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Kansas Business Review

Economic Conditions

by Professor David Shulenburger

1986

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Shulenburger, David "Economic Conditions," *Kansas Business Review* (Winter, 1985-86), pp. 24-26.

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they don't overproduce when we already have overproduction and to the consumer so he can consume more. We are well aware that we have created a lot of this mess with inflation, which had to be tamed. A non-market oriented agriculture policy has created additional distortions. We believe that income supports must be provided to the farmer, but at the same time we must get those prices down so they are competitive.

Beryl W. Sprinkel
Chairman
President's Council of
Economic Advisors

Professor David Shulenburger:

It is impossible for an economist to give an unequivocal estimation of the direction the economy will go because the economist is generally an expert only in economics. To be able to give unequivocal advice, the economist would not only have to understand the economic system thoroughly, but he would also have to understand the political system, the social system, and even the reproductive and meteorological system.

Given the imponderables that must be weighed if one is to estimate the future course of the economy, my prediction for real GNP growth for next year is 3 percent. That will be a slightly greater growth rate than we are currently experiencing. In order to make this prediction I make the following five assumptions:

1. The dollar will drop an additional 10 percent vis-a-vis foreign currencies.
2. The Federal Reserve Board will keep the money tap wide open. Interest rates will continue their gradual decline.
3. Congress will make modest progress in reducing the deficit.
4. The savings rate will remain at less than 4 percent of GNP.
5. The inflation rate will remain under 5 percent.

Let's take these assumptions one by one and discuss them.

The dollar will drop by ten percent in 1986. The dollar has dropped by 17

percent relative to a trade weighted basket of foreign currencies since February of 1985. The high dollar has caused a flood of imports into the economy and has severely restricted domestic production. Imports during the last 18 months have increased at an annual rate of over 7 percent. This has kept domestic industrial capacity usage down to 80 percent. Historically, during expansions industrial capacity in the United States is utilized to a 90 percent level. We are far below that level. We are below that level primarily because the goods that we are buying are increasingly coming from foreign factories, not from domestic factories. As imports have picked up in the last 18 months, we see that industrial capacity is falling. In August of 1984 industrial capacity utilization was at 82 percent, 2 percent above the approximately 80 percent percent right now. Continued life for this recovery depends upon domestic production increasing. This will happen if, and only if, the flood of imports abates and export growth becomes positive. An additional ten percent drop is predicted for several reasons. The fundamentals in the economy that caused the dollar to rise have now changed. International interest rates among the industrial countries, with the exception of those in Japan and Germany, are approaching or exceeding those in the United States. Flight toward high interest rates, which have characterized our economy, has been primarily responsible for our high dollar, because foreign investors have sought to get into our capital markets.

I strongly discount the argument that foreigners have moved into our markets because U.S. markets are politically more stable than those abroad. While I agree with this statement, none of us hunts absolute stability in seeking a place to put our money. There is much risk in the world and there is much return in the world. What has characterized the years during which our trade deficits have widened has been interest rates much higher than those in the rest of the world.

The second factor that has changed is that the federal government, as part of the G5 group of countries, has taken measures to push down the dollar. First came the great dollar sell-off by the G5 governments, and now we are in a second stage where foreign governments are trying to restrict their money supply growth in order to raise their domestic interest

rates. While intervention in markets generally is not lasting, this intervention occurred when the fundamentals were moving against the dollar and has contributed to its decline.

Third, I predict an additional ten percent drop rather than a greater drop because I believe the will to continue the political intervention will disappear as the dollar moves toward its 1980 levels. Domestic high interest rates in Germany, Japan, England, and France will crimp their economies to such a degree that the gains which they receive from a lower dollar in terms of reduced capital outflow will be offset by losses from high interest rates. As the dollar moves back to its 1980 levels, all intervention in the market will cease and stability will come.

It is very important to the economy that the flow of imports be stopped. It is very tempting to stop this flow of imports by enacting quotas and tariffs in the Congress. Indeed, Beryl Sprinkel of the Council of Economic Advisors now counts over 300 bills before Congress to do exactly this. Any person who has examined our trade practices will certainly conclude that our trade with Japan, Brazil, and India is unfair. However, they have the same set of barriers in effect that they had four years ago. What has changed in the last four years is that the U.S. government budget has moved massively into deficit, putting huge pressure on its credit markets and pushing interest rates above those of the rest of the world. With this rise in interest rates, the dollar went up, and the trade surplus disappeared. The change that occurred is not in the relative fairness of our trading partners, but in our own attractiveness to foreign capital. To deal with this problem by enacting trade barriers should conjure up the ghost of the Smoot-Hawley Tariff Act. International trade can collapse today as it did during the depression of the thirties if countries begin setting up competitive barriers toward their neighbors. As domestic interest rates fall, so will the dollar. As it falls, imports will decline and exports will increase.

