Economic Update

NATIONAL
Federal Reserve Bank of Dallas

Risk of Slower Growth Ahead

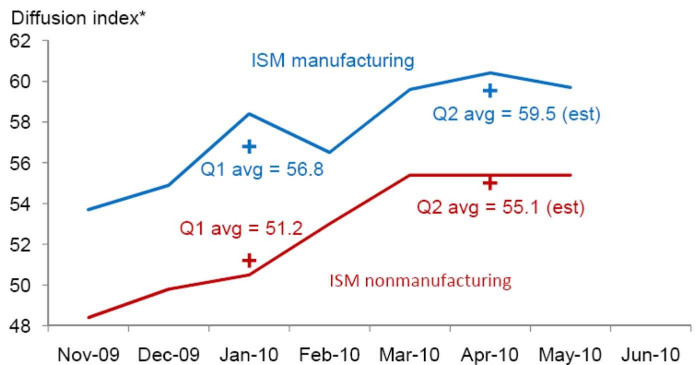
June 24, 2010

The U.S. economic recovery appears to have been solid through second quarter 2010. However, with fiscal stimulus measures and the inventory correction nearing an end, there are reasons to be concerned that growth will slow in the second half of the year.

Moderate Second-Quarter Growth Likely

The outlook for second-quarter growth is bright. Gross domestic product (GDP) grew by 3 percent in the first quarter and is expected to grow at an even faster pace in the second. This outlook is supported by the Institute for Supply Management (ISM) manufacturing and nonmanufacturing indexes (*Chart 1*). The indexes are good early indicators of GDP growth because they are timely, subject to minimal revision and cover a broad portion of the economy. The averages for both indexes are estimated to be higher in the second quarter of 2010 than in the first, suggesting an acceleration in economic activity. (Any ISM reading above 50 indicates growth. The higher the reading, the faster is the implied growth rate).

Chart 1
ISM Indexes Suggest Second-Quarter Acceleration in Real Activity

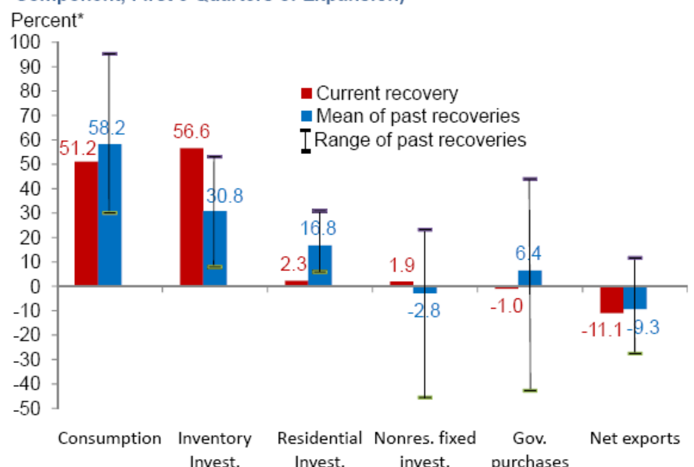


*Seasonally adjusted.
SOURCE: Institute for Supply Management.

An Unusual Recovery

The composition of growth so far in this recovery is a source of concern. During the recession, real GDP fell below final sales as firms sought to reduce bloated inventories. Once final sales began to recover, firms sought to moderate the pace of the inventory drawdown—they began to close the gap between production and sales. The recovery up to now, which began in third quarter 2009, has been unusual in how much it has relied on this production catch-up effect. Inventory investment has accounted for 57 percent of GDP growth in the first three quarters of the current recovery—the largest percentage in the past 60 years (*Chart 2*). In comparison, the fraction of GDP increase accounted for by residential investment during the first three quarters of the recovery, 2 percent, is a record low. This feeble contribution comes despite new home-purchase tax credits and Federal Reserve intervention in the market for mortgage-backed securities. Growth contributions from consumption and government purchases have been smaller than normal also, but well within the past range. Contributions from nonresidential fixed investment and net exports have been about average.

Chart 2
Inventory Investment Accounts for a Record Share of Growth During This Recovery
(Percent of Growth Accounted for by Each GDP Component, First 3 Quarters of Expansion)



*Seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

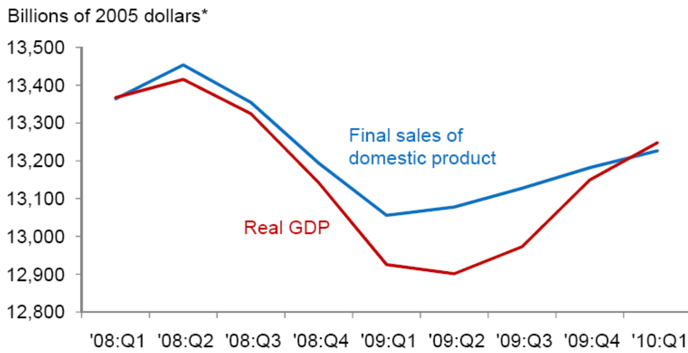
The Inventory Cycle Draws to a Close

It appears the inventory correction has nearly run its course. Output has now caught up with final demand for domestic product, signaling that the main boost to GDP growth from inventory investment is coming to an end (*Chart 3*). Unless producers or retailers now want to *add* to their inventories, in coming quarters GDP growth will be tied to growth in final demand. However, the inventory-to-sales ratio is at a level that in the past has meant little or no change in inventories relative to GDP (*Chart 4*).

