
*Econ today*SM *economics - without the hype*

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GDP Falls Short

The reports this week provided two surprises, both related to Gross Domestic Product (GDP). First, the economy grew at only a 3% annualized rate in the April - June quarter, well below the expected number. Analysts had forecast something much closer to 4% growth.

In the second and more important surprise, the shortfall in GDP was due to the smallest quarter-over-quarter increase in personal consumption expenditures since the Spring of 2001. This is even more unusual considering the differences between the economy now and in 2001 when interest rates were higher, housing had not yet boomed, and the economy was yet to enter a recession.

Where Personal Consumption Failed

We can better understand what happened to personal consumption by looking its three major components. These are 1) durable goods like cars and furniture; 2) nondurable goods like food and clothing; and 3) services like recreation and medical care.

For the first time since the Spring of 2001, the contribution to GDP from both durable and nondurable goods was negative. Looking within durable goods itself, the contribution to GDP from spending on autos has been declining since the Spring of 2003. In the nondurables area, spending declined from the previous quarter for only the second time since the Spring of 2001. A 2.3% increase in spending on services provided the sole source of growth in personal consumption during the last quarter. Quite obviously, the consumer has cut back in multiple areas simultaneously.

Emerging Drag on Consumption

The weakness in personal consumption expenditures marks a potential shift in the pattern of economic growth that has persisted at least since the Millennium. Beginning in 2001, personal consumption provided the growth that propped up the economy as business spending and industrial activity collapsed after Y2K. Only in the last four

quarters has the business economy grown faster than personal consumption. And only in the last quarter has the business economy made a larger contribution to GDP than personal consumption. Business is taking the lead while the consumer takes a rest.

The pattern is changing because the forces driving the growth in personal spending are waning and other forces are taking over. The rise in short term interest rates, the sluggishness in wage growth, the increase in energy prices, and the slide in home refinancings have all created a drag on personal consumption. For now, analysts are calling this a 'soft patch' and believe the drop will be temporary. This might be so, but the fundamental conditions that made personal spending a steady contributor to GDP are slowly reversing. As that happens, personal spending will become a smaller part of GDP and the economy will depend more and more on business and industrial spending.

The business and industrial economy began to improve in 2003, before personal consumption began to soften, bringing the business economy out of its two year slump. In fact, the business and industrial economy contributed two-thirds of the increase in GDP during the second quarter. This resurgence in business spending and industrial activity combined with a surge in consumer spending to produce the economic rebound of the last year.

Breaking the Economy's Momentum

But now, the softening in consumer spending is splitting apart the pieces of the economy which had joined together in 2003 to produce this recovery. Slowing personal consumption may leave the business and industrial economy as the biggest contributor to GDP in future quarters as well. But this split is putting pressure on the economic recovery. With 70% of GDP tied up in personal consumption expenditures, it will be difficult for the rest of the economy to grow fast enough to make up the slack and to keep the recovery on track. In other words, stagnation, neither recession nor recovery, becomes a real threat unless something changes.

Ways could be found to resuscitate consumer spending within a relatively short period of time. One scenario would see rapid job creation leading to above average wage growth. But wage growth has been sub par all year, in spite of the reported large number of newly created jobs. This disconnect between wages and jobs should cause analysts to look skeptically toward recent surveys of job growth (the seasonal adjustment process is suspect here). Another possibility would be direct fiscal stimulus like a tax rebate which consumers would spend almost immediately. But without any current legislative proposal, a tax rebate program would be months away.

At this point, the economic forces seem to be in place for something most analysts have not forecast: a consumer-led economic slowdown occurring in the near future.