

Analysis: Economic Recovery Remains Vulnerable to Setbacks

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Overview

My quarterly analysis of the economy shows growth moderating after accelerating sharply in the third quarter, producing respectable gains in the fourth quarter and into 2004. Yet, the economy is also quite vulnerable to setbacks. Despite the recent strong growth, the number of people working, which fell for two years, is rising very slowly. Despite rising stock prices and confidence, consumption could slow significantly. Despite strong productivity gains, real wage growth has slowed substantially. Finally, the huge current account deficit is driving down the dollar and may drive up interest rates in 2004.

GDP grew at an extraordinary 8.2 percent annual rate in the third quarter. Business fixed investment improved in every category and posted its greatest gains since the first quarter of 2000. In addition, consumption grew at its strongest pace since the third quarter of 1997, and housing investment surged faster than any quarter since early 1992.

Growth will not maintain this pace in the fourth quarter and in 2004. The acceleration in consumer spending in the third quarter was driven by a 26.5 percent annualized increase in durable-goods purchases, following a convergence of tax rebates, large incentives for auto purchasers, and surging mortgage refinancing. These factors will not come together again. Consumption already is in retrenchment. With little room for interest-rate cuts, housing investment will cool off. Business fixed investment is the critical area likely to continue to grow rapidly, supported by rising corporate profits and low inventory levels.

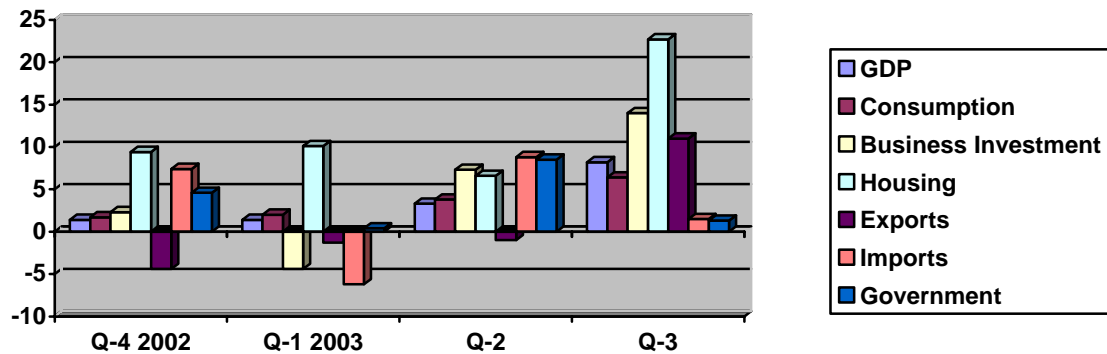
The outlook for growth in 2004 is both positive and negative. In addition to business investment, fast-rising productivity could support further expansions in consumer spending, and the continuing fall in the dollar may reduce the trade deficit. But there are trapdoors under some of the basic elements of growth. First, Americans borrow to consume, and household debt and debt service levels both have reached record or near-record highs. These burdens will weaken consumer spending if productivity gains fail to translate into significant wage and salary increases next year, as they have since April, and the job market remains sluggish. Gains in business and consumer spending also could be limited by high energy prices, especially if a cold winter pushes prices higher. Finally, pressures to finance the record current account deficit may limit the growth of business investment or, if we're unlucky, slow the economy by driving up interest rates.

We can expect 3.5 percent to 3.8 percent growth in the fourth quarter, producing overall GDP gains of 3.0 percent to 3.2 percent for 2003. Next year's outlook is more problematic. The likelihood is that we will see 3.3 percent to 3.6 percent growth in 2004, but problems with consumption and interest rates could well mean slower growth.

U.S. Economic Performance Over the Past Year

The economy, which nearly stalled in the last quarter of 2002 and the first quarter of 2003, strengthened across the board over the past six months (Figure 1). For the first time since the 2001 recession, the economy shows signs of self-sustaining momentum. While the growth spurt of the third quarter depended on temporary factors, rising productivity and the gathering strength of business investment and exports will tend to produce respectable growth through 2004.

