Growth rate up but little evidence of extended US recovery

Nick Beams
4 August 2003

It says something about the deep-seated problems of the US economy when the announcement of an annual growth rate of just 2.4 percent in the second quarter can be hailed as a turnaround and a sign that the long-predicted economic recovery will come in the second half of the year.

The US Treasury Secretary John Snow has described the US economy being "coiled like a spring" ready to snap back at any time while Commerce Secretary in the Bush administration, Donald Evans, said the announcement indicated that "our economy is clearly moving in the right direction."

Others have been less enthusiastic, given that ever since the collapse of the share market bubble there have been continuous predictions of a recovery and upturn. As the editorial in Friday's *Financial Times* somewhat caustically put it: "Yesterday brought good news for bullish Wall Street analysts and Alan Greenspan, the chairman of the Federal Reserve, alike. For three years they have predicted a rebound in US economic growth in the second half of the year. After consecutive disappointments, it now looks as if it will be third time lucky."

However there was little evidence that the US was about to embark on "an extended rapid economic expansion." The biggest factor in the gross domestic product (GDP) upturn was the 44 percent boost in military spending, the largest increase for a single quarter since 1951 during the Korean War. Moreover, the editorial continued, the achievement of a "below trend" rate after the "extraordinary loosening of monetary and fiscal policy of the past two years is nothing to shout about."

While the growth figure was an increase on the 1.4 percent rate recorded in each of the two previous quarters, it was well below the rate of between 3 and 4 percent which is necessary to secure an expansion in employment. That fact was underscored by figures released by the Labor Department which showed that while the unemployment rate fell marginally from 6.4 percent to 6.2 percent in July, employment outside the agricultural sector fell another 44,000, after declining by 72,000 in June. Manufacturing industry payrolls contracted by 71,000, after falling by 63,000 in June.

The only reason the unemployment rate did not increase is because 556,000 people were estimated to have dropped out of the workforce. In another indication of the overall direction of the economy, privately-employed workers were employed for fewer hours in the second quarter than in the first. And that trend appears to be continuing. Overall hours were down 33.6 in July from the June figure of 33.7 while factory hours fell from 40.3 to 40.1.

According to a report in Saturday's *Financial Times* (FT) the employment data "served as yet another reminder that the US remains stuck in the longest hiring drought since the Second World War. Much of the nation's manufacturing base is still evaporating and unusual business caution, rapid productivity growth and still sluggish demand for goods and services continues to weigh on hiring."

Charles McMillion, chief economist of MBG Information Services, a Washington-based consultancy told the FT the current employment situation was "uncharted territory." Twenty months after the recession of 2001 was supposed to have ended "employers are not merely continuing to cut jobs, they are cutting back on paid hours worked even more severely."

The Economic Policy Institute has pointed out that whereas 1.6 million jobs were lost during the official recession, a further 938,000 have gone since it

supposedly ended in November 2001. After the recession of the early 1990s there was also a period of so-called “jobless recovery” in which economic growth increased while unemployment rose. But at that time employment numbers also rose. Today, however, they are continuing to fall.

The main cause for official optimism was the increase in business investment revealed by the GDP data. After a decline of 4.4 percent in the first quarter, business investment grew by 6.9 percent, the largest increase since the second quarter of 2000.

Whether that indicates a sustained revival remains to be seen. The latest “beige book” survey of economic conditions published by the US Federal Reserve noted a general improvement but it did not find increases in business investment. While “several districts reported an increase in investment planned for the future” it found that on balance actual capital spending, particularly in manufacturing, “remained weak.” According to the Fed, US industry is still operating at around 25 percent below capacity—a 20-year record—and a major impediment to investment.

Changes in financial conditions, foreshadowed by sharp shifts in the bond market in recent weeks, could also have an impact on the economy in the months ahead. After falling to an historic low, yields on 10-year US Treasury notes have increased by 1.3 percentage points in the past month. If this rapid tightening of financial conditions continues it could well have an adverse effect on both consumption and investment spending.

According to the GDP data, personal consumption spending rose by 3.3 percent in the second quarter, with much of this increase coming from spending on consumer durables such as cars, which rose by 22.6 percent, largely as a result of financing provided at almost zero interest rates.

The US economy continues to be dependent on debt-financed spending. According to Jan Hatzius, an economist at Goldman Sachs in New York, the financial excesses of the 1990s have not disappeared and US businesses and households are still running a “financial deficit” of around 1 percent of GDP. That is, the private sector is spending in excess of income by $100 billion which, except for the period 1998-2001, constitutes “the biggest private deficit since the Korean War.” Consequently, a significant rise in interest rates could bring a sharp reduction in spending.

One of the factors pushing in this direction is the ever-worsening US balance of payments position. There were hopes that the fall in the value of the US dollar would see some improvement on this front. That has not happened. Exports, which should be boosted by a fall in the dollar, actually declined by 3.1 percent in the second quarter, compared to a 1.3 percent fall in the first three months of the year. At the same time, imports rose by 9.2 percent in the second quarter after falling 6.2 percent in the first.

At the end of 2002, the trade deficit stood at a record high of $554 billion, meaning that the US must suck in more than $1.5 billion a day from the rest of the world. This means that any adverse changes in international financial flows would have an immediate impact, causing interest rates to rise and choking off the debt-financed spending which has been the basis for US economic growth.