that a combination of factors will produce a healthier industry in the next few years. Among these are the increased concern for quality, improved productivity through easier work rules and the increased use of robotics, and a marked slowdown in the rise of autoworkers' wages, unit labor costs, and car prices. Combined with a strong backlog of demand, these should produce a healthier auto industry in the future.

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