The Apparent Surge in America's Rate of Economic Growth (GDP): The Facts Behind the Hype

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Global Research, April 30, 2019

Region: USA
Theme: Global Economy

Last week's US GDP for the 1st quarter 2019 preliminary report (2 more revisions coming) registered a surprising 3.2% annual growth rate. It was forecast by all the major US bank research departments and independent macroeconomic forecasters to come in well below 2%. Some banks forecast as low as 1.1%. So why the big difference?

One reason may be the problems with government data collection in the first quarter with the government shutdown that threw data collection into a turmoil. First preliminary issue of GDP stats are typically adjusted significantly in the second revision, coming in future weeks. (The third revision, months later, often is little changed).

There are many problems with GDP accuracy reflecting the real trends and real GDP that many economists have discussed at length elsewhere. My major critique is the redefinition in 2013 that added at least 0.3% (and $500b a year) to GDP totals by simply redefining what constituted investment. Another chronic problem is how the price index, the GDP Deflator as it's called, grossly underestimates inflation and thus the price adjustment to get the 3.2% 'real' GDP figure reported. In this latest report, the Deflator estimated inflation of only 1.9%. If actual inflation were higher, which it is, the 3.2% would be much lower, which it should. There are many other problems with GDP, such as the government including in their calculation totals the 'rent' that 50 million homeowners with mortgages reputedly 'pay to themselves'.

Apart from these definitional issues and data collection problems in the first quarter, underlying the 3.2% are some red flags revealing that the 3.2% is the consequence of temporary factors, like Trump's trade war, which is about to come to an end next month with the conclusion of the US-China trade negotiations. How does the trade war boost GDP temporarily?

Source: US Bureau of Economic Analysis

Two ways at least. First, it pushes corporations to build up inventories artificially to get the cost of materials and semi-finished goods before the tariffs begin to hit. Second, trade disputes initially result in lower imports while negotiations are underway. In the latest US GDP analysis reported last week, lower imports resulted in what's called higher 'net exports' (i.e. the difference between imports and exports). Net exports contribute to GDP. The US economy could be slowing in terms of output and exports, but if imports decline faster it appears that 'net exports' are rising and therefore so too is GDP from trade.

Looking behind the 1st quarter numbers it is clear that the 3.2% is largely due to excessive rising business inventories and rising net exports contributions to GDP.

Net exports contributed 1.03% to the 3.2% and inventories another 0.65% to the 3.2%. That is, over half. Even the Wall St. Journal reported that without these temporary contributions (both will abate in future months sharply), US GDP in the quarter would have been only 1.3%. (And less if adjusted more accurately for inflation and if the 2013 phony redefinitions were also 'backed out').

US GDP in reality probably grew around the 1.1% forecasted by the research departments of the big US banks.

This analysis is supported by the fact that around 75% of the US economy and GDP is due to business investment and household consumption typically. And both consumption and investment are by far the primary sources of GDP. (The rest is from government spending and 'net exports).

Consumer spending (68% of GDP) rose only by 1.2% last quarter and thereby contributed only 0.82% of the 3.2%. That's only one fourth of the 3.2%, when consumption, given its size in the economy, should contribute 68%!

Durable manufactured goods collapsed by -5.3% and autos sales are in freefall. And all this during tax refund season which otherwise boosts spending. (Thus confirming middle class refunds due to Trump tax cuts have been sharply reduced due to Trump's 2018 tax act).

Similarly private business investment contributed only a tepid 0.27% of the 3.2%, well below its average for GDP share.

Business investment is composed of building structures (including housing), private equipment, software and the nebulously defined 'intellectual property', and of course the business inventories previously mentioned. The structures and equipment categories are by far the largest categories of business investment. However, in the first quarter 2019, structures declined by -0.8%, housing by -2.8% and equipment investment rose only a statistically insignificant 0.2%.

This poor contribution of business investment contributing only 2.7% to GDP, when the long term historical average is about 8-10% normally, is all the more interesting given that Trump projected a 30% boost to GDP is his business-investor-multinational corporate heavy 2018 tax cuts were passed. 2.7% is a long way off 30%! The tax cuts for business didn't flow into real investment, in other words. (They went instead into stock buybacks, dividend payments, and mergers and acquisitions of competitors). And they compressed household consumer spending to boot.

Since Trump's tax cuts, there's been virtually no increase in the rate of Gross private domestic investment in the US. It's held steady at around 5% of GDP on average since mid-2017. Within that 5%, housing and business equipment contributions have been falling, while IP (hard to estimate) and inventories have been rising.

In short, both Consumer spending and core business investment contributions to US GDP have been slowing, and that's true within the recent 1st quarter US 3.2% GDP.

In other words, 1st quarter GDP rose due to the short term, and temporary contributions to inventories and net exports–both driven artificially by Trump's trade wars.

The only other major contribution to first quarter GDP is, of course, Trump war spending which rose by 4.1% in 1st quarter GDP. (Conversely, nondefense spending was reduced -5.9% in the first quarter GDP).

Going forward in 2019, no doubt war spending will continue to increase, but business inventories and household consumption will continue to weaken. Meanwhile, business investment on structures, housing, and equipment and household consumption will continue to remain weak at best.

Trump is betting on his 2020 re-election and preventing the next recession now knocking at the US and global economy door. He will keep defense spending growing by hundreds of billions of dollars. He'll hope that concluding his trade wars will give the economy a temporary boost. And he'll up the pressure on the Federal Reserve to cut interest rates before year end.

Summing up, beneath the surface of the US economy the major categories of US GDP–business structures, housing, business equipment, and household consumer spending (especially on durables and autos)–will continue to weaken. Whether war spending, the Fed, and trade deals can offset these more fundamental weakening forces remains to be seen.

Bottom line, therefore, the 3.2% GDP is no harbinger of a growing economy. Quite the contrary. It is artificial and due to temporary forces that are likely about to change. It all depends on further war spending, browbeating the Fed into further submission to lower rates, and what happens with the trade negotiations.

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