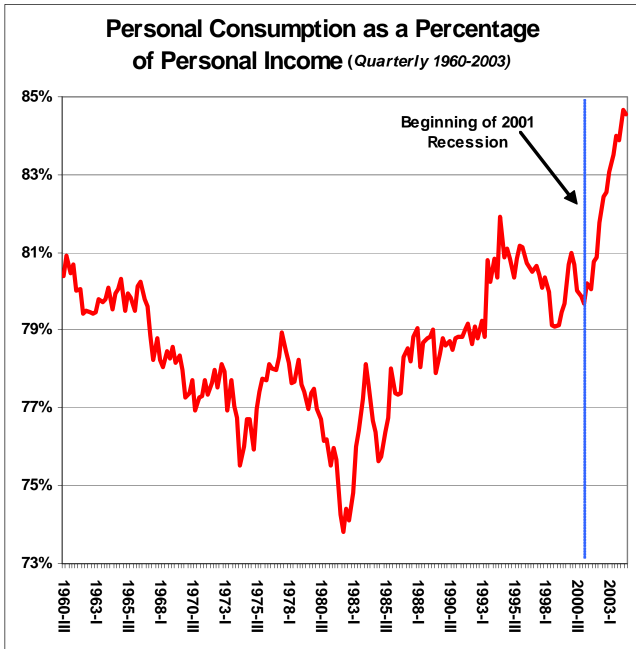
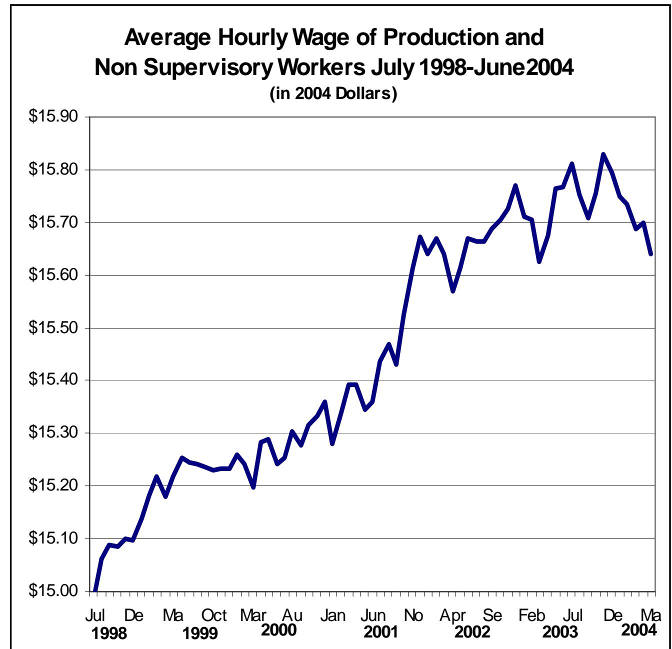
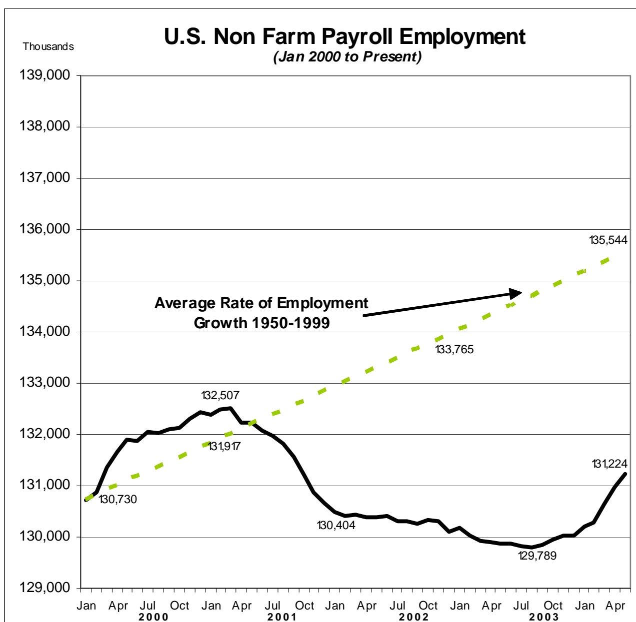
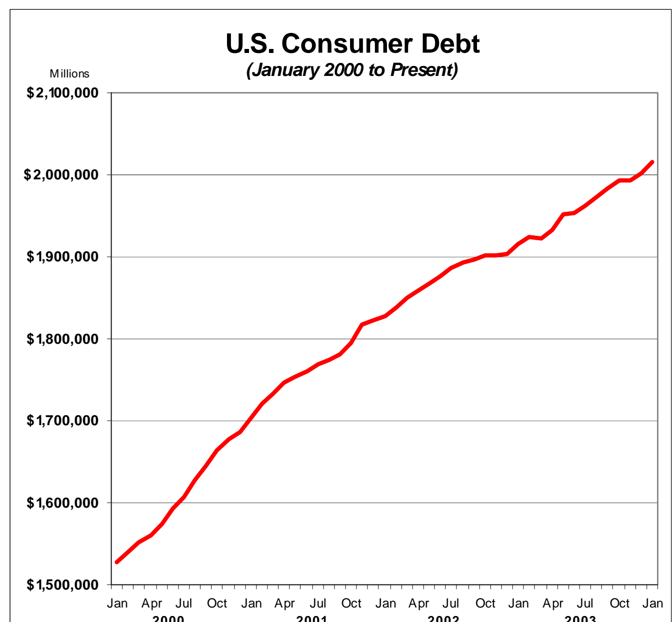
CENTER for AMERICAN PROGRESS

