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U. S. Economic Activity Accelerates; Remains below Potential

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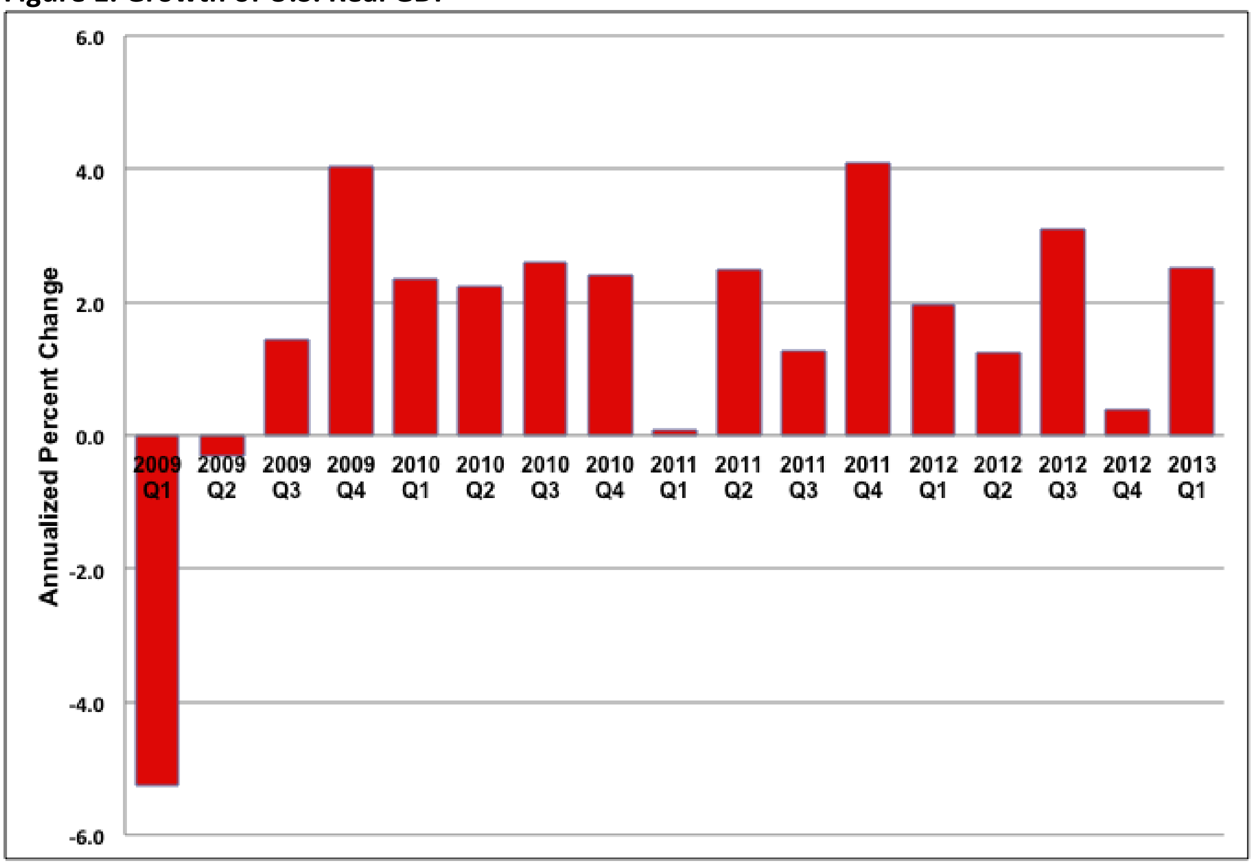
Initial data show U.S. real gross domestic product (GDP) grew at an annual rate of 2.5 percent in first quarter 2013 (Figure 1). That rate of growth marks a considerable acceleration from the fourth quarter 2012 rate of 0.4 percent, and it allays concerns that the economy is headed toward a recession. Nonetheless, the U.S. economy remains well below its potential, and a much stronger acceleration in economic growth is needed if we are to quickly close the gap between U.S. real GDP and its potential.

Figure 1. Growth of U.S. Real GDP



Source: U.S. Bureau of Economic Analysis

An examination of spending patterns shows that consumer spending, residential investment, and inventory investment made sizable contributions to economic growth in first quarter 2013. Business fixed investment made a smaller contribution. Government spending and net exports made negative contributions.

