US economic growth slows as housing bubble deflates

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The deflation of the housing bubble in the US severely damaged economic growth in the first quarter of 2007, according to preliminary data released Friday by the Commerce Department. Seasonally adjusted gross domestic product (GDP) rose at an annual rate of 1.3 percent January through March, the smallest rate of growth in four years.

The GDP growth rate was down from 2.5 percent in the last quarter of 2006. Friday's figures fell below expectations of leading economists, who had predicted 1.8 percent.

GDP is a measure of the market value of all goods and services produced within a country in a given period of time. It is calculated by adding consumption, investment, government spending and net exports.

Residential fixed investment (the purchasing of new homes and residential equipment) fell 17.0 percent and was the main contributor to the sluggish GDP growth. It was the fourth straight quarter of double-digit declines in residential fixed investment, which fell by nearly 20 percent in the last quarter of 2006. Net exports (exports minus imports) also decreased, as exports fell 1.2 percent and imports increased 2.3 percent.

The decline in the housing market counteracted a 3.8 percent increase in personal consumption, which is the largest component of GDP. The spending figure was down from a 4.2 percent growth in the fourth quarter.

Thus, GDP growth slowed despite consumer spending growth. If the collapse of the housing market begins to have a serious effect on consumer spending, as is very likely, GDP could begin to contract more sharply, leading to a recession in the US. This would have a broader impact on the international economy, as exports from other countries to the US fall off.

In addition to the GDP figure, the Commerce Department also reported a sharp rise in inflation. The price index for personal consumption expenditures (PCE) rose by 3.4 percent in the first quarter, following a one percent decline in the fourth quarter of last year. Much of this was due to rising gasoline prices. However, the PCE excluding food and energy also rose by 2.2 percent. The GDP price index increased by 4 percent, the most in 16 years and much more than expected.

The combination of inflation and poor economic growth indicates that the US economy could be headed toward a period of stagflation, similar to that experienced in the 1970s.

The GDP figures spurred a further fall in the US dollar on international currency markets. The dollar fell to a record low against the euro, with the euro equal to $1.3682 in mid-day trading, though the dollar bounced back slightly by the end of the day. The US currency also fell against the Japanese yen, the British pound and other currencies.

The fall in the dollar reflected both investor concern over the weak US economy and diminished expectations for a move to increase US interest rates. If the US Federal Reserve were to increase interest rates, this would tend to make dollar-denominated assets more attractive to investors, which would increase demand for the dollar and lift it relative to other currencies. However, since an interest rate increase would make borrowing more expensive, this would tend to decrease business and consumer spending, pushing the GDP down. With GDP figures already low, the Fed is unlikely to raise interest rates anytime soon.

At the same time, with inflation high and the dollar low, the Fed is constrained from decreasing interest rates in an attempt to boost economic growth, since the effect of this would be to push inflation higher and the dollar lower.

The value of the dollar has been falling more or less steadily for years, reflecting weaknesses in the US economy. A downturn in US economic growth will increase the threat of a run on the dollar, as investment opportunities in the US shrink further.

Underlying the contradictions in the US economy is the deflation of the housing market, which had been propelling consumer spending for some time. Earlier this week, data was released showing a sharp drop in existing-home sales (down 8.4 percent in March, the largest drop since 1989).

The housing market slump is beginning to have a serious impact on the living standards of working people, who already face stagnating wages and benefit cuts. It is particularly striking those who have relied on subprime mortgages—loans to individuals with poor credit histories.

The biggest crisis in the subprime market so far only occurred at the end of the first quarter, with the collapse of independent subprime mortgage lender, New Century Financial in mid-March. Defaults on mortgages have increased sharply, as working people find it increasingly difficult to make payments. At the same time, the deflation of home prices more broadly has made it more difficult to refinance homes in order to continue to use home debt to purchase other goods, including basic necessities.

In response to New Century's collapse and the rise in mortgage defaults, subprime lenders are beginning to cut back on their willingness to grant loans, and they are expected to continue this trend in coming months.

Consumer spending has largely been sustained by debt, which has ballooned in recent years. This trend has been particularly pronounced among the poorer sections of society. As a whole, the savings rate (income minus spending) has been in negative territory for years—i.e., Americans are spending on average more than they are earning. Such a trend is unsustainable as credit sources, including home mortgages, begin to dry up. The ultimate consequence will be a decline in consumer spending and a further deterioration in the living conditions for masses of people.