

## The Economy: Revived

The economy made an abrupt turnaround in the third quarter as GDP grew an estimated 8.2%, with strength mainly in business investment and consumer spending. This compares with 2.0% for the first quarter, and 3.1% for the second (or about 2.0% in the second if we adjust for the unusually large war expenditures made during this period).

Seeing the sudden shift from a slow-growth mode, the financial press has assumed that another economic boom is taking shape. We would prefer a little more detailed analysis before accepting this conclusion, however. The economy has received many different kinds of stimulus during the last three years, and expectations for the future depend a great deal on which particular stimulus finally jump-started this economy.

### Why Now?

The important question is why the economy broke out of its sluggish growth pattern at this particular time and not another. The Fed has prodded the economy with numerous monetary and interest rate jolts since January of 2001, without much result. While low interest rates and accommodative monetary policy provide a nurturing environment for an economic recovery, they are not themselves the seeds from which a recovery grows. To find these, we need to understand what caused the exceptional growth in business and in consumer spending.

The business-industrial economy suffered a massive slowdown following the investment boom in the late 1990's. The slowdown was set off by Fed rate hikes, higher oil prices, the end of Y2K spending, the dotcom blowup, and slowing demand for everything from cell phones to autos. Investment spending collapsed, inventories were liquidated and the industrial economy spent three years adapting to these new conditions.

The first key to the current U.S. rebound is realizing that a global economic expansion started in Asia in 2002 and has been spreading since then. This has finally created

demand in the washed-out U.S. industrial sector, and that demand was translated into a significant part of third quarter GDP growth. It now seems clear that the U.S. business-industrial recession is over.

The second key to the current U.S. rebound is realizing that the exceptional growth in consumer spending in the third quarter was the result of strong fiscal stimulus. The Federal government lowered withholding rates and provided tax rebates to American families. As a result, personal income and personal spending were up substantially compared to the second quarter. At seasonally adjusted annual rates (how the numbers are reported), disposable personal income increased \$193 billion from the second quarter, almost three times the increase from the first to second quarter. We can infer that most of this \$193 billion was spent since the savings rate increased only \$24 billion.

### What Next?

Global economic expansion seems to be leading the U.S. out of its slow growth pattern, but can the economy follow up with several more quarters of above average growth? A normal recovery would create several hundred thousand jobs monthly and stimulate significant business investment. But changes in global business practices mean that the expected benefits will be muted this time around. U.S. corporate capital spending is being split between domestic and offshore projects to a greater degree than in previous recoveries as corporations attempt to cut costs as much as possible. This means that the typical post recession contribution to GDP will be smaller than otherwise. Increased offshore capital spending also means that post-recession job creation will also be below average (already showing up in the Non-farm Payroll statistics). Essentially, the U.S. business-industrial sector is exporting a percentage of recovery benefits.

Consumer spending held up well in the last three years when about two million jobs were lost. The negative effects of no job creation were offset to some extent by low interest rates as debt service costs declined. At the same time, mortgage refinancings lowered payments to free up cash for spending elsewhere. But since interest rates have stabilized over the last six months, refinancings have slowed considerably. Job creation is the normal driver of consumer spending growth in recoveries, but this effect will be subdued as an important percentage of new jobs are sent offshore.

The economy is in a position where it requires constant stimulus from different sources to keep it from falling back into its slow growth rut. One recent positive is that the business-industrial sector will not be the drag it has been over the last three years. But this is partially offset as U.S. corporations push more and more of their capital spending and job growth offshore. Conversely, the consumer sector is more precarious now as fewer refinancings provide less stimulus than in the past.

## Conclusions

The recent data don't really support the contention that the U.S. economy is set for a robust, long-term recovery. The patterns of corporate investment and capital spending have changed considerably since the last recovery in 1991-1992. Net of the offshore effect, the business-industrial economy should now be a consistent, though modest, contributor to GDP.

On the other hand, consumer spending never fell to recession levels in the last three years and so consumers have no real 'catch-up' spending to do. Consequently, consumer spending will not be a consistently big contributor to GDP without targeted inducements to spend. GDP growth should taper off over the next several quarters in a below average recovery. Only Washington is in a position to change this scenario by providing additional fiscal stimulus.