Can Consumers Continue to Keep the Current Recovery Alive?









www.americanprogress.org

805 15th St. N.W., Washington, D.C. 20005

Written by
Scott Lilly, Senior Fellow

CAN CONSUMER PURCHASING POWER SUSTAIN THE CURRENT ECONOMIC RECOVERY?

The Federal Reserve Chairman, every official within this administration, most market analysts and a majority of financial writers agree that the outlook for the American economy is good if not excellent. The scenario is familiar to even the most casual reader of the nation's business pages. Strong gross domestic product growth over the past year has finally been accompanied by strong employment growth. Households with their pocketbooks fattened by an expanding job market will buy more and corporate executives who have been sitting on huge piles of cash will finally put that cash to work, investing in new plants and equipment, building inventories and hiring still more workers.

It all sounds convincing but there is still reason for prudent policy makers and careful investors to be skeptical. Both statistical and anecdotal evidence indicate serious weakness in the current recovery and point to the distinct possibility that it will fall apart completely over the course of the next six to eight months. The first reason for concern is the abnormal nature of the recession from which the economy is attempting to recover.

Abnormal Recession, Normal Recovery?

Since World War II, business cycles in the United States have followed a strikingly similar pattern. There were eight serious economic downturns between 1947 and the recession that began in the spring of 2001. In each, inflation fears sparked rising interest rates, choked off consumer demand and brought about sharp declines in employment. On average the total number of jobs declined by about 3 percent over a period that lasted about 10 to 12 months. As the number of jobs declined concern over prices abated, interest rates fell and a dramatic recovery ensued. Within eight months all jbs that had been lost were restored and within another 10 to 12 months the economy had produced 2.5 percent than it had when the recession began.

This persistent pattern is at variance in almost every respect to what has happened to the U.S. economy since the spring of 2001. First, consumer demand was not choked off by rising interest rates. Long-term rates (by far the most important in determining the pace of economic activity) had fallen from 6.5% to about 5.0% in the 12 months preceding the downturn. Secondly, the downturn in the nation's employment rolls continued not only past the normal 10 to 12 month period but lasted for a full 30 months.

The ability of forecasters to project the course of an economic recovery is directly tied to their capacity to understand the underlying imbalances that caused the recession to occur in the first place. Until those imbalances are corrected the path of recovery will be weak and unsustainable. Yet many observers who exude confidence about the prospects for future growth will freely admit that they are perplexed by both the nature and duration of the recession from which they now believe we are recovering. Others contend that it was simply the fallout from the speculative bubble in the stock market.

There is little evidence, however, to demonstrate how a decline in stock valuations translated into the net destruction of two and a half million jobs or why those jobs were not restored when stock valuations began to rise.

This paper will argue that the U.S. economy has been suffering from an underlying weakness in the capacity of households to consume. That weakness has been masked by the highly stimulative fiscal and monetary policies of the past several years. When effects of those policies begin to dissipate, which is already beginning to take place, the underlying economic issues facing the vast majority of American households will not only reemerge but will have been exacerbated by the policies that masked them. At the root of the problem is surging productivity which has not been recycled into the pockets of the workers but rather absorbed as corporate profits. Corporations have either held these profits in their own accounts or distributed to share holders who are for the most part either pension funds or wealthy individuals. In neither case is a large portion of the dividend being recycled into consumer demand.

