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Growth in the U.S. Economy Depends on Stronger Consumer Spending

Although U.S. declines in output and employment during late 1990 and early 1991 were less severe than in several of the last five recessions, consumer confidence is at its lowest levels since the depths of the 1981–82 recession. Households have good cause to be pessimistic; they have been hard-hit by this recession.

The decline in real after-tax income accompanying this economic contraction has exceeded declines typical in past recessions, and growth in after-tax income since April 1991—when most measures of economic activity bottomed out—has been weaker than during any of five prior recoveries. In fact, recent economic data have been weak enough to cause analysts to question whether the upturn that began last spring will, in retrospect, be labeled a recovery at all. Employment growth in the service-producing sector has been below normal, manufacturing output has flattened, and imports have been absorbing an increasing share of U.S. demand for goods.

We expect output growth to remain weak-to-nonexistent through the first and second quarters of 1992. Stronger consumer demand should lead to an acceleration of growth during the second half of the year, and, overall, real gross domestic product (GDP)[1] should rise about 2 percent in 1992. Inflation is likely to average 3.5 percent.

The State of the Recovery

A comparison of the decline in nonfarm employment over the recent contraction with the declines experienced during past recessions suggests that the recent downturn was less severe than three of the past five recessions (*Chart 1*).[2] An examination of movements in real GDP or in the unemployment rate results in a similar conclusion. Nevertheless, consumer confidence has not been this low since both inflation and unemployment peaked at more than 10 percent during the 1981–82 recession. A look at how different sectors of the economy fared during the past recession and the subsequent recovery helps explain the apparent inconsistency.

Household Sector. Chart 2 shows the path of real after-tax personal income since April 1991. For comparison, the chart also displays the range of paths that after-tax income followed during the first seven months of five previous recoveries. All series are indexed so that a value of

INSIDE

The Southwest's Stop-and-Go Economy

An 18-month review of the region's economic performance.

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"Even this forecast for modest real growth might fail to materialize if consumer spending is adversely affected by further declines in residential real estate values or the continued need to resolve bank failures."

Chart 1
Declines in Nonfarm Employment During Recessions, 1960–91

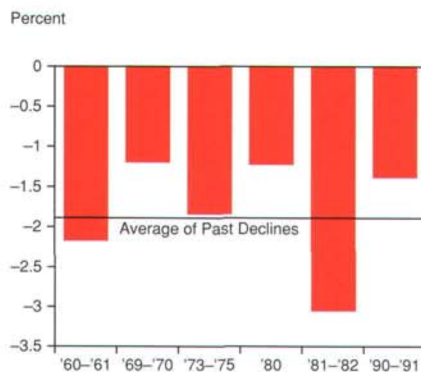
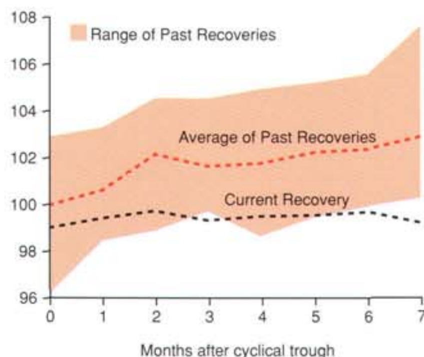


Chart 2
Real After-Tax Income



100 represents the level of income prevailing when the recession began.

On average, after-tax personal income has not declined during past recessions; rather, it only stopped growing. In Chart 2, the average index value of income at past business-cycle troughs is 100—the same value as at business-cycle peaks. During the recent recession, however, the usual shock absorbers—such as government welfare and unemployment compensation programs, the progressive structure of the income tax and the tendency of firms to reduce retained earnings rather than cut dividend payments—failed to prevent a decline in after-tax personal income. Income growth has been unusually slow during the recovery, as well. Low consumer confidence is not so surprising considering that, relative to its level at the start of the recession, after-tax personal income is lower now than at the comparable stage of any other recent recovery.

As might be expected, movements in consumer spending tend to mirror those in after-tax personal income (*Chart 3*). Like real after-tax income, real consumption expenditures usually do not fall during recessions. But the recent recession was an exception: consumption spending declined more than 1 percent from July 1990 to April 1991. Further, consumption spending has been stagnant since July 1991.

Service-Producing Sector. Chart 4 shows that the pattern of service-producing employment has also mirrored that of after-tax income. Thus, employment in the service-producing sector declined more than usual during the 1990–91 recession and has grown more slowly than past experience would suggest during the recovery. This slow growth may, in part, represent a reallocation of resources away from the retail trade and financial services sectors. Another possibility is that recent reductions in the availability of bank credit have had an especially strong impact on firms in the service-producing sector.

Goods-Producing Sector. Although the service-producing sector was hit hard by the recent recession, the decline in total employment was smaller than the average job loss in the five preceding recessions, indicating that the goods-producing sector of the economy fared unusually well during the most recent downturn. Chart 5 illustrates that, indeed, manufacturing output fell by a relatively small amount during the recent recession. Since July 1991, however, increases in manufacturing activity have been substantially smaller than average.