Consumer Spending

Consumer spending is the largest component of the economy, accounting for about 70 percent of real GDP. Real consumer spending grew at a fairly robust 3.2 percent annual rate in first quarter 2013, contributing 2.24 percentage points of real GDP growth (Table). The growth rate in real consumer spending is the second highest since the great recession and close to the 3.3 percent annual growth rate seen in real consumer spending from 1947 to 2012.

Table. Contributions to the Growth of U.S. Real GDP

	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1
Real GDP (percent change annual rate)	2.5	1.3	4.1	2.0	1.3	3.1	0.4	2.5
Contributions to Real GDP Growth								
Final Domestic Sales	1.93	2.32	2.21	2.29	1.47	1.99	1.56	1.97
Personal Consumption	0.70	1.18	1.45	1.72	1.06	1.12	1.28	2.24
Business Fixed Investment	1.30	1.71	0.93	0.74	0.36	-0.19	1.28	0.22
Residential Investment	0.09	0.03	0.26	0.43	0.19	0.31	0.41	0.31
Government Purchases	-0.16	-0.60	-0.43	-0.60	-0.14	0.75	-1.41	-0.80
Net Exports	0.54	0.02	-0.64	0.06	0.23	0.38	0.33	-0.50
Exports	0.56	0.83	0.21	0.60	0.72	0.27	-0.40	0.40
Imports	-0.02	-0.81	-0.85	-0.54	-0.49	0.11	0.73	-0.90
Inventory Investment	0.01	-1.07	2.53	-0.39	-0.46	0.73	-1.52	1.03

Note: Data are reported at seasonally adjusted annual rates.
Source: U.S. Bureau of Economic Analysis

The gain in consumer spending is somewhat extraordinary because it occurred in the face of declining income. Real personal income declined at a 4.0 percent annual rate in first quarter 2013. Real disposable personal income declined at a 5.3 percent annual rate.

Looking forward, the continued growth of consumer spending looks somewhat fragile. Households have improved their debt-to-income ratios somewhat, but they remain slightly elevated. In addition, the labor market has shown somewhat sluggish improvement.

Private Investment

Private investment grew by a robust 12.2 percent in first quarter 2013, contributing 1.56 percentage points of real GDP growth. Residential and business fixed investments made smaller contributions than in fourth quarter 2012. Inventory investment contributed 1.03 percentage points of real GDP growth, whereas it had made a negative contribution in fourth quarter 2012.

In first quarter 2013, residential investment grew at a 12.6 percent annual rate and contributed 0.31 percentage points to real GDP growth. Looking forward, residential investment seems likely to continue making a strong contribution to U.S. economic growth. Sales of new and existing homes have been on an upward trend—held back only by a lack of inventory. The low supply of homes, low mortgage interest rates, and rising rental costs have contributed to rising house prices. With these factors in place, the housing market recovery and investment in new residential construction seem set to continue growing well into 2014.

In first quarter 2013, private nonresidential fixed investment grew at only a 2.1 percent annual rate, the fourth lowest reading and well below the average annual growth rate of 7.3 percent seen during the recovery. Looking forward, businesses remain skittish about investment, and many face obstacles in borrowing for expansion. Although businesses are sitting on considerable cash assets, business fixed investment seems likely to remain conservative in 2013. Nonetheless, the first quarter figure probably represents a fairly low-water mark, and we are likely to see moderate gains in business fixed investment in 2013 and 2014.

In first quarter 2013, inventory investment contributed 1.03 percentage points to the growth of U.S. real GDP. Given the somewhat elevated inventory-to-sales ratio in the second half of 2012, businesses probably didn't intend to make such sizable inventory investments. They likely expected stronger sales, particularly to the government and other businesses. Therefore, much weaker inventory investment is likely over the next few quarters.

Government Expenditures

In 2012, declines in government spending at all levels subtracted 0.35 percentage points from GDP growth. State and local government expenditures fell in three of four quarters. The GDP figures for fourth quarter dramatize the negative impact that sharp declines in government spending can have on the economy. A contraction in federal government spending led by a 22.1 percent reduction in defense spending, nearly offset the contributions the private sector made to final domestic sales. Declining government spending also eroded economic growth in first quarter 2013.

