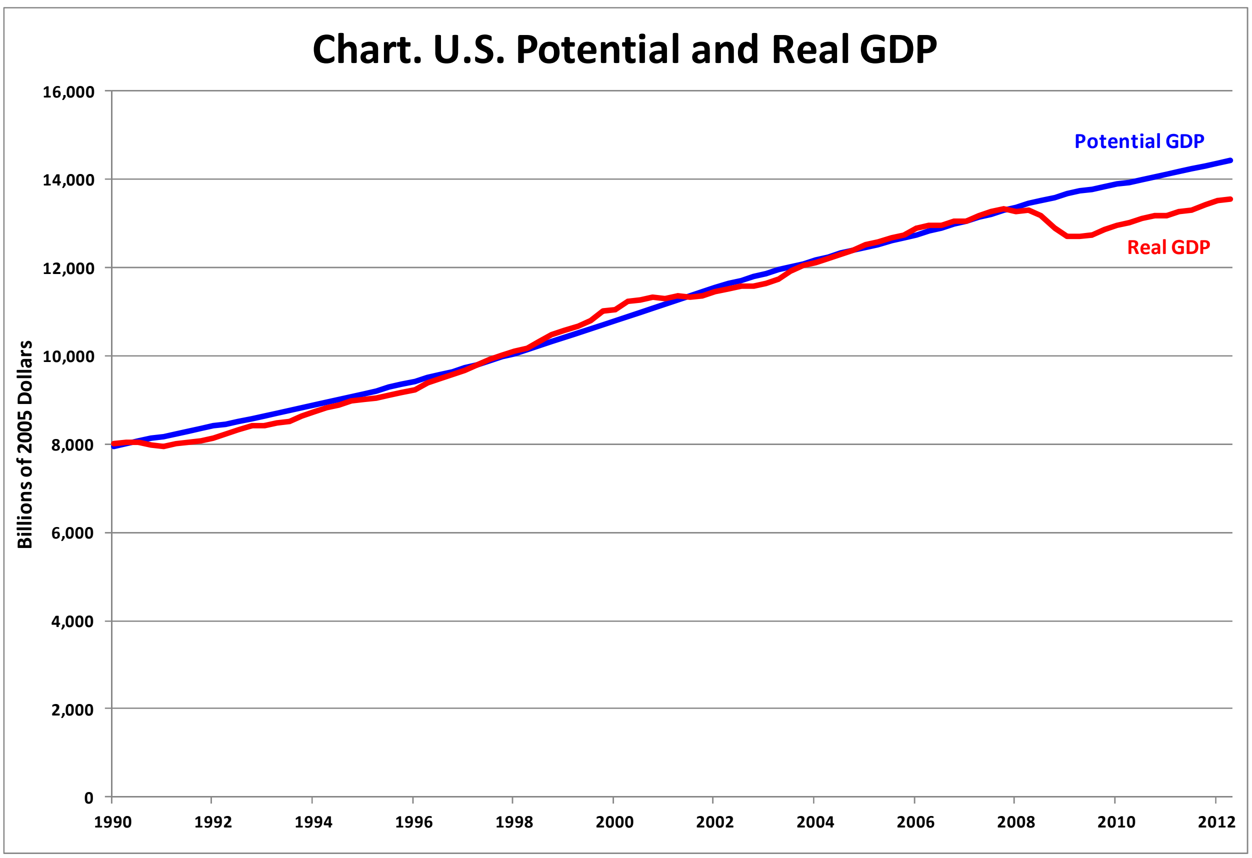
CENTER FOR BUSINESS & ECONOMIC RESEARCH
LEE BUSINESS SCHOOL

September 28, 2012

Where Is the U.S. Economy Headed?

Stephen P. A. Brown

The growth rate of U.S. real gross domestic product (GDP) slowed from a 4.0 percent annualized rate in fourth quarter 2011 to a 2.0 percent rate in first quarter 2012 and then a 1.3 percent rate in second quarter 2012. As of second quarter 2012, U.S. real GDP remained 6.0 percent below its potential (Chart). Is economic growth likely to accelerate and close the gap with potential GDP, or is it likely to languish? To answer this question, we examine the recent course of spending in the economy and its likely course over the next few quarters.



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

Contributions to GDP Growth

In the first two quarters of 2012, much of the growth in U.S. economic activity was the result of personal consumption spending (Table, page 2). In fact, consumption spending grew at a faster rate than GDP in both quarters. In the first half of 2012, personal consumption spending accounted for 1.8 percentage points more of GDP than it did over the time period from 1995 through 2012.

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

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

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

Overall private investment—business fixed investment, residential investment, and inventory investment—also contributed to GDP growth in the first half of 2012. Dominated by the movements in business fixed investment and inventory investment, total investment spending decelerated sharply from fourth quarter 2011 to second quarter 2012. Residential investment rose strongly from fourth quarter 2011 to first quarter 2012, but saw slower growth in second quarter 2012.