**Figure 1. Growth of GDP and its Major Components Over the Last Four Quarters
(Percent Change from Preceding Period, at Annual Rate)**

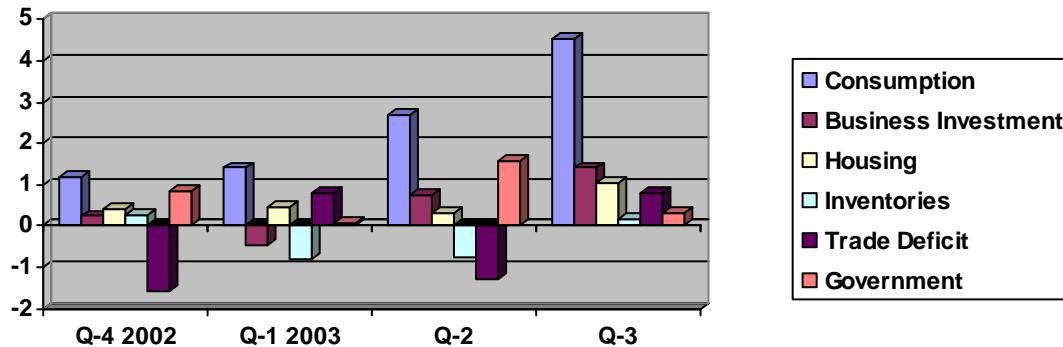


	Q-4 2002	Q-1 2003	Q-2	Q-3
<i>GDP</i>	<i>1.4</i>	<i>1.4</i>	<i>3.3</i>	<i>8.2</i>
Consumption	1.7	2.0	3.8	6.4
Business Investment	2.3	-4.4	7.3	14.0
Housing	9.4	10.1	6.6	22.7
Exports	-5.8	-1.3	-1.0	11.0
Imports	7.4	-6.2	8.8	1.5
Government	4.6	0.4	8.5	1.3

The Components of Growth

The improvement in the economy is clear when we examine the contribution of each of GDP's major components, taking account of each element's performance and its role in overall growth over the past year (see Figure 2, below). The last quarter of 2002 and the first quarter of 2003 produced shallow and spotty gains; but by the second quarter, the gains were larger though still uneven, dominated by consumer purchases and federal spending for the Iraq war. However, business investment also turned around in the second quarter. In the third quarter, consumption, investment and housing all grew very substantially, while government spending and volatile inventory investment played much more modest roles.

Figure 2. Contribution to Growth of GDP's Major Components



Component	Q-4 2002	Q-1 2003	Q-2 2003	Q-3 2003
Consumption	1.19	1.40	2.68	4.55
Business Investment	0.24	- 0.47	0.74	1.40
Housing Investment	0.41	0.45	0.31	1.02
Inventory Investment	0.28	- 0.82	-0.74	0.16
Trade	-1.59	0.78	-1.29	0.79
Government	0.85	0.08	1.59	0.30
<i>Total GDP Growth</i>	<i>1.40</i>	<i>1.40</i>	<i>3.30</i>	<i>8.20</i>

The Economy's Prospects Over the Next Year

Most private forecasters are very bullish about growth in the fourth quarter and next year. A recent survey of Wall Street and corporate forecasters reported a consensus for 4 percent growth in the fourth quarter and 4.3 percent growth in 2004. My view is more skeptical. The outlook for business investment is clearly strong: Rising corporate earnings will provide the cash to maintain current levels of capital spending; and ending the recent inventory liquidation cycle would add 1.2 percentage points to fourth-quarter growth. But consumption and housing have begun to fall back: Real consumer outlays, which rose at an 8 percent rate from April to August, contracted in September and October; and new home sales fell 1.9 percent in September and 3.5 percent in October.