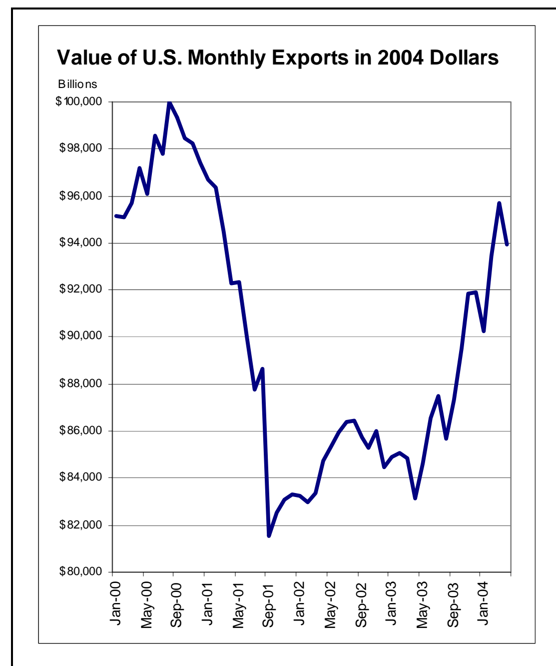
The paper will also argue that the prospects of expanding consumer demand above current levels are extremely weak given the current level of consumer indebtedness, the slowness in the current rate of job creation, and most importantly, the decline in real wages.

Disaggregating Aggregate Demand

The rules of economics are in many ways relatively simple. Before someone will go to the effort to produce something he or she must believe that there is someone to purchase it. There are four possible buyers: governments, foreign purchasers, businesses and household consumers. These four groups of buyers make up what we refer to as aggregate demand and aggregate demand is what drives economic growth. To predict what the future course of the economy is going to be we have to examine the capacity of each of these groups to increase their rate of purchasing above current levels and evaluate the likelihood that they will do so.

If real output were to increase by 4% or more this year as some forecasters project, the growth in demand among these four sectors would have to increase by the rate of inflation (now projected at 2.5% to 3%) plus an additional 4%. If one sector were to grow less than 6.5% to 7.0% the others would have to grow even faster.

The Congressional Budget Office forecasts that U.S. Government outlays will increase from $2.3 trillion in the



Source: U.S. Department of Commerce

current fiscal year to $2.4 trillion in the year beginning October 1st or by about 3.9% leaving real or inflation adjusted growth of a little more than 1%. That is far short (about $66 billion) of the growth that would be required from a sector that represents about one fifth of the total economy. The projected level of spending by states and local government is less readily determined, but anecdotal information indicates that those budgets will be more restrained than the federal budget.

Exports are another potential source of demand. Over the course of the past 5 years, exports have declined significantly as a share of overall demand. Earlier in the year there was hope that that trend would be reversed in 2004. Higher oil prices, economic weakness in Europe and a decision by Chinese authorities to slow the pace of expansion in that country have diminished that optimism. While exports may provide their share of increased demand, they are not likely to increase by enough to offset deficiencies of any size in the growth of demand in other sectors.

Despite some recent improvement, business investment has been sluggish for several years. This stems from a variety of factors. One has been the capacity of American businesses to generate very significant productivity gains through the better use of existing plant and equipment. It is therefore possible to meet increased demand without opening or expanding factories or service centers.

There has also been a fundamental shift in the way most businesses are run. During the 1970s and 1980s there was concern that the people who managed American corporations had too little stake in the outcome of their efforts. While CEOs and other executives had large salaries they often had little in the way of real equity in the companies they operated. As a result they could be well compensated even when their stockholders were losing money. Efforts were made to tie executive pay more closely to stock valuations through a variety of stock option and incentive plans.

Further, the market became increasingly focused not only on quarterly profit reports but also on the rate at which a corporation can increase its profitability. A company that could increase its profits by 3% a year might have stock that would sell at only 10 or 15 times annual per share earnings. But a company that could produce earnings growth of 20% a year might sell for 40 or 50 times annual earnings. As a result CEOs who could demonstrate higher rates of growth in profitability received enormous rewards. This placed strong pressure on CEOs and CFOs to limit costs defer investments and squeeze out extra productivity.

These pressures also appear to have made managers more risk adverse in terms of making investments required to meet growing consumer demand until there was concrete evidence that demand would materialize. Therefore, the key to business investment is the future prospects for consumer demand.

