

## War Spending Saves GDP

Have we finally turned the corner and started a sustainable economic recovery? The financial gurus says 'Yes' and point to the final revision of second quarter GDP which showed a 3.3% growth rate. On the surface this looks remarkably stronger than the first quarter's sluggish 1.4% growth. On the other hand, if we dig beneath the surface we will see that this 3.3% number is not all it appears to be.

### Defense and Durable Goods

The Bureau of Economic Analysis releases a tremendous amount of data related to GDP. Some of the most interesting are the tables that show the percent of GDP contributed by different parts of the economy (see the web site, [www.bea.gov](http://www.bea.gov); the data can be found in Tables S.2 and 8.2 of the National Income and Product Accounts).

Because of the Iraqi war, national defense spending surged in the second quarter, rising 46% from the previous quarter. By itself, defense spending created 1.74% growth in GDP from the previous quarter, over half the total number. This is highly unusual (nothing like this has happened since the Korean War) because defense spending's contribution to GDP is usually about 0.3% to 0.4%. If we adjust GDP for this unusual number by substituting the average level of quarterly defense spending, then we see that non-defense related growth in the second quarter was more on the order of 2.0%. This is still an improvement over the first quarter, but not a sign of dramatic economic expansion that the financial press has touted it to be.

Aside from defense, only one other area contributed substantially to GDP in the second quarter. This was durable goods, especially autos, auto parts, furniture and appliances, which together accounted for about 1.8% growth in GDP from the first quarter. Auto sales have been supported by ever-growing rebates, especially from the domestic manufacturers. It is also worth noting that spending on information technology did pick up in the quarter. On the other side of the ledger, imports were a big negative for GDP.

## Where's the Growth?

Predictions for third quarter growth are now averaging around 4.5%, more than twice our adjusted non-defense estimate of 2% for the second quarter. Assuming that the 4.5% estimate does not include a huge defense spending component, we need to ask from where the growth can come.

Consumer spending is the first place to look, of course, since it accounts for about 70% of economic activity. Autos and housing have been strong in July and August but the trend may be changing. The recently released September survey of Consumer Confidence (from the Conference Board) includes details of consumers' future buying plans. This showed that plans to purchase autos, appliances and homes have dropped to the lowest levels of the last six months. This occurred in spite of the lower tax withholding rates that added roughly \$4 billion to disposable personal income in both July and August. With the data already in, consumer spending should be strong in the third quarter but we question whether it will be double the rate of the previous quarter.

## Too Optimistic?

The wildcard for the current quarter is capital spending. Even though corporate profits picked up in the second quarter, capital spending has been meager. Meanwhile, job growth has been negligible so far in this 'recovery'. So, even though it looks like third quarter GDP could be the high point for all of 2003, we still think 4.5% growth is too optimistic a projection.