The decline in total government purchases—including federal, state, and local—contributed to a slowing of GDP growth from third quarter 2010 through second quarter 2012. From first quarter 2011 through first quarter 2012, much of the decline came from the federal government. In second quarter 2012, most of the decline came from state and local government.

The Necessity of a Spending Acceleration

For the economy to show stronger growth, we must see an acceleration of overall spending—whether the spending comes from consumers, investors, the government, or an improved export-import balance. In the next few sections, we examine the prospects for accelerated spending in each of these categories.

The Outlook for Consumption Spending

Consumer spending, which excludes residential investment, accounts for about 71 percent of GDP. As such, it is the single largest component of spending. During the recession and recovery, consumer spending maintained a slightly stronger pace than overall GDP. Consumer spending didn't slip by as much as GDP during the recession, and it didn't grow by as much during the recovery. In addition, the variation in consumption spending during the recovery has contributed some of the volatility in GDP growth.

As we look forward, personal consumption and retail sales show signs of strong acceleration into third quarter 2012. Surveys of consumer attitudes offer conflicting signals—with consumer sentiment rising and consumer confidence slipping. Slow employment growth certainly remains a concern for consumer spending. Combined, these indicators suggest strengthening consumption spending in third quarter with the possibility of slower growth in fourth quarter.

Investment Spending

Investment spending currently accounts for about 14 percent of GDP. During the recession and recovery, investment spending was much more volatile than GDP. It saw a much sharper decline and a stronger recovery. Nonetheless, investment spending was 10.6 percent lower in second quarter 2012 than it was at GDP's prerecession peak (fourth quarter 2007).

The outlook for investment spending depends on the type of investment. Business fixed investment faces a number of near-term challenges from the industrial sector. Industrial production remains below its prerecession levels; industrial capacity utilization remains below its historical average; and the purchasing managers' index is below 50. All of these factors suggest relatively little reason for strong investment spending in the industrial sector. On the other hand, private service-producing employment is relatively robust.[1] Together, these factors suggest a continuation of moderate growth in business fixed investment spending.

On the other hand, the housing market is providing evidence of strengthening residential investment. Housing sales, starts, permits, and prices are on a general upward trend. The number of months of existing supply for sale in many markets also suggests a need for new construction. All these signs bode well for increasing residential investment.

After a strong buildup in fourth quarter 2011, inventory drawdowns have contributed to weaker economic activity in the first two quarters of 2012. Even with strong retail sales, the inventory-to-sales ratio remains high by post-recession standards. That ratio suggests we can expect inventory investment to make small negative contributions in the remainder of 2012 before turning positive in 2013.

Government Spending

When federal, state, and local government purchases of goods and services are combined they currently account for about 18 percent of GDP.[2] Over the course of the recession and recovery, government spending saw slightly stronger growth than GDP. Unlike other sources of spending, however, government spending increased during the recession and decreased during the recovery. In fact, overall government spending has declined for eight consecutive quarters, from third quarter 2010 through second quarter 2012. Reduced federal government spending has been an important part of reduced government spending, but state and local government spending also declined as state and local governments faced declining revenues.

Looking forward, we see the potential for a sharp reduction in federal government spending as the result of the so-called fiscal cliff.[3] Otherwise, only moderate cuts in federal government spending are likely. State government tax revenues are increasing with economic activity, and increased spending seems likely as we move forward.

Local government spending is another issue. In most states, local governments rely highly on property taxes. With property taxes lagging behind property values, local governments are likely to see further reductions in revenues and face continued pressure for fiscal austerity through 2013.

---

[1] Service production typically requires less capital investment than manufacturing.
[2] This government spending figure excludes transfer payments, which account for about 17 percent of GDP.
[3] See Brown, Stephen P. A. and Kylelar P. Maravich, "Fiscal Cliff Raises Specter of U.S. Recession," *Economic Commentary*, Center for Business and Economic Research, University of Nevada, Las Vegas, August 24, 2012. http://cber.unlv.edu/commentary/CBER-24August2012.pdf.

Net Exports

U.S. net exports are currently about minus 3 percent of U.S. GDP. In the first half of 2012, the United States saw gains in net exports, with a net stimulus to GDP growth. Increases in exports more than offset increased imports. Looking forward, we can expect weakness in the European and Asian economies to weaken export growth. At the same time, however, a weak international economy will reduce the cost of U.S. oil imports. These two factors will mostly offset each other, and changes in net exports will have little effect on overall U.S. economic activity.

The Overall Direction of the U.S. Economy

Combining the outlooks for consumption, investment, and government spending with that for net exports, we see the likelihood of a slow improvement in the growth rate of U.S. GDP as we assess the second half of 2012 through the end of 2013. Consumer spending is showing signs of acceleration. Investment spending—particularly residential investment—is also evidencing gains. Barring a plunge off the fiscal cliff, government spending is likely to be less of a drag. Net exports can be expected to make relatively little contribution to the direction of the economy.

Third quarter 2012 is shaping up to be stronger than second quarter. Fourth quarter may be a bit weaker than third. It still looks to be quite a few years before GDP closes the gap with potential GDP.

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