Consumers Have Provided Virtually all of the Lift for the Current Recovery

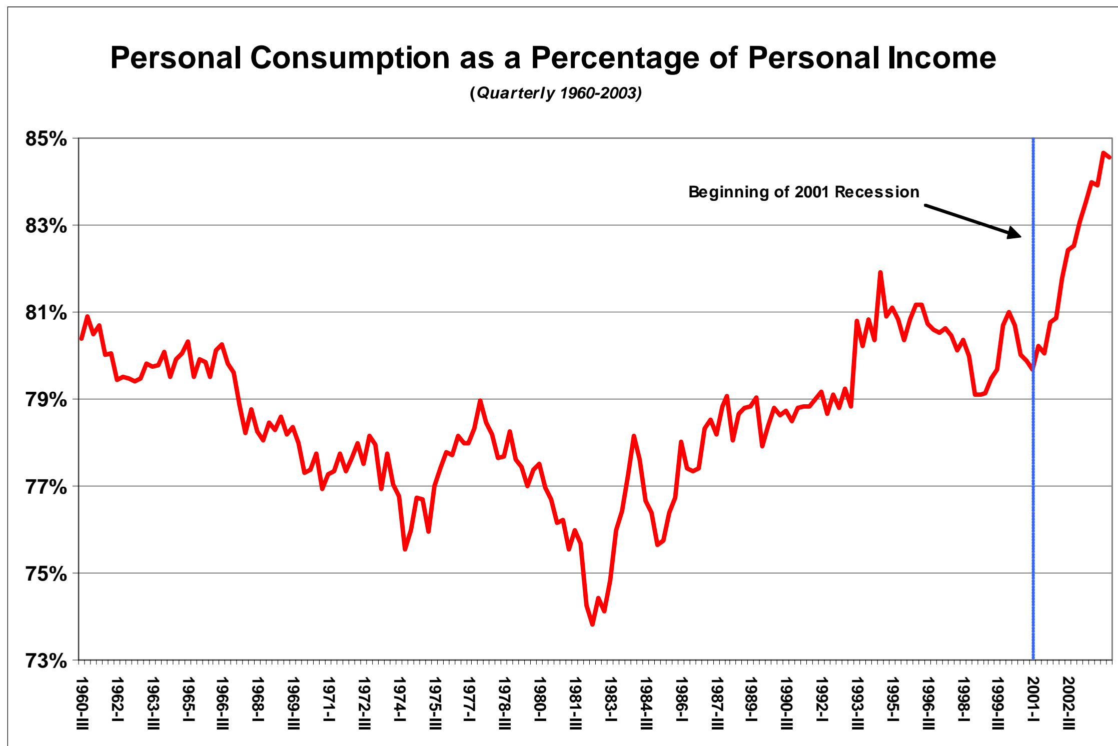
During the first quarter of 2001, the annual rate of fixed private investment (excluding residential real estate) exceeded $1.2 trillion. Investment began to fall in the early months of the

recession and by late 2003, it remained more than $100 billion below the 2001 levels.

During that same period, U.S. exports declined as a share of GDP. That left the entire burden of returning the U.S. economy toward expansion on the shoulders of households and the government.

On the other hand the growth of household consumption during the last 36 months has been remarkable, particularly in light of the decline in employment, the stagnation in wages and the relatively slower growth in personal income. The National Product and Income Accounts indicate that even after adjusting for inflation, consumers are spending nearly 10% more today than they were when the recession began in March of 2001. During that same period, however, personal income rose by only slightly more than 5%. As a result, consumption as a share of personal income rose dramatically from 80% in April of 2001 to more than 84% today—a level significantly higher than at any point in the last 50 years and equaled only during the period following the lifting of government rationing of consumer goods following the end of World War II.

As dramatic as these numbers appear, they probably understate the current relationship between spending and income for most households. Since the vast majority of American families are dependent upon wages, salaries or transfer payments (Social Security) for virtually all of their income, it is the growth of these forms of income that determine the buying power of the vast majority of U.S. households. Since Social Security payments are by law indexed to inflation they remain relatively unchanged on a per household basis. Between April of 2001 and the first quarter of 2004, inflation adjusted