The Federal Reserve will keep the money taps open. Over the past few months the U.S. M-1 growth rate has averaged 15.9 percent. The money growth rate will continue at this high level. Inflation has not become a problem in our economy. I want to deal more with the reason for this later, but those who

study the Federal Reserve Board know that it has principally responded to inflation in setting its policies. While we have anticipated increased growth in inflation, it has not yet developed and the Federal Reserve hasn't had to retard monetary growth.

The second reason that the Federal Reserve is likely to continue the growth rate of the money supply is that it is caught in a bind. It realizes that the United States has an overwhelming interest in depressing the value of the dollar. As I discussed earlier, this reduction of value in the dollar is one of the few things that can get our industrial economy moving again. Our commitment with the G5 group of nations is to reduce our domestic interest rates while they increase their domestic interest rates. The way to do so is to continue domestic money supply expansion. The Federal Reserve is more afraid of imports than inflation, and therefore rapid rates of money supply growth will continue at least until the point that inflation begins to rise rapidly.

Congress will make modest progress in reducing the deficit. Primary evidence of this is that our lawmakers have given such serious attention to the Gramm-Rudman amendment. It is clear that surrender of such great prerogatives to the unknown president who will succeed Ronald Reagan is an extreme thing for Congress to do. This represents strong evidence that Congress is concerned about the deficit and is willing to take unprecedented (and perhaps unwise) measures in an effort to reduce it.

I don't expect Congress to have a great deal of success at significantly reducing the deficit. My best estimate is that within the next year and a half the deficit may be reduced to the \$150 billion range. This is a far better level than where the deficit was heading. Projections of the deficit given recent rates of economic growth have it well over \$300 billion in 1989. If we go from \$300 billion to a \$150 billion deficit, this is indeed progress. To dramatically reduce the deficit would be unwise. To withdraw from the economy so much purchasing power in such a short period of time would be enormously destabilizing to the industries that have grown to depend upon it. Were Congress to dramatically decrease the deficit or to dramatically increase the deficit my prediction for next year's GNP growth

would certainly be lower than three percent.

Savings will remain at less than four percent of disposable income. Our post-war savings rate is approximately seven percent. Our unprecedented low savings rate has been an enormous engine driving the economy. This means that three percent more disposable income is chasing goods than we would normally expect. This additional money amounts to about \$90 billion worth of consumption per year, which would not be accruing were it not for the abnormally low savings rate.

Why predict that an abnormal occurrence like this low savings rate will continue? The primary reason is observation of the demographic structure of the economy. The decline in the savings rate from its historic 7 percent level began in 1974 and is continuing today. In the period between 1974 and 1984, the 25-44 age-group grew approximately 20 percent while the 45-64 age-group grew only 5 percent. We could characterize 25-to-44-year-old people as "spenders;" 45-to-64-year-old people as "savers." During their earliest years individuals generally are spending considerably beyond their means, buying houses, cars, raising families, borrowing for college expenses. Indeed the savings rate for many of the 25-to-44-year-old age-group is negative.

The older group, which we called the savers, are looking forward to retirement and saving money, and they also have few demands for large ticket items that haven't been met; their houses are purchased.

This demographic shift into the young group has continued. From 1980 to 1984, the 25 to 44 age-group grew by 10.3 million people while the 45 to 64 age-group shrank by 750 thousand people. Society saved less because there are fewer of us who are in the savings-prone years. This is likely to continue through 1995 when the rate of growth in the older cohort equals the rate of growth in the younger cohort. This is definitely short-term good news for the economy. We will be spending instead of saving. In the long term this either means that we will be unable to finance growth in our economy, or else that the financing of growth in our economy will have to come from foreign sources.

The inflation rate will remain under five percent. It is currently bouncing

around in the three to four percent range. Hence, my prediction allows for a two percent increase in the inflation rate through the end of 1986. The biggest change that will lead to additional inflation is the decline in the trade-weighted dollar. Historically a 10 percent drop in the trade-weighted dollar has led to a one percent increase in inflation. The trade-weighted dollar has already dropped 17 percent since February. Rough calculations suggest about two percent more inflation due to this. But I don't believe a dollar lower by 10 percent will mean higher import prices by 10 percent, which would free domestic manufacturers to raise their prices by 10 percent and be no worse off. The reason I don't predict this is that foreign producers have pretty healthy profit margins at the moment. They can afford to raise their prices by less than the decline in the value of the dollar and still have adequate profit margins. Domestic producers won't be free to raise prices as the dollar falls.

In addition, another point I made earlier is important, manufacturing capacity is at 80 percent. We can place many more demands on domestic production capacity before we begin to run at capacity and to push up cost: Indeed, as the capacity rate approaches 90 percent we generally have increased inflation, so we've got a way to go.