The expansion will soon be buffeted by powerful conflicting forces. In addition to rising business investment, continuing fiscal stimulus should support spending; and stronger growth in Europe and Japan, combined with a weaker dollar, should reduce the trade deficit's current drag on growth. But 2004 also could well see much slower spending by consumers. Substantial productivity gains—averaging more than 5.5 percent for the last two years—should continue, but rising productivity of late has generally failed to lift incomes: Gains in average hourly earnings have fallen 110 basis points since February, and pretax wages have been flat for the past three months. There is also little pent-up spending demand, because auto and home sales have been unusually strong for some time. To pick up strength, the expansion also has to create more jobs. Finally, without

more income tax reductions or interest rate cuts, high debt levels and a continuation of the current slowdown in hourly wage gains will slow consumption spending.

And no one expects the Federal Reserve to further reduce interest rates next year. Falling rates provided crucial support for housing and consumer spending in the third quarter, as in the preceding two years. While the Federal Reserve has signaled its intention to keep interest rates low for the next few months, a shift in the Fed's inflation assessment next year will signal higher rates, which will likely slow the economy, at least modestly.

Financing pressures associated with our huge current account deficit could trigger those rates next year. As the current account deficit has passed 5 percent of GDP, the dollar has fallen substantially against the euro; but it has declined much less against the yen and not at all against China's yuan. Managing this record deficit depends on foreign investors being willing to continue to accumulate dollar assets almost without limit. If foreign preferences for those assets shift to any appreciable degree under pressure from our unprecedented financing demands, it will force us to raise interest rates, slowing growth.

U.S. Labor Markets: Continuing Problems with Job Creation

For the first time, an expansion failed to produce new jobs for almost two years. In prior postwar recoveries, private-sector jobs increased by an average of 5.5 percent in the first two years. This time, private employment is still *down* 1 percent, producing a shortfall of 7 million jobs. And recent research indicates that 80 percent of the job losses in 2001 and 2002 are permanent and structural, rather than cyclical and temporary. Firms did finally start creating net jobs four months ago, but average gains of 75,000 jobs/month are *one-fourth* the average monthly gains from 1995 to 2000.

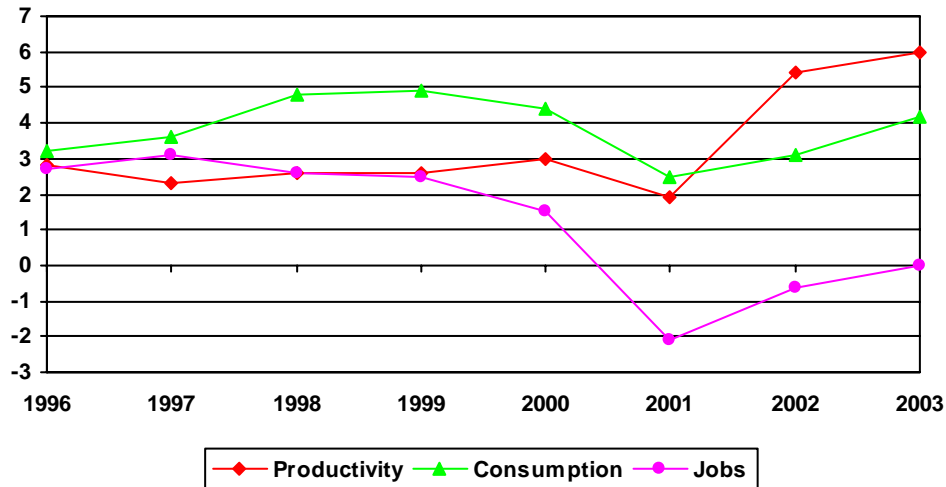
Unless this dynamic changes soon, job creation will remain weak, and that will ultimately limit the strength and duration of the expansion.

One key factor noted in prior reports is the unusually combination of strong productivity gains and sub-par GDP growth. U.S. productivity rose 2 percent in 2001 despite a recession, jumped 5.3 percent in 2002, and so far this year has risen at a 6 percent rate. Normally when productivity increases rapidly, consumption and investment rise even faster, which in turn drive overall growth and job creation (see Figure 3, 1997-2000, below). This time, growth was relatively slow until the third quarter and job creation has been stalled, because below-average increases in consumption and investment accompanied the above-average productivity gains.