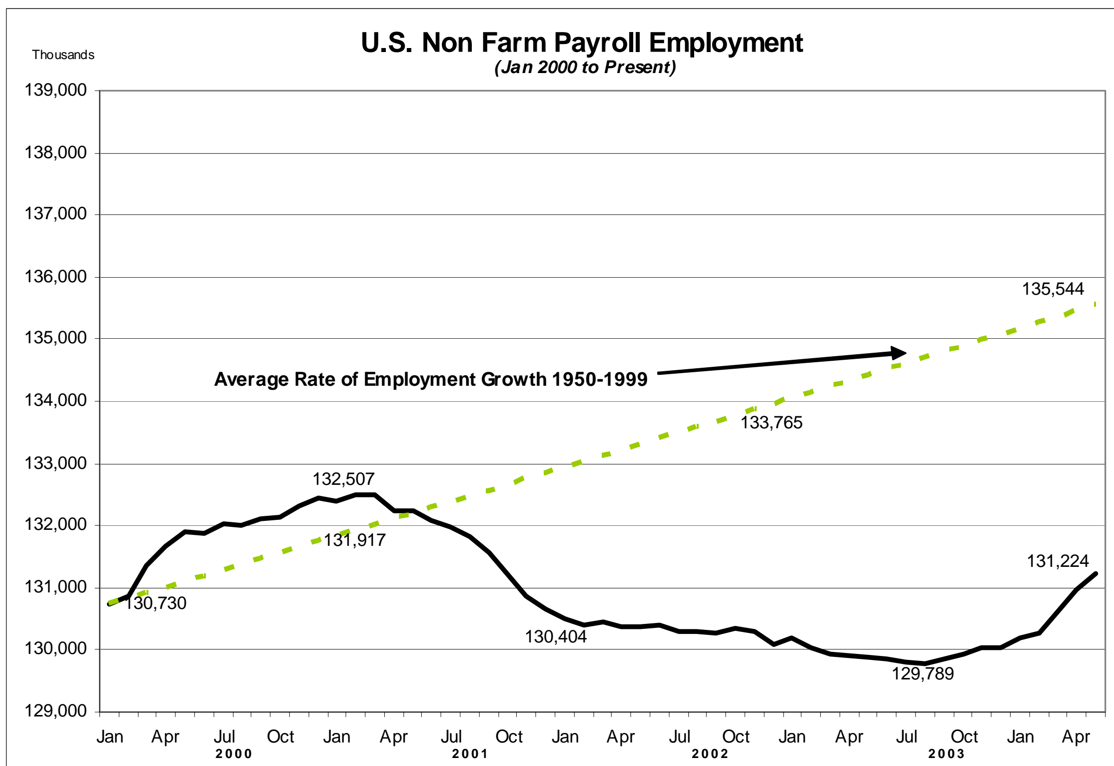
Source: Bureau of Economic Analysis, National Income and Product Accounts

income from wages and salaries grew by only $12 billion or less than one quarter of one percent. When viewed on a per household basis real wage and salary income declined.

This is in sharp contrast to the change that occurred in income from dividends and proprietorships. Dividend income grew by $48 billion or by 12% while proprietorship income grew by $89 billion or 11%. Since very few households receive a significant portion of their income from either dividends or proprietorships, one must assume that consumption as a percentage of total income has grown even more dramatically in such households assuming that increases in consumption were spread across the income spectrum.

During this period consumer debt increased from 1.6 trillion to more than 2.0 trillion. As a percentage of total personal income, non mortgage consumer debt grew from 17.9% to 21.3%. As a percentage of all salaries and wages, consumer debt grew from 30.7% to 38.5%. But the biggest increase in household debt came as a result of home mortgage debt and specifically, home mortgage refinancing. Total mortgage debt outstanding stood at $6.9 trillion in 2000. By 2003, that debt had grown to $9.2 billion and that number has grown significantly as the flood of mortgage refinancing and mortgage financed home sales continued through the end of 2003 and into the first quarter of 2004.

Statistics developed by Christian Weller of the Center for American Progress from the Federal Reserve's Flow of Funds Data indicate that refinancing of home mortgages became a significant means of expanding consumer purchasing power during 2002, 2003 and the first quarter of 2004. Historically, U.S. households have used on average about 1% of personal income to pay



Source: Bureau of Labor Statistics, Current Employment Statistics

down the principle on outstanding mortgage debt. During 2003, homeowners not only failed to use any share of personal income to pay down the principle owed on home mortgages but actually increased household purchasing power by nearly 4% beyond what their personal income would have otherwise allowed by refinancing and increasing the level of mortgage debt outstanding. That means that households were able to purchase about 5% more in goods and services during 2003 than they would have been able to if they had made the normal contribution toward reducing the principle owed on their home mortgage.

Can the American Consumer Keep it Up?

The U.S. Commerce Department tells us that American households made purchases at an annual rate of more than $8 trillion during the first quarter of 2004. That is 4.4% above the purchases made in the first quarter of 2003 even after adjusting for inflation. Can consumer purchases increase at the same rate by the first quarter of next year? To do so, they will need to find about half a trillion in additional cash. Where will that come from?

Source: Bureau of Labor Statistics,
Current Employment Statistics

One possibility that markets are focused on is expanding employment. As more workers are hired, household incomes increase and the capacity to manage current debt and buy more products expands. Past recoveries have been marked by dramatic increases in consumer demand so why should the same not be true of this recovery? There are three principle reasons.