Trade Sector. Movements in imports and exports have heavily influenced the behavior of manufacturing output over the recent recession and recovery. Between the third quarter of 1990 and the first quarter of 1991,

Chart 3
Real Consumption Expenditures

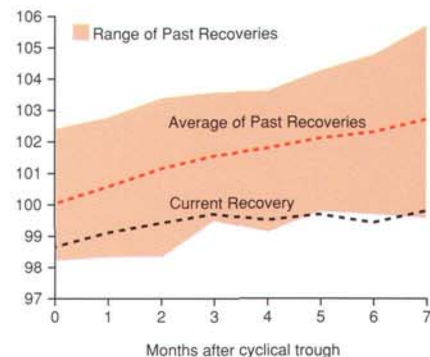


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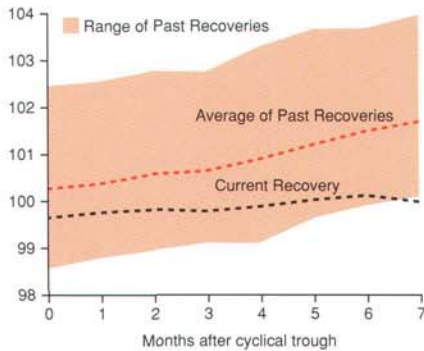
Chart 4
Service-Producing Employment



as the economy contracted, exports rose as a share of U.S. manufacturing output, while the share of imports remained roughly constant (*Chart 6*). Thus, growth in exports helped sustain the manufacturing sector in the face of a sharp decline in domestic demand. Between the second and third quarters of 1991, however, import growth outstripped growth in U.S. manufacturing output, while growth in the ratio of exports to manufacturing output ceased. With imports meeting much of the increase in domestic demand during the summer of 1991, growth in the manufacturing sector halted.

Outlook for Growth in 1992

Real output appears to have changed little between the fourth quarters of 1990 and 1991. Sluggish real GDP growth, at an annual rate of 1 percent or less, most likely will continue into the first half of 1992. The GDP growth rate should rise to 3 percent during the second half of the year. From the fourth quarter of 1991 to the fourth quarter of 1992, real GDP should increase about 2 percent (*Chart 7*). In short, the expansion that began early last spring has stalled but will resume sometime early this year.

This prediction of moderate growth in 1992 is based on two key assumptions: strong export demand from U.S. trading partners and an increase in consumer spending. If these two conditions are met, the economy will also benefit from an end to inventory cutbacks, a resumption of growth in state and local government spending, and rising investment in plant and equipment.

As their economies improve, other countries' demand for U.S. products should rise. Canada, the largest U.S. export market, began an economic expansion in the second quarter of 1991, and a recovery of the British economy may also have begun. Further, despite a much-publicized slowing of growth in the western part of Germany, growth in that country is expected to accelerate in 1992. Together, Canada and Western Europe absorb more than 50 percent of U.S. exports. Exports to Latin America may also improve, as several countries there have dramatically lowered their barriers to imported goods.

At least in the short term, export growth is largely beyond the control of U.S. policymakers. The timing of consumer spending, on the other hand, is affected by household liquidity, on which domestic monetary policy can have considerable influence. Recent Federal Reserve–engineered reductions in short-term interest rates have begun to have an impact on the monetary aggregates, all of which recorded higher growth in the fourth quarter of 1991. This faster growth, if continued, bodes well for consumer spending in coming months. Any threat to household wealth, on the other hand, will tend to weaken consumer spending.

Assuming that export growth and consumer spending do indeed strengthen, GDP will also get a boost from the cessation of inventory cutbacks and a resumption of growth in state and local government spending. Inventories fell sharply in the fourth quarter of 1990 and the first two quarters of 1991. Inventory declines halted during the third quarter of 1991—largely because of an unanticipated slowing of sales—but new declines are expected in early 1992. By the end of 1992, inventory cutbacks will have ceased, adding substantially to the growth of GDP during the second half of the year. Addi-

Chart 5
Manufacturing Output

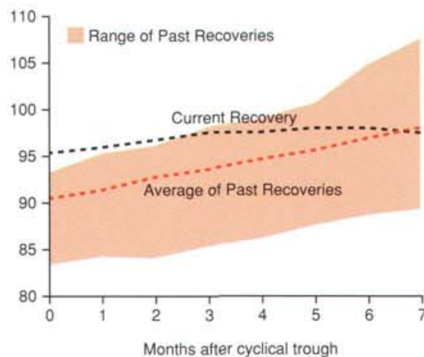


Chart 6
Real Merchandise Imports and Exports as a Share of Manufacturing Output

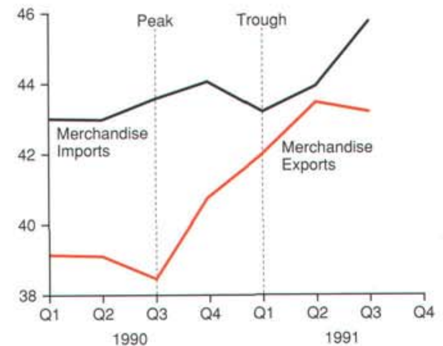
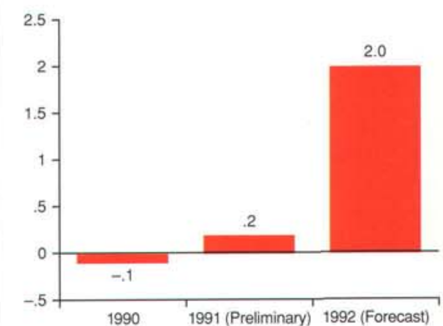


