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At Last, the End of the Tunnel

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By John O. Bornhofen

As of early April, it is apparent that the Great Recession of 1981-82 is finally over, and the economy has embarked on its long-awaited expansion. In a later article, we will review the reasons why the economy behaved as it did, why the recession occurred, and why it went on so long. In this article, we will look at what happened during the last two years and the likely outlook for 1983.

The Recession Just Ended

The recession probably ended last December, after beginning in July, 1981. This duration of one and a half years made it the longest since World War II, although not the deepest.

The best measure of overall economic activity is real Gross National Product, which measures total production of all final goods and services in the American economy, after adjustment for inflation. It fell at a seasonally adjusted annual rate of 1.1 percent from the second quarter of 1981 to the fourth quarter of 1982. Accordingly, since the real output fell, fewer workers were needed, and employment fell while unemployment rose. The number of people employed dropped from almost 100.9 million in July, 1981, to 99.1 million in December, 1982. In that same period, the number of unemployed rose from 7.8 million to 12 million. Accordingly, the unemployment rate rose from 7.2 percent in July, 1981, to 10.7 percent in December, 1982. Both the number of the unemployed and the rate (unemployment as a percentage of the labor force) were postwar records.

The decline in total output was evident from the decline in the utilization of business productive capacity (plant and equipment). The Federal Reserve's measure of capacity utilization in manufacturing dropped from almost 80 percent in mid-1981 to 67.5 percent in December, a postwar low. This mirrored the decline in industrial production of 12 percent during the recession.

The reduction in sales, production, and capacity utilization are all manifested in the "bottom line" for business—profits. Corporate profits before taxes and other adjustments plunged almost 23 percent between the third quarter of 1981 and the fourth quarter of 1982, and the decline for big industrial companies such as those in the Dow-Jones Industrial (stock) Average was even greater.

The decline in production was not across the board, however; it never is. This time it was accounted for by noticeable declines in consumer purchases of "big-ticket" items (until the end of 1982), in business investment in plant and equipment and inventories, and in exports to foreign countries, and by a very slight decline in state and local government purchases of goods and services, all in real terms. The reduction in business inventories, always a factor in recessions, was especially sharp this time. From the third quarter of 1981 to the fourth quarter of 1982, inventories fell by $30 billion. Personal consumption expenditures by households on nondurable goods and services rose, as did Federal Government expenditures on goods and services.

The surprising part of Federal government spending on goods and services (not transfer payments) is that, in spite of President Reagan's efforts to get it under control, it still rose, even after adjustment for inflation. And, contrary to popular belief, non-defense spending was rising faster than defense spending! This at a time when investment in our future productive capacity, which is necessary to maintain and advance our standard of living, was falling.

Not all the news was bad in the last two years, however. The severe costs of the recession (lost output to all and misery to some) did bring a benefit—reduced inflation. By all measures, inflation was much less severe at the end of the recession than at the beginning. The inflation rate on the general (GNP) price index fell from 9 percent in the third quarter of 1981 to 3.7 percent in the fourth quarter of 1982. The inflation in producer's prices was also moderate. That index rose only 3.8 percent during the recession. Those facts notwithstanding, the progress against inflation was most impressive on consumer prices. The consumer price index, which was rising at almost 15 percent annually in July, 1981, rose only 2.3 percent annually during the second half of 1982. These declines notwithstanding, however, inflation has not ended. More on this later.

Personal income—the income of the household sector—continued to grow in nominal terms despite the recession, increasing at a 6.6 percent rate. All sources of personal income continued to grow although at reduced rates from the past, except for the rental income of households, which actually declined. The sources rising the fastest were transfer payments, followed by interest income, dividends, fringe benefits for labor, wages and salaries, and the income of proprietors, in that order. Transfer payments increased over 19 percent from mid-1981 to December, 1982, because of the rise in joblessness due to the recession and in spite of President Reagan's well-publicized attempts to curb social spending at the Federal level.

As would be expected, interest rates dropped sharply during the recession. Treasury bill rates went from 15-16 percent in mid-1981 to 8 percent in December, 1982, and AAA corporate bonds fell from over 15 percent to below 12 percent in the same period. The prime rate at banks also declined, from over 20 percent to 11 percent.

Prices of common stock declined during the recession, until August, 1982. Then they jumped, in one of the most spectacular surges on record. For example, the New York Stock Exchange composite index of stock prices fell 18 percent from June, 1981, to July, 1982, but then rose at an astounding annual rate of 64 percent from July to December, 1982.

The First Part of 1983

The first quarter of 1983 showed the first sustained evidence of economic expansion since early 1981. If the whole year continues as it began—and it is expected to—it will be a year of improvement. Real GNP rose at a 3.1 percent seasonally adjusted annual rate in the most recent quarter. Reflecting this increase, industrial production and capital utilization also grew and, spurred on by lower interest rates, the rise in housing starts continued to accelerate. Although employment remained unchanged, the civilian unemployment rate edged down to 10.1 percent in March.

Inflation continued to abate in the first quarter. While the GNP deflator index rose faster than in the previous quarter, the CPI and Producer's Price index were flat. They indicate that inflation has been throttled, but only temporarily.