Slow Job Growth

First, just as this recession has been unlike any other Post-War downturn, this recovery has also been unique. While the employment rolls began growing last August, unlike previous recoveries they grew very slowly for the first four months. And despite the widely held perception to the contrary, job growth has been tepid since then compared to growth in previous recoveries. During the eight other Post-War recoveries, the average monthly rate of growth in employment was 0.32% per month. The 240,000 average monthly increase in employment since the beginning of 2004 represents less than a 0.19% rate of growth or not even 60% of the normal recovery rate.

Falling Real Wages

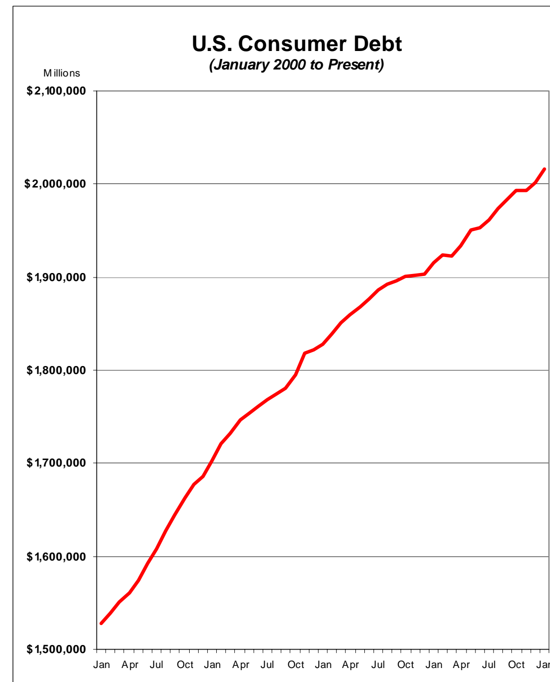
This means that money will be trickling into household bank accounts more slowly than normal but is important also because its slowness prevents it from offsetting another trend occurring in the labor market. The second problem

facing the recovery is that the average real (or inflation adjusted) wages of most workers is falling. During about the same period in which job growth began to accelerate (Nov 2003 to May 2004) real wages began to fall. Between November 2003 and May 2004, employment in the United States increased by 1.2 million or by 0.9%. During that same period the average hourly real wage of production and non supervisory workers (a group that represents about 80% of the U.S. total workforce) fell from $15.83 to $15.64, a drop of 19 cents or about 1.2%. This indicates that wages are falling about 30% faster than employment is rising.

Rising Interest Rates

The third problem facing this recovery is interest rates. Past recoveries have been sparked by a fall in interest rates. This has made homes, automobiles and other large ticket items more affordable. It has also provided some home owners with the opportunity to get out from under mortgages they signed prior to the trough of the recession when rates were high. But during this recovery, consumers will be facing higher rates. Car loans are higher and home mortgages rates have jumped by more than 1 full percentage point since March 2004, adding $188 to the monthly payments on the $300,000 mortgage or $68,000 to the cost of buying a home or the course of a 30 year mortgage.

In addition, the cash that consumers have been taking out of their home equity trough mortgage refinancing has already come to a screeching halt. On June 9, 2004 the Mortgage Bankers Association announced that, *"the Refinance Index is **down 86.3 percent** from the record high of 9977.8 set exactly one year ago."* During 2003



Source: Federal Reserve Board, Consumer Credit Statistics (seasonally adjusted)

home owners increased the principal owed on homes they already owned by more than $250 billion and used the funds for other needs. The opportunity for such financing has now passed and before consumer demand can rise above last years levels, households will have to first find someplace to make up the $250 billion plus windfall they received from refinancing in the past year that they will not have in the months ahead. At the same time they will be making larger principal payments than ever before. In addition about $1.8 trillion in home mortgages are financed at adjustable rates. Increases that have already occurred in long-term interest rates mean that millions of homeowners will be sending significantly more to mortgage companies in the coming months than they did last year.

Fiscal Winds have Reversed Direction

Finally, it should be noted that fiscal policy has played a significant role in maintain a higher level of economic activity than we might have otherwise experienced. This is because the federal government has shifted from spending substantially less than it was receiving in revenue (nearly 2% of GDP) to spending substantially more than it was receiving in revenue (nearly 4%) in a period of only 3 years. The deterioration in the financial condition of the federal government is bad from many perspectives but it is a plus for purposes of elevating aggregate demand. The increase in government borrowing added about 2% to aggregate demand last year and is expected to add 1% or more in the current year. But for fiscal year 2005, the deficit is expected to decline and that will place a drag on economic activity in addition to the problems mentioned above.