Chart 7
Growth of Real Gross Domestic Product, 1990–92



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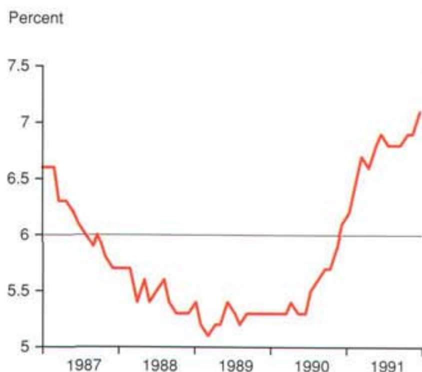


tionally, declines in state and local government spending restrained GDP growth during 1991. However, growth in state and local government spending should resume during 1992.

If, contrary to expectations, consumer spending continues to weaken and export growth slows, the hoped-for end to inventory cutbacks will not materialize. Further, state and local governments might find they are unable to fund increased purchases.

Finally, as sales pick up and existing machinery wears out, investment in plant and equipment should begin to rise. During the first three quarters of 1991, cuts in business fixed investment subtracted almost a full percentage point from real GDP growth. By the end of 1992, business fixed investment should turn around and begin to make a positive contribution to the recovery. Without strong export demand or a rebound in consumer expenditures, however, investment spending will likely remain subdued.

Inflation Outlook

The path of the real economy affects the inflation rate. Charts 8 and 9, for example, illustrate the connection between the unemployment rate and the rate of inflation. According to Chart 9, inflation drifted upward from mid-1987, when the unemployment rate fell below 6 percent of the labor force, until the beginning of 1991, when the unemployment rate again reached 6 percent. Many economists regard an unemployment rate of about 6 percent as the lowest level that can be sustained without triggering an acceleration of inflation.

Because real output must grow by more than 2 percent each year just to hold the unemployment rate steady, the GDP growth outlook for 1992 implies that the unemployment rate is unlikely to fall much below 7 percent during the remainder of the year. Therefore, labor-market slack will continue to put downward pressure on the rate of inflation. Indeed, the rate of consumer price inflation should decline by almost a full percentage point—from 4.4 percent in 1991 to 3.5 percent in 1992 (*Chart 10*). Inflation should trend downward over the entire year.

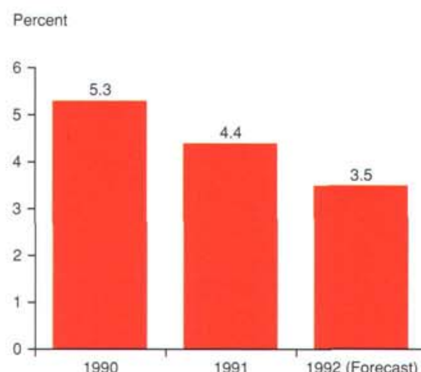
Summary

The recovery that began in spring 1991 has stalled. Employment growth in the service-producing sector has been below normal and imports have absorbed an increasing share of U.S. demand for goods. Growth in real output should remain sluggish through the first half of 1992, with GDP growth of less than 1 percent at an annual rate. During the second half of the year, the GDP growth rate should reach 3 percent. In 1992, real GDP should rise, overall, by about 2 percent—a pace slow enough to yield further declines in inflation but, unfortunately, not fast enough to yield any reduction in unemployment.

Even this forecast for modest real growth might fail to materialize if consumer spending is adversely affected by further declines in residential real estate values or the continued need to resolve bank failures.

—Harvey Rosenblum
Evan F. Koenig
D'Ann M. Ozment

NOTE: The rate plotted is a 12-month moving average of growth in the consumer price index, excluding food and energy.



NOTE: The rates shown are the percent change in the consumer price index, excluding food and energy, from December to December.

[1] We use gross domestic product (GDP) rather than gross national product (GNP) as our measure of aggregate real economic activity. GDP measures the total quantity of goods and services produced within U.S. borders—including output produced within the United States by foreign multinational corporations. Because GDP includes output produced by foreign-owned factories in the United States and excludes output produced by U.S.-owned factories abroad, it is more closely related to U.S. employment levels and policy decisions than is GNP.

[2] The business-cycle-dating committee of the National Bureau of Economic Research has not yet announced the month in which the recent recession reached its low point. All the most frequently cited monthly indicators of general economic conditions bottomed out in either March or April 1991, however. Accordingly, our analysis *assumes* that the latest contraction ended in April 1991.

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