Where Will Growth Come From?

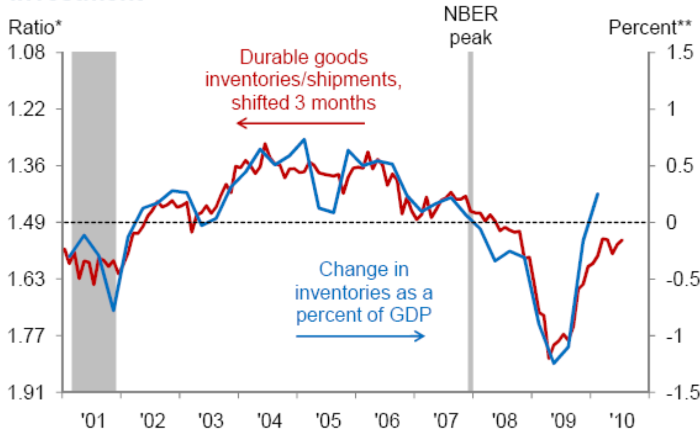
Increasing government purchases were an important early source of growth in final demand during the recovery but have gradually faded. Support for residential investment from special tax incentives is at an end. Business investment has been growing well in recent quarters but usually acts as an amplifier of growth that originates elsewhere, rather than an independent source of strength. Real consumption spending is growing at roughly the same 3 percent pace as before the recession but starting from a lower base (*Chart 5*). To replace inventory investment's contribution to the recovery, this growth rate would have to increase to 5.5 percent—a pickup that is uncertain, at best, given still-tight credit and households' aversion to debt. Such an acceleration might even be undesirable because it would risk an exacerbation of global imbalances (large U.S. trade deficits and rising U.S. international indebtedness).

Chart 3
Inventory Reductions Run Their Course as Output Catches Up with Sales



*Seasonally adjusted.
SOURCE: Bureau of Economic Analysis.

Chart 4
Inventory-to-Sales Ratio Suggests Little Incentive for Further Increases in Inventory Investment



*Seasonally adjusted.
**Seasonally adjusted, annualized rate.
NOTE: Gray shading represents NBER recessions.
SOURCES: Bureau of Economic Analysis; Census Bureau.

Chart 5
Real Consumer Expenditures Resume Their Growth, But on a Lower Path

*Seasonally adjusted.
SOURCE: Bureau of Economic Analysis.

Net Exports a Possible Bright Spot

Net exports provided a big boost to U.S. final demand in second quarter 2009 with a 1.6 percentage point growth contribution. Since then, net exports have contributed little to growth, but there is some reason to believe that this will change in the second half of 2010. Through the first quarter, leading indexes for the U.S. and for the major industrialized countries as a group suggested that economic prospects here and abroad were improving about equally rapidly—a neutral for our net exports' prospects. Meanwhile, the U.S. gross domestic purchases price index has been rising relative to the U.S. gross domestic product price index (*Chart 6*). A growing purchases/product price ratio means that U.S. imports are becoming more expensive relative to U.S. exports, encouraging growth in exports relative to imports. Ordinarily, this relative-price effect would kick in during the second half of 2010. However, recent developments in Europe have added to financial strains there and increased calls for fiscal restraint. So, while some increase in the growth contribution from net exports in the second half is possible, it is by no means certain.

Slower Growth Likely, On Balance

In sum, GDP growth will continue in the second half of the year but quite possibly at a slower rate than we've seen during the recovery to date. Deceleration is likely because the boost to growth from rising inventory investment is near an end now that output has caught up with final demand. The inventory boost has accounted for over 50 percent of GDP growth so far during the recovery, so a substantial pickup in final demand growth will be necessary to keep gains in employment and output from slowing. That the required pickup will occur is far from obvious.

—Tyler Atkinson, Evan F. Koenig and Max Lichtenstein

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About the Authors

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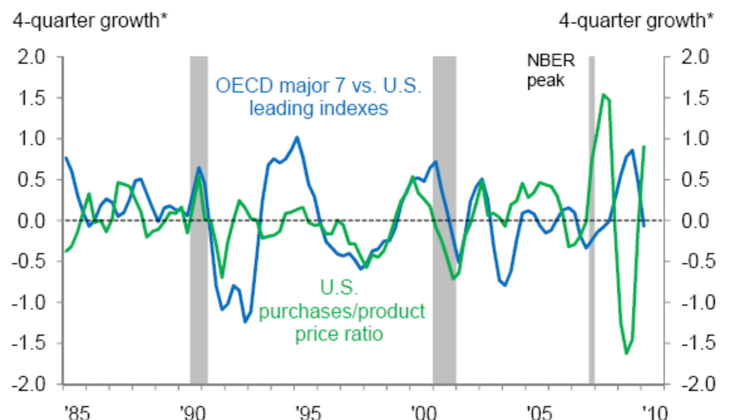
Chart 6
Changes in Relative Growth Prospects and Relative Prices Sum to a Positive Outlook for Net Exports



*Seasonally adjusted.
NOTE: Gray shading represents NBER recessions.
SOURCES: Organization for Economic Cooperation and Development; Bureau of Economic Analysis.