Another important factor is the increasing capacity of U.S. service companies, like their manufacturing counterparts, to outsource new, higher-skill jobs to low-wage countries. As expected, this new form of global labor arbitrage is most notable in firms exposed to strong international competition, including wholesale distribution, air transport, finance, telecommunications and information services. One result is that while nearly half of all U.S. industries report some modest hiring in the last three months, nearly 80 percent of

new hires are concentrated in four, non-tradable industries—education and health services, temporary staffing, and government.

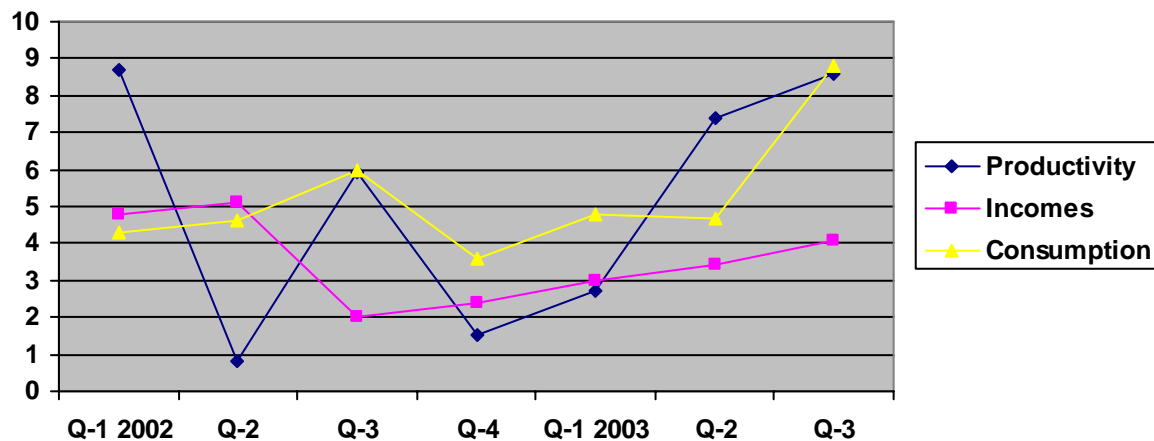
Figure 3: Jobless Recovery: Annual Rate of Gains/Losses in Jobs, Productivity, and Real Consumption, 1996-2003



Consumer Spending and Housing Investment

With consumption spending accounting for two-thirds of GDP, the pace of the expansion will depend significantly on consumers. In the first half of 2003, consumer spending was supported by gains in personal income based on rising productivity, and by large-scale mortgage financing spurred by falling interest rates (in the past two years, half of all U.S. homeowners refinanced \$4.5 trillion in mortgage debt). In the third quarter, income tax rebates further boosted consumer spending, producing its strongest gains in six years.

**Figure 4. Growth Rate of Labor Productivity, Personal Incomes and Consumption, 2002 and First Three Quarters of 2003
(Percent Change from Previous Period at Annual Rate)**

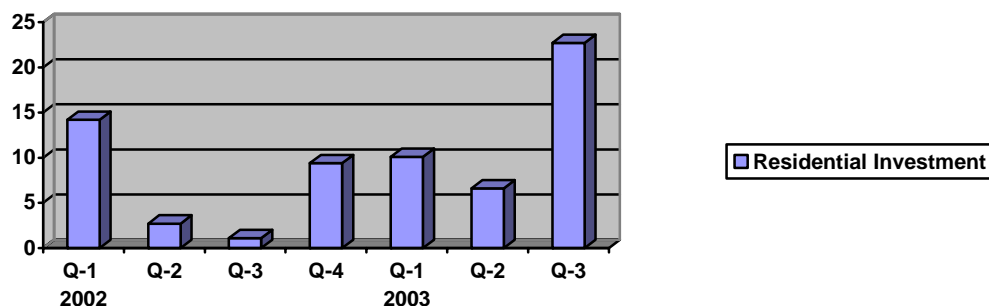


Strong productivity gains are likely to continue, but consumer spending could still slow significantly in 2004. The continuing problems with job creation may undermine consumer confidence and spending. There is also evidence that recent productivity gains have been based more on cost-cutting than productive investment, weakening the link between rising productivity and higher incomes: Despite large productivity increases, gains in average hourly earnings have fallen by 110 basis points since February, and pretax wages have been flat for the past three months.