Looking forward, mandated cuts in federal government spending, popularly known as "the sequester," can be expected to further reduce government spending in second quarter 2013. Although the overall economic impact of the sequester is thought to be fairly small, it could contribute to a measureable slowing in economic activity in the second quarter.[1]

Net Exports

Exports were a pillar of strength in the early stages of the U.S. economic recovery. Exports contributed substantially less to U.S. GDP in 2012, as the sovereign debt crisis in Europe created a mild recession and the Asian economies decelerated. The negative effects of waning exports on GDP intensified in fourth quarter 2012, but we see strengthening economic activity in Europe and Asia, which has boosted exports. Nonetheless, a sharp gain in U.S. imports—partially the result of higher oil prices and partially the result of more aggressive U.S. consumer spending—led to a negative contribution from net exports. If the gain in imports proves transitory, net exports could make more favorable contributions to the growth of U.S. real GDP for the remainder of 2013.

U.S. GDP below Potential

Despite the stronger growth in first quarter, U.S. real GDP remains 5.6 percent below its potential (Figure 2). At the trough, U.S. real GDP was 7.5 percent below potential. With real GDP growing a little faster than potential, the economy has been slow to close the gap.

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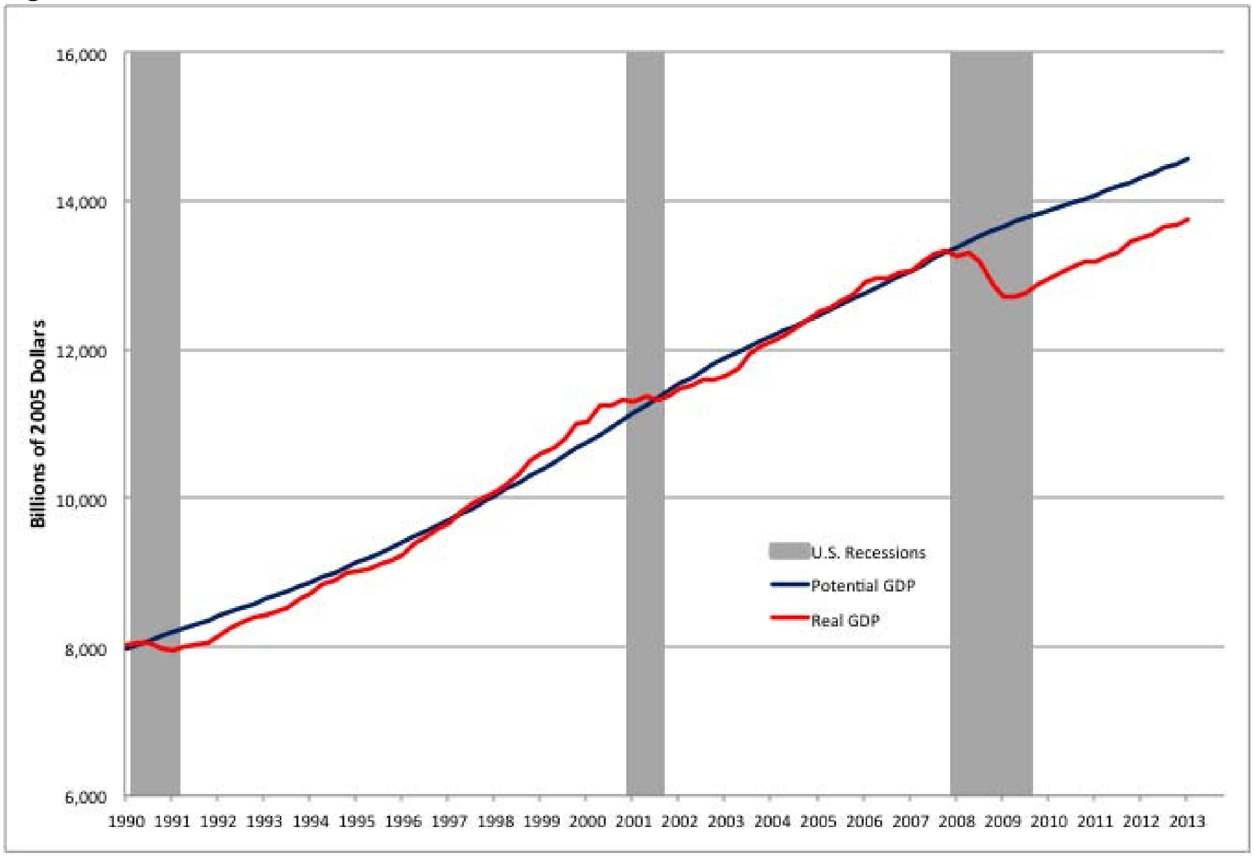
[1] See Stephen P. A. Brown, "Will the Sequester Push the U.S. Economy into Recession?" *Economic Commentary*, Center for Business and Economic Research, University of Nevada, Las Vegas, March 5, 2013, http://cber.unlv.edu/commentary/CBER-05Mar2013.pdf.