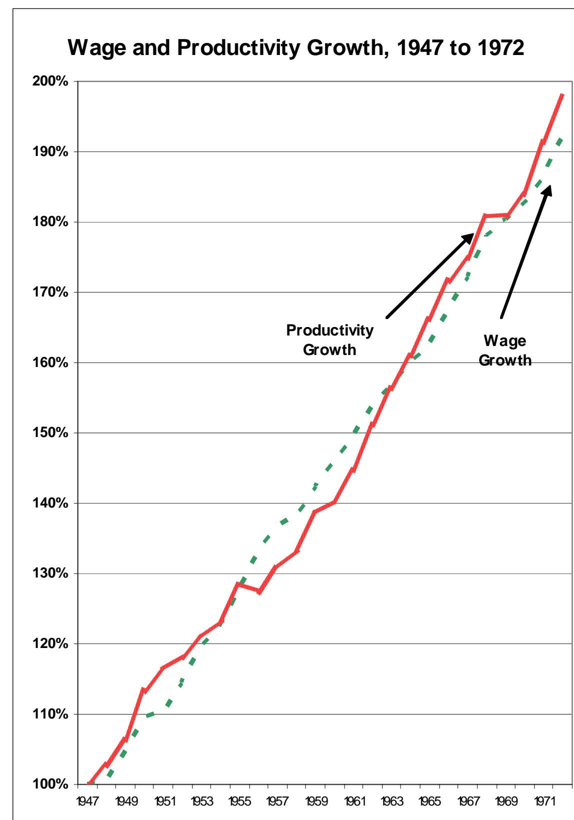
What has Changed in the U.S. Economy to Cause Continuing Economic Sluggishness?

There seem to be far more proposed solutions to the economic problems we are now facing than solid explanations as to what caused them. This paper presents one suggested explanation which if proven at least partially correct may help to produce remedies that have better prospects of success.

Among the arguments now taking place over the current condition of the economy and in particular the labor market is the question of whether "outsourcing" or "offshoring" is less or more of a problem than rapid productivity growth. The truth may be that the two together are the problem.

Increases in productivity have a powerful impact on not only economic activity but the overall cohesiveness of society. Productivity growth has the potential to generate enormous wealth and the means by which the lot of all stakeholders can be improved. But productivity growth was also behind much of the social unrest and upheaval in England in the 19th Century. Our failure to distribute the gains of productivity growth here in this country during the tremendous production boom following World War I is believed by many to be a principal cause of the stock market crash of 1929 and the depression of the 1930s.

In some countries in Europe there is a legal incentive for all increases in worker productivity to be passed back to workers in the form of increased wages. In the United States that practice was



Bureau of Labor Statistics

followed despite the absence of any legal requirement for a quarter of a century following World War II. In the mid 1970s some separation began to develop and in the 1980s that separation widened significantly. Only in the late 1990s did wages keep pace with productivity gains. But since 2000 productivity has increased at an accelerating pace and only a fraction has gone back in the form of increased wages. Over the past six months, productivity gains have continued at high levels while wages have fallen.

One explanation is that wages do not measure the full cost of employment. Employers can not be expected to increase wages to fully offset productivity gains when they also have to pay higher health and other benefits for the same workers. But rising employer costs do not tell the story either. The most recent survey data from the Department of Labor indicates that the average cost of employing a worker for one hour (including supervisors and executives) in $24.95. Of that amount $17.71 is for salaries and wages and $7.23 is for benefits. Between 2000 and 2003, salaries and wages for all workers rose by slightly less than 3%. The total cost of employing a worker for one hour increased by less than 7%. But productivity increased by 12%.

While there is not clear evidence that the outsourcing of U.S. production and services overseas has at this point resulted in large-scale job loss, it is clear that outsourcing exacerbates the problem of maintaining consumer demand here at home. It slows the expansion of employment opportunities and perhaps more importantly, the threat of outsourcing significantly undercuts the ability of workers that are not outsourced to seek a larger share of their productivity gains in increased wages. It also provides managers with a means of insuring that the domestic labor market does not get tight enough to give workers generally more leverage in wage negotiations.

Why is it Important that Productivity Gains be Passed on as Wages and Salaries

Some people argue that wages should reflect productivity gains on the grounds of social equity, distributional fairness or economic justice. There is, however, a fundamental economic argument for passing productivity gains through to workers.

