

Private Consumption Poses Downside Risks to U.S. Economic Growth



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The United States economy became increasingly out of balance in many ways during the investment-led boom of the 1990s. Unlike typical expansions, inflation did not accelerate during the expansion of the 1990s, even though the unemployment rate dropped to historically low levels. Surging imports, productivity gains and the strong dollar all helped to keep a lid on inflation. Economic growth was facilitated by significant foreign investment activity, in other words through rising U.S. indebtedness to the rest of the world. Both the trade and current account deficits widened sharply. U.S. household and corporate spending outpaced income, leading to increasingly higher levels of private sector debt. Public sector finances, which had been in persistent deficit for several decades, finally moved into surplus in 1998, helped by favorable growth in tax revenues. Buoyant investor confidence bid stock prices to unsustainably lofty levels, pointing to an eventual correction in equity markets. The stock market crash which followed in 2000 has, indeed, been cited as a major source of the economic lethargy witnessed in recent years. It will take some time for the economy to adjust to the overinvestment that was associated with the stock market boom of the 1990s.

According to the National Bureau of Economic Research (NBER), the economy was in recession between March and November of 2001. The brevity of the recession meant that many economic imbalances accumulated during the expansionary period were not corrected, as is

typically the case during downturns. The current-account deficit and household debt are still alarmingly high.

Despite strongly expansionary monetary and fiscal policies, growth in the U.S. has remained exceptionally slow. The central bank has lowered its target interest rate 13 times since early 2001, from a level of 6.5 percent to its current level of one percent. Tax cuts, rapid growth in public expenditure and slow revenue gains have pushed the fiscal balance into deficit. The deficit already stood at 3.4 percent of GDP last year and is set to widen further this year and next, a sharp turn of events considering the 1.4-percent budget surplus recorded in 2000. Economic growth appeared to be gaining momentum in the beginning of 2002, but the budding recovery was quickly halted by the accounting scandals and sharply rising oil prices brought on by what was then a threat of war in Iraq.

The war in Iraq ended surprisingly quickly, and oil markets briefly settled down. Difficulties in resuming oil production in Iraq, acts of terrorism and the threat of such acts have kept oil prices exceptionally high at times. However, recently released indicators point to strengthening economic activity in the near term. Equity prices have risen noticeably, and industrial confidence has returned to healthy levels. Industrial production embarked on a mild path of recovery in July, and GDP increased strongly in the second quarter reflecting robust growth in private consumption and defense expenditure

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as well as the resumption of growth in business investment. In normal circumstances, a sustained economic recovery would be almost certain.

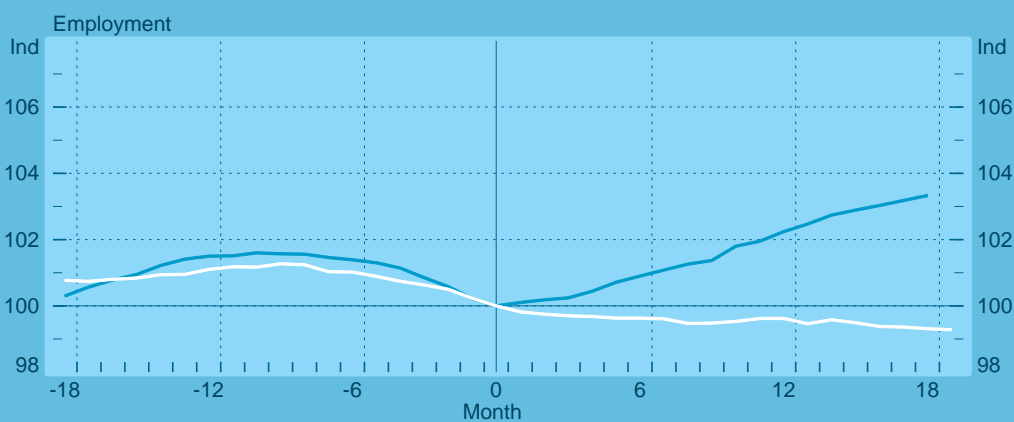
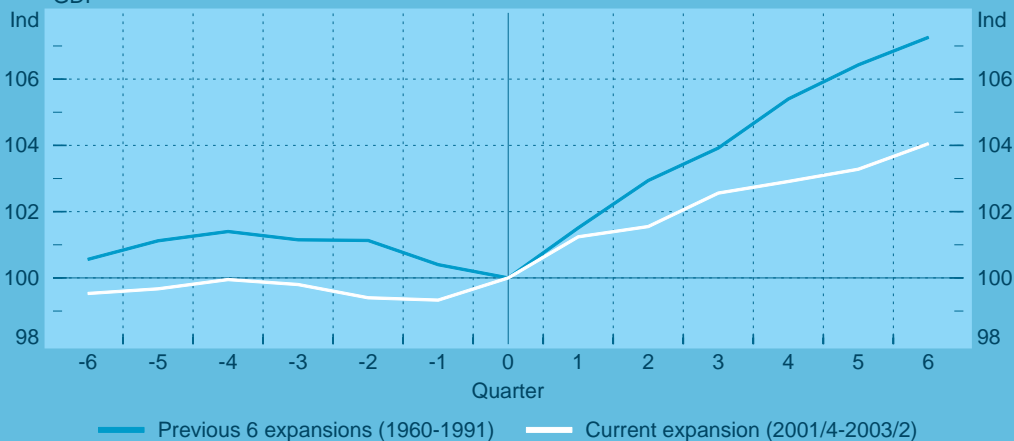
It appears that the U.S. economy will expand quite rapidly in the second half of this year. Stockbuilding, foreign trade and investment may provide a considerable boost to growth given that activity in these components is starting from very low levels. In terms of sustaining the economic recovery, however, it is essential that the main component of demand, private consumption, continues to expand. Consumers