Figure 2. U.S. Real and Potential GDP



Sources: U.S. Bureau of Economic Analysis and Congressional Budget Office

Looking forward, we can expect a slight slowing of economic growth in second quarter followed by a gradual acceleration, with private sector gains driving the economic growth. With potential GDP projected to grow at a 1.8 percent annual rate in 2013 and then gradually accelerating to a 2.3 percent rate in 2017, moderate growth rates will yield only a gradual closing of the gap between U.S. real GDP and its potential. With only moderate economic growth, a gap of 1.8 percent between potential and real GDP could remain in 2017.

Why Such a Slow Economic Recovery?

We may have grown somewhat accustomed to slow economic growth over the past few years. Nonetheless, U.S. real GDP at 5.6 percent below potential nearly four years after the recession ended is unusual by post-World War II standards. Previous research finds that deep U.S. recessions have been typically followed by strong recoveries.[2] What is so different about the current recovery?

Unlike the previous ten post-World War II recessions that the United States endured, the 2007-09 recession was precipitated by a housing and financial crisis. Economic research, including that by the International Monetary Fund (2009) and Reinhart and Rogoff (2009), shows that financial

[2] See Nathan S. Balke and Mark A. Wynne, "Are Deep Recessions Followed by Strong Recoveries?" *Economics Letters*, 39(2), 1992, pp. 183–189.

crises tend to lead to recessions that are more severe and recoveries that are substantially slower.[3] Financial crises have persistent effects on investment, labor productivity, employment, the unemployment rate, and real GDP. In some cases, the crisis may affect economic activity for as much as a decade after the recession's official end.

What the researchers find is that financial crises create an uncertain environment that disrupts the relationships between lenders and investors and undermines private investment and job creation, which reduces consumer confidence and lowers consumer spending. New banking regulations can further limit lending and the investment necessary for economic growth. The result is weakened economic activity and more uncertainty, both of which further undermine investment.

Restoring U.S. Economic Activity to Potential

For an economy to grow at its potential, economic growth needs to be supported by consumer confidence, business confidence, *and* the financial sector. Confidence and economic growth work together. Growth in consumer confidence leads to a growth in consumer spending, which fosters increased business confidence. Increased business confidence generates increases in employment and investment spending. Those gains in turn foster further gains in consumer confidence and business confidence. The effect is a self-reinforcing cycle.

A cycle that includes only consumers and businesses can take economic growth only so far. A strong financial sector is the necessary complement to the investment spending necessary for strong economic growth. As the financial sector gains confidence in the economy, it provides the additional funding that supports both investment and consumer spending, and that spending will increase the pace of economic growth.

Where the U.S. Economy Is Headed

The U.S. economy is showing moderate gains driven by moderate gains in consumer spending and strong gains in residential investment. Business investment has been fairly robust throughout the recovery, but it slowed in first quarter 2013. Reductions in government spending have contributed to economic weakness.

Under current conditions, moderate gains in economic activity are all that can be expected. For economic activity to accelerate to its potential, spending must increase considerably. Those gains in spending will only come when consumer, business, and financial sector confidence in the economy increases enough to support greater spending.

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[3] International Monetary Fund, *World Economic Outlook*, 2009 (October) and Carmen M. Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises," *American Economic Review*, 99, 2009, pp. 466-472.