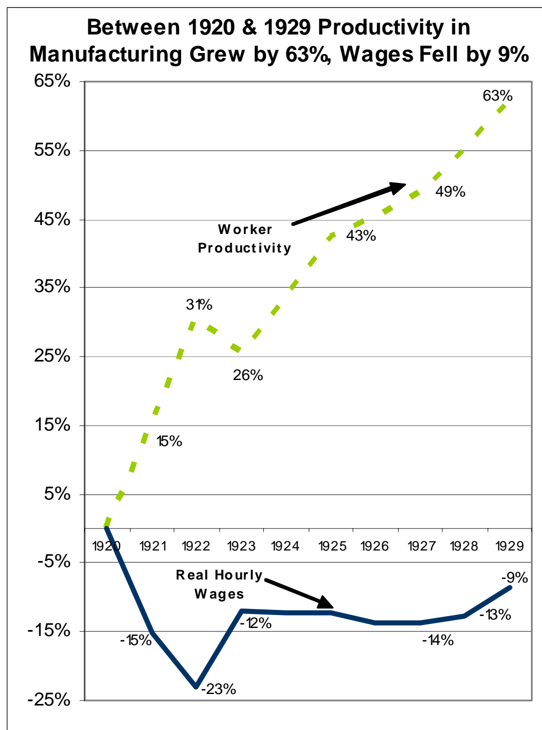
Henry Ford became famous for his articulation of the argument. He said that it was to his benefit that the people who worked in his factories be able to buy his cars. But even more compelling is that fact that markets must expand as fast as, or faster, than productivity gains if unemployment is to be reduced or even remain stable.

Rising productivity means that the same amount of goods or services can be produced with fewer employees. Unless there is a market for additional goods, rising productivity will result in rising unemployment which will further diminish purchasing power and that downward spiral will destroy the value of the businesses that initially believed that they were benefiting from the increased profits that they were withholding from productivity gains.

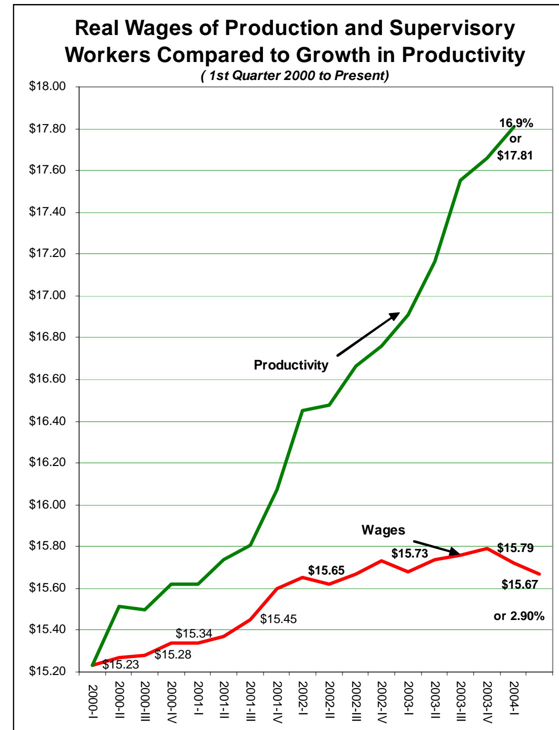
As a result, investors who have allocated their savings to create capacity will find that the capacity cannot be used and both stockholders and production workers will suffer.

What we have experienced in the United States for the last few years has been an explosion of demand fueled almost entirely by rising debt in the face of stagnant or declining worker earnings. Just as the 1990s bubble in tech investing was certain at some point to burst, so is the current bubble in debt driven consumer demand.

If we are going to escape a hard landing from the bursting of that bubble we need to find ways of getting more cash into the hands of ordinary households. We must help consumers simultaneously reduce their level of indebtedness and maintain and expand the current level of purchasing. That will be extremely difficult, but not necessarily impossible, if the right prescriptions are followed before the imbalance grows even worse.



National Bureau of Economic Research, Indexes of Employee Output (1869-1969



Source: Bureau of Labor Statistics, Current Employment Statistics

"As perspective has enabled economists to disentangle the causes of the collapse (the 1929 Crash), the following points have come to seem most crucial:

1) ***Management's disposition to maintain prices and inflate profits while holding down wages and raw material prices meant that workers and farmers were denied the benefits of increases in their own productivity. The consequence was the relative decline of mass purchasing power. As goods flowed out of the expanding capital plant in ever greater quantities, there was proportionately less and less cash in the hands of buers to carry the goods off the market. The pattern of income distribution , in short, was incapable of long maintaining prosperity."***

Arthur M. Schlesinger, Jr.
The Crisis of the Old Order