We have made a great deal of progress in the last two years in reducing the most resistant source of inflation, that is inflation in the services area. We have especially made progress in the difficult area of medical cost inflation. I suspect that most of the progress in reducing inflation in the services area is a result of deflation in the goods area in the economy. Goods producers who buy services like medical care have pressured their service producing brethren to hold the line on costs as a way of helping the goods producer survive.

Wage costs in our economy are under much better control than they were a few years ago. Indeed, there is much evidence that a bit of a symbiotic relationship is developing between union and management in this economy. Unions certainly have a realization today that strong domestic firms are necessary if they are to continue to produce for their membership. Union wages are increasing at a slower rate than non-union wages. This has been the case for the last two years.

A major cause of our erratically higher rates of inflation in past years has been oil shocks. Oil shocks to the economy look exceedingly unlikely now. Indeed, the cartel of OPEC is essentially broken. Thus, what has been a source of severe inflation since 1974 appears to have been vanquished from the economy.

Conclusion

Moderate growth in the economy will continue. I see many ways in which this

prediction can be stymied. The most probable cause of error in my forecast is the assumption about Congress. If Congress makes no progress on the deficit and the deficit rises far beyond \$200 billion, call the forecast off and look for a real decline in the economy next year. The other major possible source of error in the forecast is my assumption about the Federal Reserve Board. The Federal Reserve is insulated more than perhaps is good for the economy from a political process. "Dumb" actions by the Federal

Reserve Board to sharply limit the growth of the money supply could indeed bring a screeching halt to the growth of the economy. If I believed I were wrong about my initial assumptions, I wouldn't forecast a three percent growth rate. Being optimistic I will stand pat and forecast three percent real growth for 1986.

David Shulenburger
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Business School
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The Kansas Economy



After a strong period of growth during the 1970s the Kansas economy has shifted gears in the 1980s. The initial stagnation of the early 1980s was originally hoped to be a temporary phenomenon. However, as we move into 1986, the Kansas economy has shifted from leading the national economy to trailing it. As a prelude to the 1986 forecast for Kansas, we will review the economic performance of Kansas throughout the 1980s. Then using this context as a basis for projecting the performance of the Kansas economy, the staff forecast will be presented.

Recent Kansas Economic Performance

The 1970s were an excellent period for the Kansas economy. From 1971 through 1979 the Kansas economy experienced nearly continuous growth despite the severe national recession of 1974-1975. Not only was growth more consistent in Kansas than in the nation as a whole, but growth was also greater in Kansas. The economic performance of Kansas in the decade of the seventies can be attributed to the fortuitous tendency of the volatile sectors of the Kansas economy—agriculture, aircraft, and autos—to offset one another. The aircraft and auto industries' performance closely mirrors the national

business cycle while the agricultural sector is more dependent upon international events determined more by climate and politics than economics.¹ At no time in the 1970s were all three volatile sectors down at the same time.

Compared to the 1970s, Kansas's economic performance in the 1980s has been disappointing from two points of view. From 1971 to 1979, 270.8 thousand non-agricultural wage and salary jobs were created in the Kansas economy.² During that period, employment increased 40.1 percent. From 1979 to 1985 only 35.2 thousand nonagricultural wage and salary jobs were created, and employment increased a meager 3.7 percent.³ Part of this decline in growth in the Kansas economy can be attributed to the national economy. The period 1980 to 1983 saw two recessions with the second being the worst post-World War II recession the United States has experienced. However, even taking this into account, Kansas performance has been disappointing. During the 1971 to 1979 period when Kansas employment grew 40.1 percent, U.S. employment grew 26.1 percent. Nonfarm jobs were being created at a much faster rate in Kansas than in the United States. This trend has reversed in the 1980s. From 1979 to 1985 employment in Kansas grew only 3.7 percent

while in the United States it grew 8.3 percent.

The weak performance of the Kansas economy relative to the U.S. economy in the 1980s is illustrated in Figure 1.⁴ Three distinct periods of economic activity can be seen in Figure 1: 1980-1981 is stagnation, 1982-1983 is decline, and 1984-1985 is recovery. During each of these periods, the United States out-performed Kansas. As Table 1 demonstrates, this statement can be extended to every year. Throughout the 1980s, the United States has always out-performed Kansas.

A more detailed breakdown of the relative performances of the United States and Kansas economies is provided in Table 2. This table shows that employment in the nonagricultural sectors has, in almost every case, grown faster in the United States than in Kansas. The four sectors that had greater employment increases or lesser employment declines in Kansas than in the nation were nondurable goods (manufacturing), mining, federal government, and state and local government. The Kansas growth rate in the four sectors that grew the most in the nation was about two-thirds of the national growth rate. This is an indication that it is not the failure of one or two sectors in Kansas that has reversed the favorable trends of the 1970s, but rather