Best Times Behind Us?

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Progressive Ideas for a Strong, Just, and Free America

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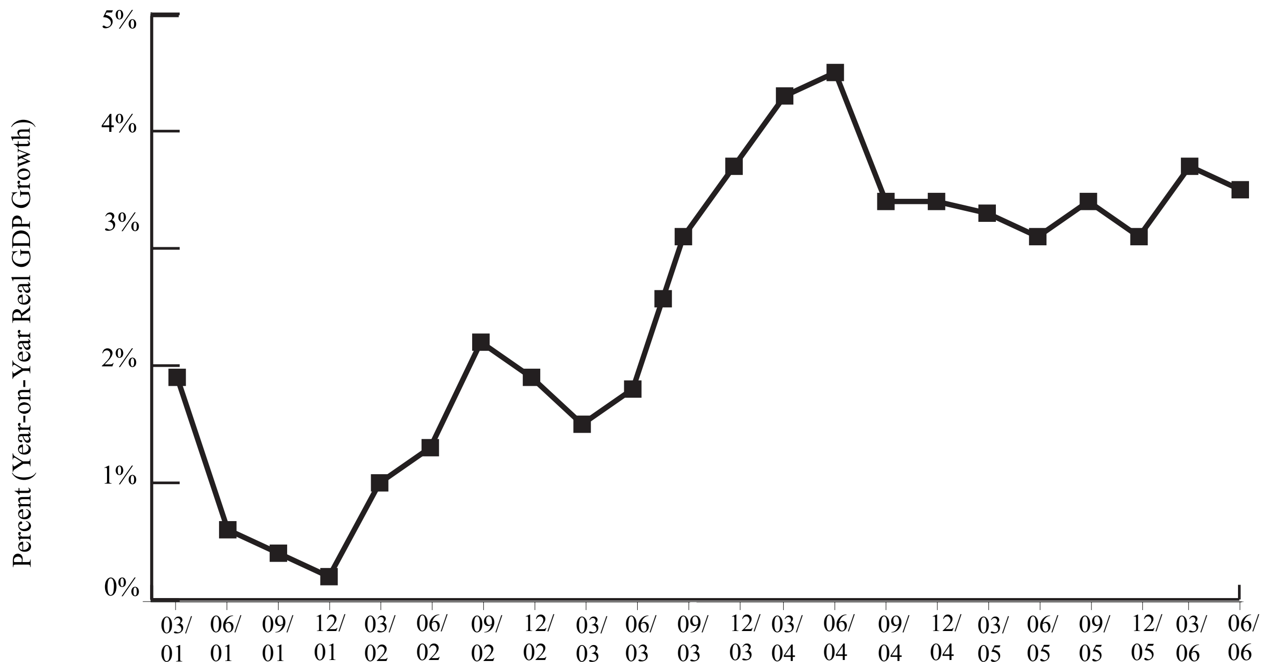
A sharp slowdown in consumer spending and family spending on their homes, alongside slowing business investment and a widening trade deficit, resulted today in a surprising drop in the government's estimated economic growth in the second quarter of this year.

The weak estimated economic growth rate of 2.5 percent is a result of the heavy indebtedness of America's households and of policy decisions by the Federal Reserve to raise interest rates for two years in a row, which made the debt burden more cumbersome for America's families. According to the government's Bureau of Economic Analysis, economic growth in the second quarter is less than half the strong annualized 5.6 percent in the first quarter.

This decline in the economic growth rate in the second quarter continues a longer term trend of a slowing economy. Year-on-year growth in the second quarter was 3.5 percent, down from 3.7 percent in the first quarter and a far cry from the high of 4.5 percent for the period ending in the second quarter of 2004.

Figure 1: Year-on-Year Inflation Adjusted (Real) Growth of Gross Domestic Product (GDP)

Figures calculated from BEA NIPA Table 1.1.6. Real GDP Chained 2000 Dollars, Washington, D.C.: Bureau of Economic Analysis



With interest rates rising, families have found it harder to maintain the steep pace of the real estate boom of the past few years. And no wonder: By the first quarter of 2006, the last period for which data are available, American households had amassed debt in the equivalent of a record high of 126.4 percent of their disposable income.