supported the economy during the recession and in its aftermath by borrowing heavily. The household debt service burden has risen to a near record level, raising the risk that consumers will curb spending considerably in order to correct their debt positions. A large-scale pull-back in spending would lead to a sharp rise in the household saving rate, dampening growth in domestic demand.

Changes in consumer confidence typically help predict future movements in consumer spending. Fluctuations in confidence, in turn, are usually associated with changes in employment

Comparison of US GDP and Employment During Different Business Cycles

The business cycle trough (the start of the expansion) occurs at time 0 at which time the series is normalized at 100



Sources: NBER, ETLA.

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conditions. During the current expansion, which began in November 2001 according to the NBER, growth in GDP has been exceptionally weak while employment has continued to decline. The risk that consumers will become

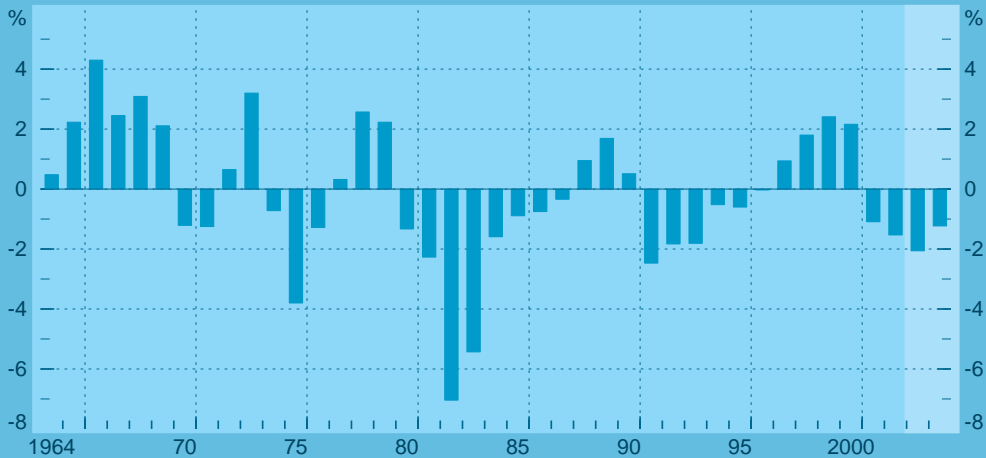
considerably more cautious in their spending is high, particularly since employment conditions will probably continue to weaken in the near term.

The Unemployment-Output Relationship in the U.S.



The U.S. Output Gap

The output gap is defined as the percentage difference between the actual and the potential level of real GDP



Risk of Higher Unemployment Unless Economic Growth Strengthens

With GDP growth reaching only 2.5 percent since the recession ended in late 2001, employment will probably continue to deteriorate and the jobless rate rise over the short term. The connection between unemployment and economic growth is often summarized by a statistical relationship known as “Okun’s Law,” which was developed by Arthur Okun in 1962. According to the rule of thumb based on Okun’s Law, a percentage point of output growth in excess of its potential rate is associated with a drop in the unemployment rate of half a percentage point. This implies that, in the case of the U.S., the unemployment rate will fall when output growth exceeds three percent. In the case of the Euro Area, output growth of 2.5 percent is sufficient to lower unemployment while in Finland the figure is around 3.5 percent or so.

