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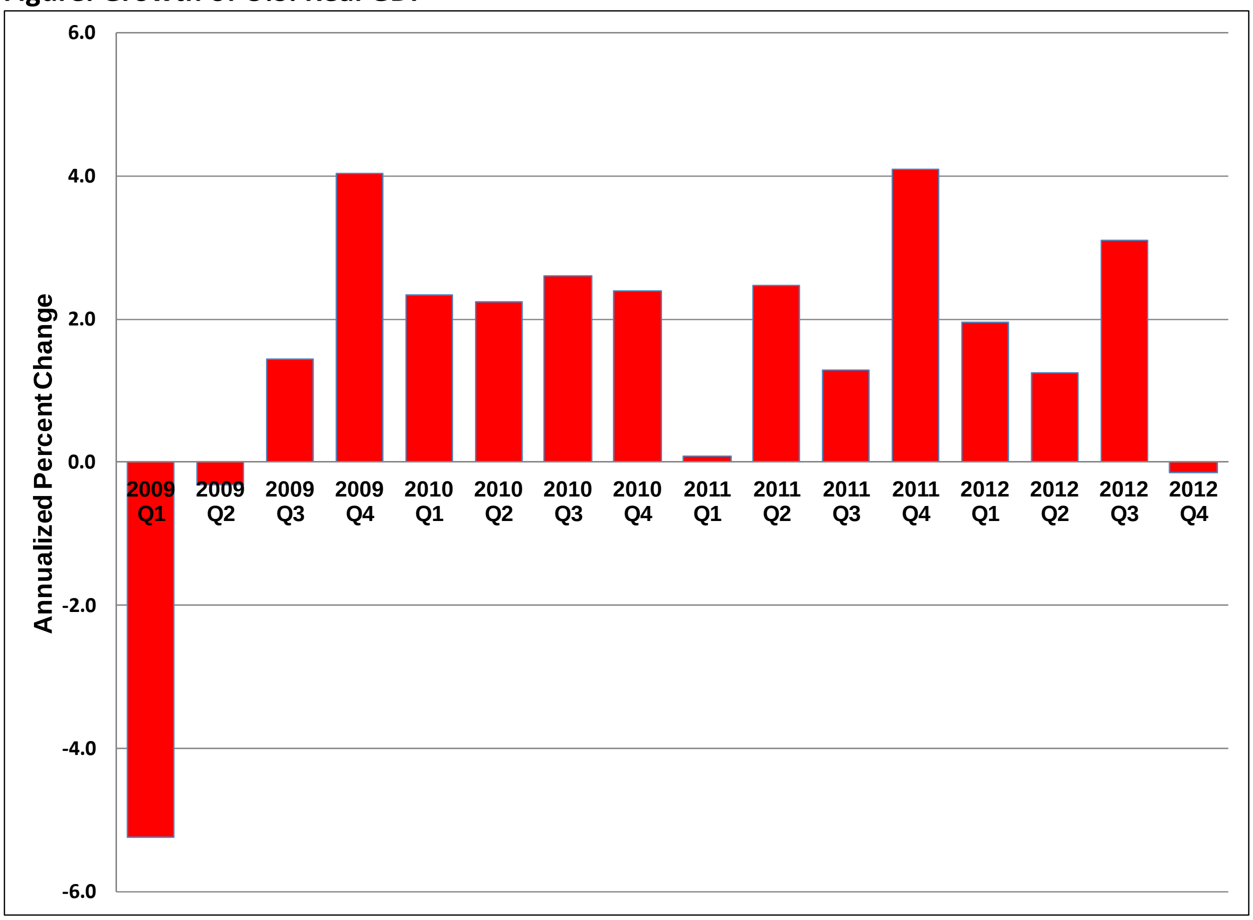
Is the U. S. Economy Headed for Another Recession?

Stephen P. A. Brown and Parameshwaran Bhahirethan

U.S. real gross domestic product (GDP) contracted at an annual rate of 0.1 percent in fourth quarter 2012 (Figure). The reduction marks the first decline in U.S. real GDP since the end of the Great Recession in June 2009. The dip in output brings to the forefront anxieties about whether the economy is headed toward another recession.[1] To evaluate the chances of another recession, we analyze the current factors shaping spending and the outlook for these components of economic activity.

Figure. Growth of U.S. Real GDP



Source: U.S. Bureau of Economic Analysis

[1] A recession is commonly thought of as two consecutive quarters of reduced GDP. The National Bureau of Economic Research provides official dating of U.S. recessions, using a variety of measures of economic activity.

Consumer Spending

Consumer spending is the largest component of the economy, accounting for about 70 percent of GDP. It grew at a respectable pace of 2.2 percent in the fourth quarter of 2012, contributing 1.52 percentage points of real GDP growth (Table). Nonetheless, the growth of consumer spending remains sluggish by historical standards. Real consumer spending averaged a 3.3 percent annual growth rate from 1947 to 2012.