Other factors also may undermine consumer demand next year. The recent, sharp increase in consumer purchases has exhausted much of any pent-up demand, especially for durable goods. In a related development, household debt rose 11 percent over the last two quarters, the fastest increase in almost 20 years; and debt service now claims a record 13 percent of disposable incomes, despite the lowest interest rates in 45 years. Finally, with interest rates no longer falling and likely to rise in 2004, mortgage refinancing also will likely slow substantially.

Historically-low interest rates made housing investment a major support of the current recovery, especially in 2003 (Figure 5). Most analysts trace the third-quarter jump in housing investment to the Fed's second quarter interest-rate reduction. Two factors, however, could end the current housing cycle next year. First, with the federal funds rate at 1 percent, the Federal Reserve has little if any room left to cut interest rates further. Moreover, after 11 years or nearly twice the length of the average postwar housing cycle, there is relatively little pent-up demand for new housing.

**Figure 5. Real Growth of Housing Investment,
2002 and the First Three Quarters of 2003
(Percent Change from Preceding Period, at Annual Rate)**



Q-1 2002	Q-2	Q-3	Q-4	Q-1 2003	Q-2	Q-3
14.2%	2.7%	1.1%	9.4%	10.1%	6.6%	22.7%

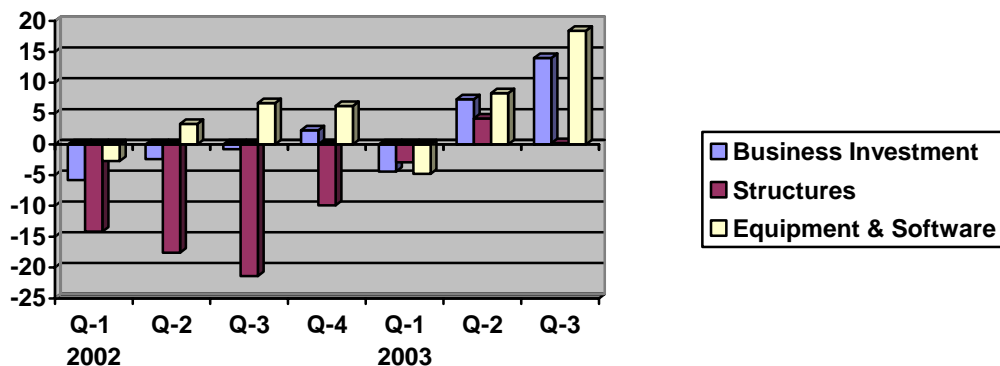
Rising interest rates pose the greatest threat to a strong expansion in 2004, through their direct and indirect effects on both consumer spending and housing investment. For the first time since the 1990s boom, long-term interest rates rose sharply this summer: From

mid-June to mid-August, rates for conventional 30-year fixed mortgages and AAA corporate bonds increased more than 20 percent, and the yield on 10-year Treasury bonds jumped 37 percent. Since August, rates have generally stabilized. Should they rise again in 2004, as many analysts expect, it will slow the growth of consumer spending and could end the current housing cycle.

Business Investment

Sustained business investment is the strongest current support for the expansion in 2004. In the second and third quarters of this year, business investment overall and in equipment and software saw their strongest gains since the 1990s. And there is ample room for more gains: Real business investment in the third quarter was 7 percent lower than it was in 2000 and 2 percent below the average levels during the 2001 recession.