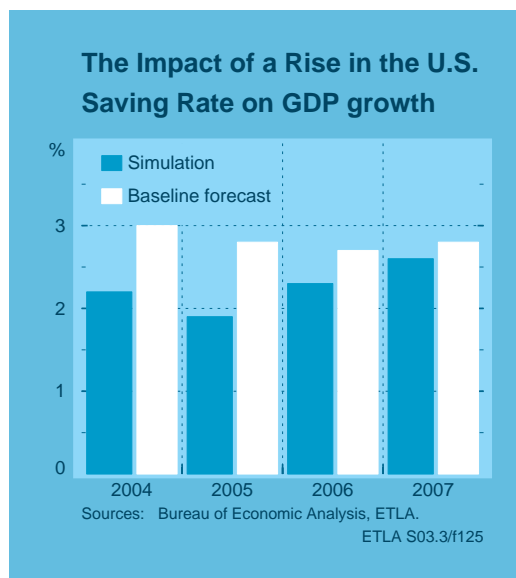
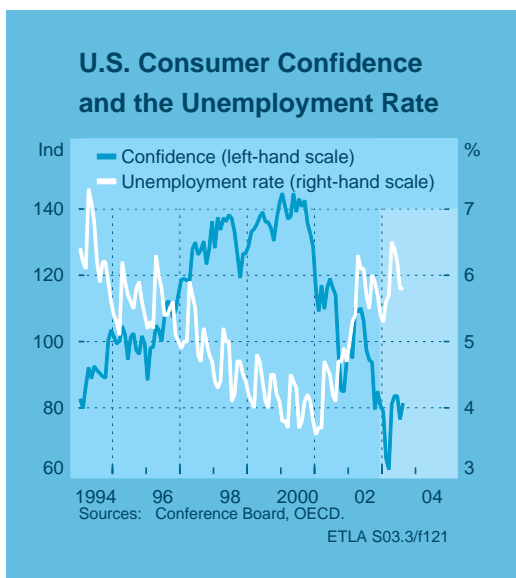
Okun’s Law is a clear and useful rule of thumb, although also has its deficiencies. Many other factors can affect the relationship between the unemployment rate and economic growth. The rule of thumb can change markedly, for example, in response to structural changes in the economy.

Measuring an economy’s potential rate of growth is particularly difficult. Fortunately, however, potential output growth does not fluctuate all that much over time because the factors determining it – productivity, the capital stock, and employment – are relatively stable.

Private Consumption Growth May Slow

If U.S. economic growth does not accelerate appreciably from its current pace, then rising unemployment will likely weigh heavily on consumer confidence. In this environment, the household saving rate would rise, and private consumption would provide only weak support to the overall economy. Attaining a fast pace of economic growth without moderate gains in private consumption is difficult, since it accounts for around 70 percent of GDP.

In the mid-1990s, the U.S. personal saving rate began to decline appreciably, reflecting the consumption boom that took place at the time in response to the “wealth effect” from elevated stock prices. From 1960 to 1995, the saving rate averaged 8.7 percent, while by 2001, when the recent recession began, it had fallen to 2.3 percent. The Bush Administration’s three fiscal stimulus packages since 2001 helped reverse this trend slightly, and the saving rate has re-



mained steady at the low level of around 3.5 percent since early 2002.

That the saving rate has not been reversed more sharply since the recession is unusual, given the crash of the stock market bubble in 2000 and its negative impact on household wealth. On the other hand, rising housing prices have partly offset this negative impact. Moreover, record-low interest rates have fueled household spending, particularly on durable consumer goods, helping to postpone the correction in the saving rate.

Nevertheless, the financial position of American households is very fragile. Although the saving rate is positive, household expenditure including homes has grown considerably faster than income, requiring already heavily indebted households to increase their borrowing. Flow of funds data provided by the Federal Reserve show that total household debt as a share of disposable income rose in the beginning of 2003 to its highest level ever, 107 percent. This has helped lift debt service payments to almost record heights as a percentage of disposable income, despite historically low interest rates.

Our baseline forecast assumes that the household saving rate will rise gradually over the next few years, as the impact of the recent fall in net worth begins to translate into slower consumption growth. Although the saving rate rises in the baseline scenario, it remains below its long-run average. The downside risk, however, is that the persistent weakening in employment since early 2001 could prevail for several more quarters unless growth picks up considerably. This could weaken consumer confidence and trigger a sharper downward correction to spending and thus a faster increase in the saving rate.

A Rise in the Saving Rate Would Slow Growth Considerably

We employ the NIGEM model to examine the possible economic impacts of a faster correction in the personal saving rate. In the simulation, we assume that households react to the labor market weakening and high debt levels by reducing growth in consumption to a level that brings the saving rate in line with its long-run average by the end of 2006, namely 7.7 percent. The Federal Reserve accommodates the slowdown by reducing interest rates, which, given the Keynesian features of the model, would tend to boost aggregate demand through higher business and residential investment. However, we do not think the Keynesian framework would necessarily work in this environment; instead, it is possible that the correction in private consumption would send a signal to investors that the recent upturn in investment (induced by the monetary easing) was overdone, prompting slower growth in investment than that embedded in the baseline forecast.

According to the simulation results, GDP growth slows by just almost one percentage point in 2004 and 2005. Growth in 2006 and 2007 is also slightly slower than in baseline. The slowdown weakens growth in labor demand over the next few years, and the unemployment rate rises gradually to almost seven percent instead of falling as in baseline. The Federal Reserve does not embark on a monetary tightening in 2004, as in our baseline case, but instead lowers its policy interest rate close to zero by the beginning of 2005.

Returning to a sustained path of growth requires a correction in the financial balance of households. Active monetary and fiscal policies may delay this adjustment and could prolong the period of slow economic growth that is needed to unwind the imbalance. At worst, such policies could make the eventual correction more painful if the imbalances were to widen.