10-30-1987

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COOPERATIVE EXTENSION SERVICE

Economics Newsletter

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No 255 October 30, 1987

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by

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What is in store for the United States' economy? Answering this question is very difficult. Economics is concerned with many interrelationships. There is the paper (portfolio) sector; this includes the stock and bond markets. The "real economy" deals with things like consumption, investment, government expenditures, taxes, and trade. Commercial banks and other financial institutions also have an important role. Their structure has undergone tremendous changes in the past 15 years. Economics can also be subdivided into the micro and macro sectors: a comparison of differences between the household or business firm and the aggregate performance of the society.

<u>What Has Happened?</u>

Recent occurrences in our economy have been perplexing. Even seasoned analysts are confused. Until several months ago, stock prices moved up the roller-coaster. As measured by the Dow Jones Industrial Average, they increased two-and-a-half fold between early 1983 and August 1987. On a single day, October 19, 1987, they lost nearly a quarter of their value.

The "real economy", for most us, is most important. It involves our jobs and other income; for the business person it also involves the market for goods both here and in other countries. We are presently faced with many confusing signals in the real economy. In 1982, we had the most severe post-World War II recession. Since that time, we have had our longest period without a major downturn.

There are, however, a number of matters of concern. For one thing, we have been having record deficits in our Federal Budget. The National Debt has increased from less than one trillion dollars in 1980 to about 2.5 trillion dollars in 1987.

Another matter of concern is our international financial and trading position. Prior to 1970, we had surpluses in the Merchandise Trade Balances. Since that time, the U.S. has encountered increasing trade deficits. In 1986, our shortfall on Merchandise Imports was about 145 billion dollars. During the first six months of 1987, this deficit was even larger than during the comparable 1986 period.

Trade deficits and budget deficits are related. For a number of years the U.S. dollar soared in value compared to most other major world currencies. The rise in the dollar's value was heavily influenced by our high real interest rates. This made it attractive for people in other countries to shift investment funds into the U.S. The increased flow of foreign funds pushed up the demand for dollars causing exchange rates to move up also. The U.S. Government's borrowing, to help finance the budget deficit, was a major factor behind the high interest rates.

It operated in the following manner. Interest rates were pushed up by the budget deficits which stimulated domestic spending and competed with private demands for investment funds. At the same time, the U.S. followed a policy of cautious monetary growth, fearing that a rapid increase in the money supply would refuel inflationary pressures. This combination of an expansionary fiscal policy and a restrictive monetary policy forced up interest rates, caused an inflow of foreign investment funds, and strengthened the value of the U.S. dollar.

The strong dollar was a panacea for American consumers. It meant cheap foreign imports. Low priced trips to other countries and high living standards for Americans living abroad were also part of the picture during this period. On the other hand, we were pricing ourselves out of world markets and were faced with a flood of low priced imports from other countries. American farmers, among others, found it more difficult to sell abroad and many American manufacturers found that many of their domestic and foreign markets were being taken away.

Since 1985, the value of the dollar has been dropping. This should have a beneficial impact on reversing the trade deficits. Lags, however, exist and it is too early to tell when a meaningful turnaround in the trade figures will take place.

The U.S.'s large trade deficits have earned hundreds of billions of dollars for people in other countries. Many of these dollars have been reinvested in our stock and bond markets. Stock price fluctuations on American exchanges are, therefore, becoming increasingly more dependent upon the decisions of foreign investors.

It is easy to blame government for all our misfortunes. The direction of the private sector also deserves some emphasis. Many large U.S. corporations have been more concerned about carrying out or preventing mergers than with making adequate investments in plant, equipment, and inventories. Compared with many of our trading partners, our large business firms have been placing more emphasis on short-term profits and less on new technology, new products, research, and development.