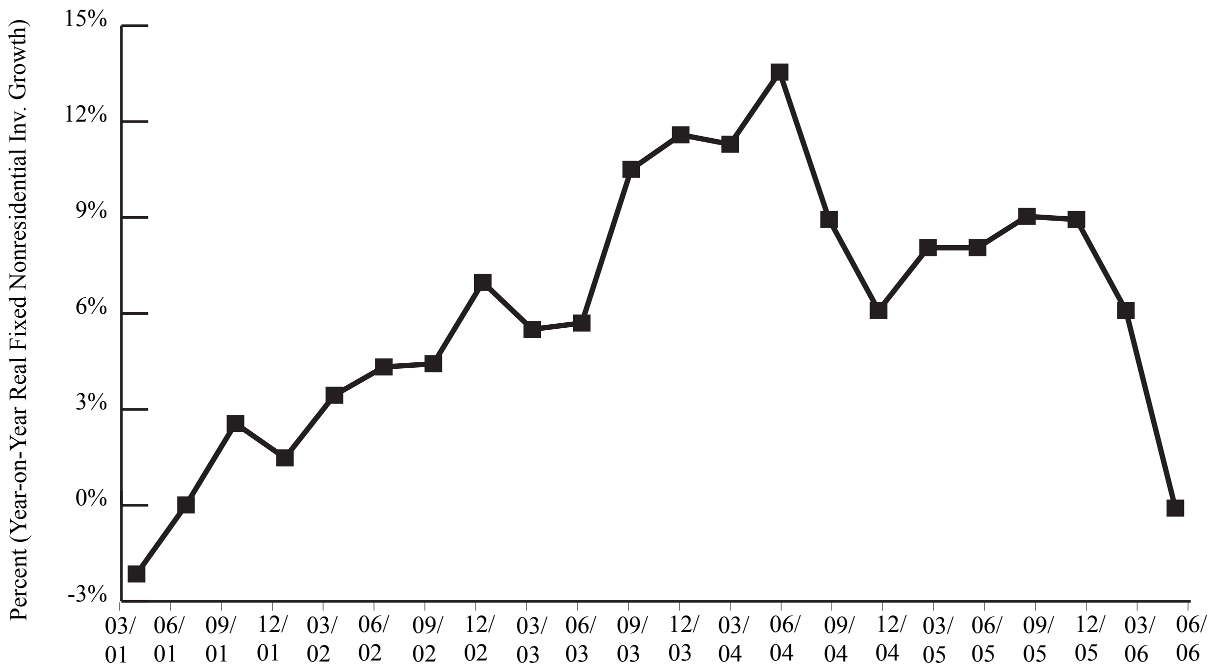
In the second quarter of 2006, residential fixed investment, or families' spending on their homes, declined by a stunning 6.3 percent in the second quarter of 2006, the third decline in a row and the largest decline since the second quarter of 1995. Compared to a year earlier, residential fixed investment was -0.2 percent lower than in the second quarter of 2005. This is substantially slower than the 6.1 percent growth from the first quarter 2005 to the first quarter of 2006 — nowhere near the growth rate of 13.7 percent between the second quarter of 2003 and the second quarter of 2004.

In the wake of a slowing housing boom, consumer spending growth for other items also appears on a downward trend. Consumers spent 2.5 percent more on an annualized basis in the second quarter than in the first quarter, down from an increase of 4.8 percent in the first quarter. Year-on-year consumer spending grew by 3.0 percent in the second quarter, compared to 3.4 percent in the first quarter and a high of 4.1 percent between the first quarter of 2003 and the first quarter of 2004.

With the American consumer less inclined to borrow, continued strong economic growth would have required more business investment. But with consumer spending slowing, businesses apparently have fewer incentives to spend their money on new plants and equipment. In fact, data from the Federal Reserve shows that non-financial corporations have been holding about 6 percent of their total assets in cash, the largest share since the mid-1960s.