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All of these results are consistent with a set of Federal government policies that have been expansionary for at least nine months. Federal fiscal policy is still stimulative in that the deficit that would be expected if the economy were operating at a high-employment level is very large. According to the Government's own estimates, the Federal budget would have a deficit of $40+ billion in 1983 even if the economy were operating at a high level of output and employment, rather than just rising from a cyclically depressed level. Other estimates of the high-employment deficit are even higher.

As things are, the Federal deficit is expected to be around $200 billion this year. Since Federal spending is adding more to aggregate demand for goods and services than Federal taxes are taking out, the Federal budget is stimulative in the direct sense. However, the deficit must be financed, and that financing is keeping interest rates high. High interest rates hold down private demand for goods and services, because they represent the cost of borrowing and the return from lending instead of spending. These indirect effects offset some of the direct effects of the Federal fiscal stimulus. This is "crowding-out," and, unfortunately, it will get even worse as economic activity picks up and private credit demands rise.

The Federal Reserve's monetary policy has also been expansionary since mid-1982. All of the monetary aggregates, such as M_1 (the stock of money in currency and transactions-type balances), total reserves, the monetary base (total reserves and currency), and M_2 (the more broadly-defined stock of money), have been rising rapidly. M_1 has risen at a seasonally adjusted annual rate of over 15 percent since September. It has been fueled by an 11+ percent increase in the monetary base and a 14+ percent rise in total reserves since September. And since the first of the year, this growth has accelerated.

While there is presently much idle capacity and unemployment in the economy to absorb the additional demand that monetary expansion can bring about, it would be easy for the Federal Reserve to go too far in this regard. Excessive monetary growth of the magnitude we have been seeing of late has typically been associated with high and accelerating rates of inflation in subsequent periods. Indeed, the stubbornly high level of interest rates we see in the financial markets is consistent with the view that those markets expect inflation to bottom out soon and to speed up in the future.

Rapid outbursts of monetary growth for relatively short periods of time, such as we are now witnessing, are no substitute for a steady, moderate growth of money, period after period, to the extent that that is achievable. The recent strong rise in M_2, total reserves, and the monetary base indicate that there is more going on than just funds being shifted out of checking and saving deposits and money market funds and into the new "Super NOW" and "Money Market Deposit Accounts" at banks and thrift institutions. The growth of the monetary aggregates has been excessive and must be brought under control before it really has an impact on total demand and expectations of future inflation. The major danger to the recovery is the possibility that the Fed will continue to inflate the money stock at excessive rates and then slam on the brakes as they have done so often in the past. It is assumed here that the Fed has learned from its past mistakes and will not repeat them at this juncture.

The Outlook for the Rest of 1983

It is anticipated that the growth in the first three months will continue throughout 1983 but at a slightly faster rate. This is supported by a number of factors such as the stimulative monetary and fiscal policies cited above, rising leading indicators, rising housing starts, improving measures of consumer confidence, and surveys of corporate purchasing agents that indicate that production and orders are up and that inventories are very lean. Other positive factors are the recent declines in oil prices and the orderly way in which the debt of Third-World and Eastern bloc countries is being rescheduled by commercial banks.

For the rest of 1983, the expansion will be unbalanced, as most are at this stage. Consumption spending by the household sector, including spending on durables, will lead the way. While this will include an increase in the demand for new cars, domestic auto production is expected to increase less rapidly than in previous expansions, because of high new-car prices, stiff foreign competition, and a changed role for automobiles. Nevertheless, car production and sales should improve as incomes pick up, and Michigan should experience noticeable improvement.

Other sectors of demand will be mixed. Housing construction should be strong reflecting the sizeable decline in mortgage interest rates in recent months. Government purchases of goods and services in the market will increase (in real terms) and help buttress consumer spending. Business spending for inventories should increase modestly as the expansion unfolds, but expenditures on fixed plant and equipment will lag behind the rest of the economy at least until the second half. This reflects the abundance of unused plants and equipment along with the business sector's severe cash flow problems over the last 18 months. High real interest rates are keeping many projects from being profitable and are still holding down investment.

Our net export position should continue to weaken in the coming months because of several factors. Among these are the strong dollar in the foreign exchange markets which is keeping foreign imports cheap and making U.S. exports to the rest of the world expensive. Also, the recovery in incomes in the U.S. will induce people to buy more goods from abroad, thus increasing our imports. In addition, the recession in much of the rest of the world and the lack of buying power on the part of the less-developed countries will also hold down demand for American goods. All told, net exports (exports minus imports) should continue to weaken and hold down the growth of domestic demand.

All in all, we are looking for about a 4 percent growth in real GNP for the calendar year 1983. Employment will rise as the economy picks up, but trend growth in the labor force along with a cyclical return of "discouraged" workers will keep unemployment high. The unemployment rate should average 9.5 to 10 percent for the year. Inflation should continue to be moderate, averaging 3 to 5 percent depending on the price index. Modest expansion of demand along with favorable price performances by food and petroleum will also insure no real resurgence of inflation this year.

In short, 1983 looks even more like it will be a fairly good year, and 1984 looks good also.

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