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

	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4
Real GDP (percent change annual rate)	0.1	2.5	1.3	4.1	2.0	1.3	3.1	-0.1
Contributions to Real GDP Growth								
Final Domestic Sales	0.59	1.93	2.32	2.21	2.29	1.47	1.99	1.33
Personal Consumption	2.22	0.70	1.18	1.45	1.72	1.06	1.12	1.52
Business Fixed Investment	-0.11	1.30	1.71	0.93	0.74	0.36	-0.19	0.83
Residential Investment	-0.03	0.09	0.03	0.26	0.43	0.19	0.31	0.36
Government Purchases	-1.49	-0.16	-0.60	-0.43	-0.60	-0.14	0.75	-1.33
Net Exports	-0.03	0.54	0.02	-0.64	0.06	0.23	0.38	-0.25
Exports	0.75	0.56	0.83	0.21	0.60	0.72	0.27	-0.81
Imports	-0.72	-0.02	-0.81	-0.85	-0.54	-0.49	0.11	0.56
Inventory Investment	-0.54	0.01	-1.07	2.53	-0.39	-0.46	0.73	-1.27

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

A number of factors are contributing to the slow growth of consumption spending. Primary among them is the slack in the labor force and the associated weakness in income. The unemployment rate is 7.9 percent, but adding underemployment and discouraged workers to create the broadest measure of labor force slack pushes the rate up to 14.4 percent. In addition, consumers have been working to reduce their debt.

Looking forward, continued gains in personal income should encourage a growth in consumer spending, but the end of the payroll tax holiday and the resulting increase in social security withholdings from 4.2 percent to 6.2 percent could dent consumer spending. In fact, recent reports about consumer confidence and sentiment affirm the negative impact that the expiration of the payroll tax holiday had on consumer attitudes. Together, these factors suggest the likelihood anemic growth in consumer spending in early 2013.

Private Investment

Private investment grew by 3.2 percent in 2012, with most subcategories posting impressive gains. Residential investment led the subcategories, rising by 14.5 percent over 2011. New and existing home sales have been on an upward trend. Furthermore, the decline in home prices, which was a major factor holding back buyers during the past few years, seems to have come to an end. A low supply of new and existing homes is likely to offer further support to rising prices. Low mortgage interest rates and soaring rental costs are also contributing to a stronger housing market. We expect the recovery in housing to continue well into 2013.

Many analysts expressed concern that uncertainty surrounding the federal government budget would cause businesses to curtail investment in 2012. These fears seem misplaced, as business fixed investment was robust in fourth quarter 2012, particularly in equipment and software. After a sharp increase in first quarter, investment in nonresidential structures remained flat for the remainder of 2012. A renewed sense of business confidence could keep business fixed investment growing in 2013.

The inventory-to-sales ratio was elevated for most of the second half of 2012. Therefore, it was not too surprising that businesses decided to slow inventory building in the fourth quarter, which subtracted 1.27 percentage points from the annualized growth rate of GDP for fourth quarter. With inventories still elevated in late 2012, we can expect weak inventory investment in early 2013.

Government Expenditures

In 2012, declines in government spending at all levels subtracted 0.3 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 22.2 percent reduction in defense spending, completely offset the contributions the private sector made to final domestic sales.

With weak overall economic activity, government expenditures could be the difference between the U.S. economy resuming on an expansionary path or slipping back into a recession. The likely course of government expenditures remains unknown. Enacted during the 2011 debt-ceiling crisis, the Budget Control Act of 2011 mandated significant across-the-board cuts in federal government spending beginning January 1, 2013. Popularly known as "the sequester," these cuts in spending were delayed until March 1, 2013, as a result of the deal reached to avoid the fiscal cliff. A White House report places the expected cuts in federal government spending under the sequester cuts at $109 billion in 2013. At present, it is unclear whether Congress will allow the sequester to take effect or whether it will enact legislation to postpone the spending cuts or reduce their magnitude.

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 the International Monetary Fund projects the global economy strengthening slightly 2013. Hence, net exports could make more favorable contributions to the growth of U.S. real GDP in 2013.

Summary

Operating well below its potential, the U.S. economy continued on a sluggish expansion for most of 2012 before hitting a dip in fourth quarter. Consumer spending held up reasonably well, but the expiration of the payroll tax holiday could weaken consumer spending in early 2013. The housing sector, a major contributor to the economy's weakness, seems to be improving. Business fixed investment has turned positive.

The contraction in GDP seen in fourth quarter 2012 was primarily the result of declines in inventories, net exports, and government spending. A high inventory-to-sales ratio suggests that inventory investment could remain weak into early 2013. Net exports could contribute some to economic growth in 2013, if the world economy strengthens as expected.

As far as government spending is concerned, much rests on how Congress and the administration resolve the looming spending sequester. Sharp reductions in federal spending will intensify the downward pressure on U.S. economic activity, which would result in either a continuation of subpar economic growth or another quarter of falling GDP. Given a little bit of strength in other areas of spending, we may avoid another quarter of falling real GDP, but just barely.

Stephen P. A. Brown, Ph.D.
Director
Center for Business and Economic Research
University of Nevada, Las Vegas

Parameshwaran Bhahirethan
Graduate Assistant
Center for Business and Economic Research
University of Nevada, Las Vegas