Figure 2: Year-on-Year Growth of Fixed Residential Investment Growth

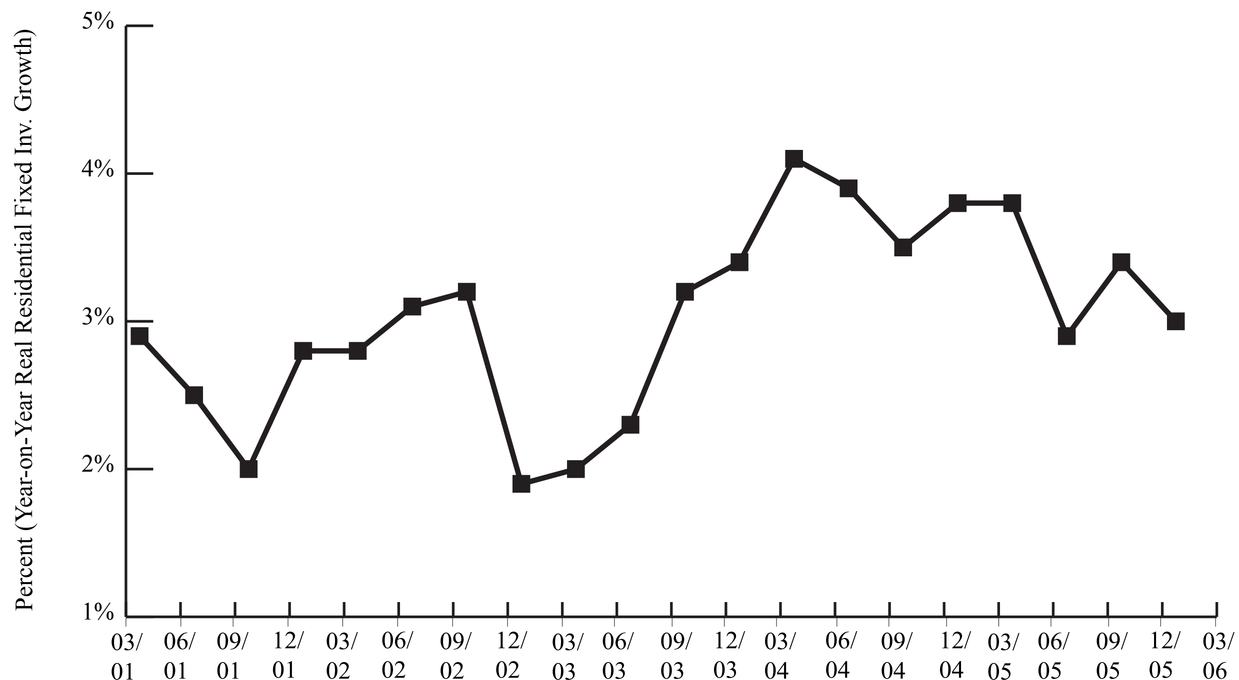
Figures calculated from BEA NIPA Table 1.1.6. Real GDP Chained 2000 Dollars, Washington, D.C.: Bureau of Economic Analysis



Corporations' reluctance to part with their cash is also reflected in the slowdown in business investment spending in the second quarter of 2006. Business investment grew at a low rate of 2.7 percent in the second quarter – the lowest growth rate since the first quarter of 2004. As a result, the year-on-year growth rate for the second quarter slowed to 6.8 percent in the second quarter, down from 7.4 percent in the first quarter of 2006.

Figure 3: Year-on-Year Inflation Adjusted (Real) Consumption Growth

Figures calculated from BEA NIPA Table 1.1.6. Real GDP Chained 2000 Dollars, Washington, D.C.: Bureau of Economic Analysis



Nor are the remaining sectors of the economy picking up the slack. Government spending was essentially flat in the first quarter with an annualized increase by 0.6 percent as spending by the federal government declined by 3.4 percent and spending by state and local governments grew by 3.0 percent. And foreigners are not buying U.S. products either. The trade deficit expanded again relative to the size of the economy.

To revive U.S. economic growth in the U.S., consumers need to find a way to raise their spending without going deeper into debt. This can only come about if more jobs are created and workers see real wage gains. At least in this case, today's figures provide some hope that the labor market may be on the way to a stronger recovery.

Figure 4: Year-on-Year Inflation Adjusted (Real) Fixed Nonresidential Investment Growth

Figures calculated from BEA NIPA Table 1.1.6. Real GDP Chained 2000 Dollars, Washington, D.C.: Bureau of Economic Analysis.