**Figure 6. Real Growth of Business Fixed Investment and its Major Categories
2002 and First Three Quarters of 2003
(Percent Change from Preceding Period, Annual Rates)**



	Business Fixed Investment	Structures	Equipment & Software
Q-1 2002	-5.8	-14.2	-2.7
Q-2	-2.4	-17.6	3.3
Q-3	-0.8	-21.4	6.7
Q-4	2.3	-9.9	6.2
Q-1 2003	-4.4	-2.9	-4.8
Q-2	7.3	4.2	8.3
Q-3	14.0	0.2	18.4

Business investment should also grow fairly rapidly in the fourth quarter and into 2004. Inventory levels have fallen so low that merely ending the inventory liquidation of the past two quarters would add 1.2 percentage points to fourth-quarter growth. Further, U.S. corporations are currently generating sufficient cash flow to finance their own investment needs, which is one reason why credit demand is still declining at the large banks that usually finance new investments by large firms.

The Current Account Deficit, the Dollar, and Saving Rates

The current account deficit has been deteriorating sharply since early 2002 and poses a genuine threat to the expansion over the next two years. The data for the first three quarters of 2003 show that current account stabilizing at quarterly deficit levels of \$135 billion to \$140 billion, about 5 percent of GDP. There is little likelihood of any significant change in the near term. The largest element, the trade deficit, remains persistently high: The deficit in goods and services was \$120.8 billion in the third quarter, compared to \$121.6 billion and \$122.6 billion in the first and second quarters. The trade imbalance was \$41.8 billion in October, compared to monthly averages in the first three quarters of \$40.3 billion to \$40.9 billion. Over the first three quarters, the trade deficit ran 21 percent above the comparable period in 2002. The major reason is rapid growth of imports: U.S. imports in 2003 have grown 8.5 percent as exports rose 3.2 percent. *We expect a trade deficit this year of \$485 billion (4.4 percent of GDP) and a current account deficit of \$550 billion (5.0 percent of GDP).*

Figure 10. U.S. Current Account Deficit, Levels and As a Share of GDP

	Deficit	Share of GDP
Q-1 2002	\$106.7 billion	4.14%
Q-2	\$122.8 billion	4.73%
Q-3	\$122.7 billion	4.67%
Q-4	\$128.6 billion	4.86%
2002	\$480.9 billion	4.60%
Q-1 2003	\$138.7 billion	5.19%
Q-2	\$139.4 billion	5.14%
Q-3	\$135.0 billion	4.88%

Low U.S. saving rates are the major factor in the current account deficit. U.S. gross saving in 2003 is 14 percent of GDP, down from 15.5 percent in 2002 and a postwar average of 18.8 percent. Depreciation accounts for 92 percent of those gross saving, for a net saving rate of roughly 1 percent of GDP. To finance new investment as well as rising budget deficits, we now borrow \$2 billion per business-day from abroad; by the end of 2004, our foreign borrowing could reach \$3 billion per business-day. Moreover, dollar depreciation has not yet worked to correct the current account imbalance. The dollar's trade-weighted value is down 12 percent since early-2002, with the largest shift occurring against the Euro, 29.7 percent. By contrast, foreign intervention has blocked any adjustment with the Yuan and limited the decline against the Yen to less than 20 percent.

In recent weeks, the dollar's depreciation accelerated as global confidence decline in both the currency and Bush administration policies. Since November 6, the dollar's trade-weighted value has fallen 2.2 percent or almost 20 percent of its total decline since February 2002. In the past six weeks, the dollar also has fallen 7.4 percent against the euro or 19.2 percent of its total decline against the euro in almost two years, and 2.6 percent against the yen or almost 13 percent of its total two-year decline.

One way or another, the current account deficit will slow U.S. economic growth. A major increase in saving rates would help reduce the imbalance, but by reducing consumption. More likely, foreign lenders will demand higher compensation for accepting such extensive dollar-currency risk, which will push up U.S. interest rates and thereby dampen investment and consumption. Or some of our large foreign creditors could hedge their bets by liquidating their dollar holdings, triggering a full-blown dollar crisis that would drive up interest rates and drive down U.S. stocks, bonds and growth.

Robert J. Shapiro is co-founder and chairman of Sonecon, LLC, a private firm that advises U.S. and foreign corporations, governments and other entities on market conditions and economic policy. He also is a senior fellow of the Brookings Institution and the Progressive Policy Institute.