Other Considerations

During the 1980s, South Dakota agriculture has been facing difficult times. This has created problems for most sectors of our state's economy. At the present time, "shocks" are taking place in the portfolio markets. This can and often does influence the "real economy". These influences involve both psychological and "portfolio" factors. The severity of these impacts is hard to predict, however, and has not followed a consistent pattern after previous market drops.

If consumers become worried about their jobs and delay consumption and business firms become pessimistic about future sales and delay investments, the changes in the securities market could trigger an early recession. If, on the other hand, people look upon the present situation as a much needed adjustment from an overpriced security market, the real-world impact may well be slight.

The security markets influence the real economy in other ways as well. Economists sometimes refer to the "portfolio effect" as the impact of real or imagined wealth upon expenditures. Included here is everything from the willingness to make charitable contributions to the status of a person's retirement fund. Portfolio values also influence college endowment funds, the collateral for business investments, and a variety of other factors. Further large drops in the prices of our equity securities could, therefore, trigger large drops in employment, output, and profits.

On the other hand, the conditions of late October could trigger a resurgence of inflation. The public sector, in its attempt to correct the present situation, could possibly follow expansionary tactics. For example, both money and credit could be made too readily available. This could easily result in sharp increases in the price level.

Possible scenarios range from continued national progress with low inflation to further drops in security markets, a loss of confidence by the public, and a large dose of governmental interference. Stagflation, simultaneous recession and inflation, would then become a possibility.

Policy Tradeoffs

Practically all analysts are critical of the very large governmental deficits that have been taking place. These large governmental shortfalls are all the more deplorable in view of our relative prosperity. Nevertheless, many of us feel that fiscal stimulus plays an important role in getting the economy out of deep recessions. Fighting major wars is also impossible without large scale governmental borrowing.

If we increase the money supply too quickly, inflation and possibly, in the long run, higher interest rates could result. On the other hand, if we do not increase the money supply quickly enough, higher unemployment, lower business profits, and recession might take place. Another disadvantage of a restrictive monetary policy would be higher interest rates in the short-run.

The two previously mentioned policy tradeoffs deal with macro (aggregate) economic performance. Our policy makers are also concerned with rules and regulations that affect the individual (micro) sectors of our economy.

Prior to the late 1970s, banks were strongly regulated with respect to the interest rates they could pay, the geographic area in which they were permitted to operate, and the types of economic activities in which they were allowed to engage. In recent years, interest rates have become deregulated, banks have found ways to cross state lines, and banks have entered business areas from which they had previously been prohibited. At the same time, other types of business firms have entered the turf that had previously been the exclusive domain of the banks. Some, especially independent bankers, argue that deregulation has gone too far and has had destabilizing impacts on our economy. Others, such as large banks and financial institutions, express the viewpoint that the "supermarket" is more efficient in providing financial services than the "corner grocery store".

No Simple Answers

The implementation of economic policy is directed by Congress and the President, by our State Legislatures and our Governors. It requires a constant vigilance and defies easy solutions. It is made more difficult by uncertainty about the future. It involves a recognition that to attain one objective we may have to make sacrifices in other areas. An economic policy which helps some groups often hurts other groups.

An improvement in economic literacy would be helpful to both individuals and our country. Being better aware of what takes place in our economy helps us to make decisions in our personal spending patterns. It also influences the type of direction that we give to our governmental policy makers.

Editor's Note

This is to alert you to a special publication, South Dakota's Agricultural Economy, that is being published by the SDSU Economics Department. The publication involves assessments of the past, the present, and the future. It covers a wide variety of issues bearing on the State's economy, including an expanded treatment of some of the points raised by Dr. Greenbaum in this newsletter issue.

The scheduled date for publishing South Dakota's Agricultural Economy is December 15, 1987. The Table of Contents follows.

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Begin now to consider whether you'd like a copy of the entire publication, a copy of one or more of its six component parts, or a copy of one or more of its individual chapters. We'll be letting you know about the ordering procedures for this popularly written, yet substantive, treatment of South Dakota's agriculture economy.