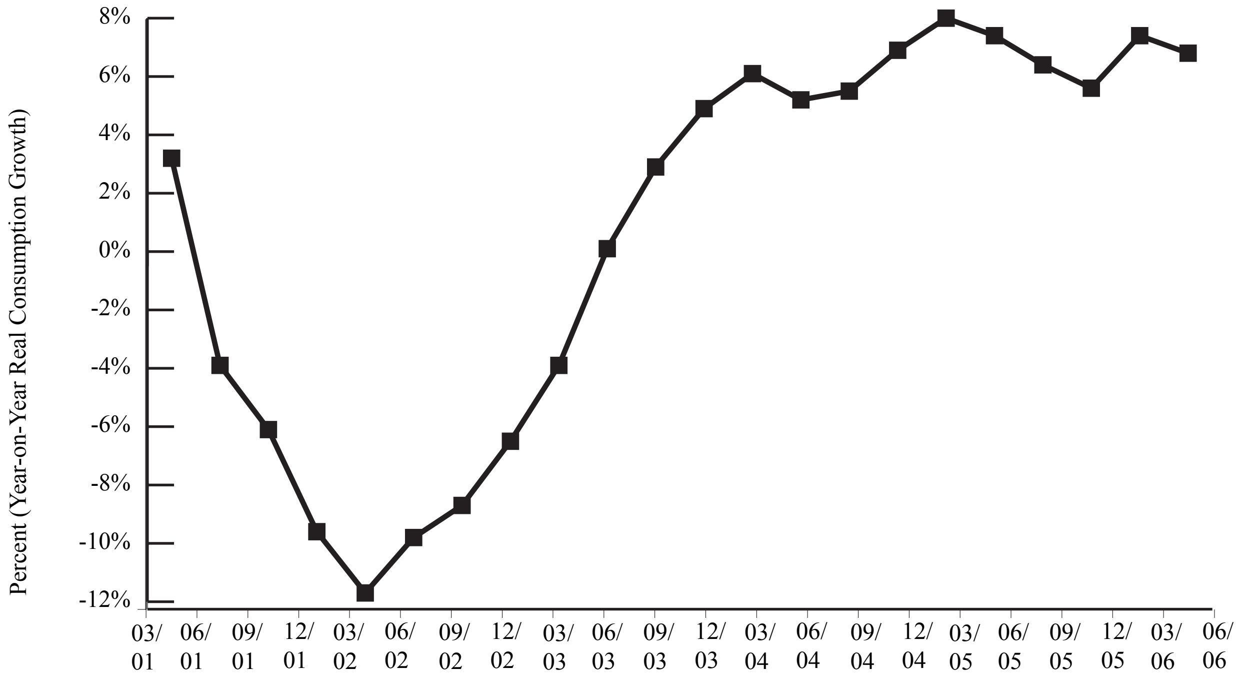
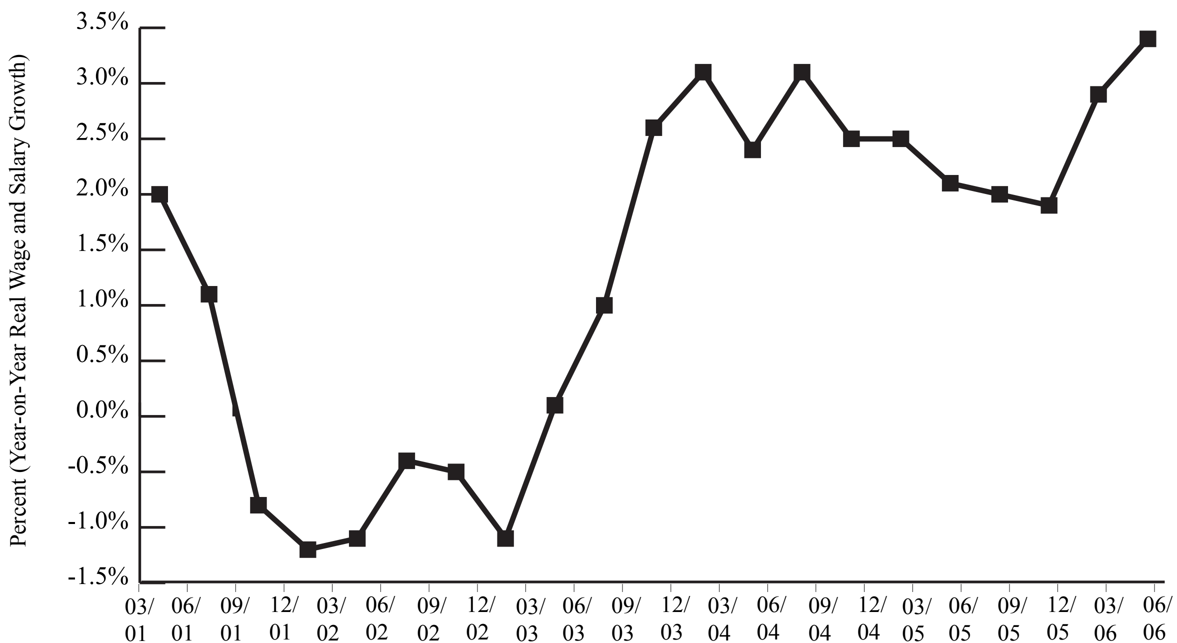


Figure 5: Year-on-Year Inflation Adjusted (Real) Wage and Salary Growth

Figures calclulated from BEA NIPA Table 2.1. Personal Income and Its Disposition. Inflation adjustments made with figures from BEA NIPA Table 2.3.4. Price Indexes for Personal Consumption Expenditures by Major Type of Product, Washington, D.C.: Bureau of Economic Analysis.



Total inflation-adjusted amount of wages and salaries were 3.4 percent higher in the second quarter of 2006 than in the second quarter of 2005. This is the second time in a row that the year-on-year growth rate expanded and it is the highest year-on-year growth rate of this business cycle, which started in 2006.

The critical question, though, is if these apparent, albeit small, improvements can be sustained in the face of a Federal Reserve determined to slow the economy through higher interest rates, especially in the face of continued rising inflation. Without a revival of consumer spending on consumption and homes, though, the economy could find itself in this apparent slowdown for some time to come.