EconomicUpdate NATIONAL
Federal Reserve Bank of Dallas

Slowing Down

August 10, 2011

The advance release of gross domestic product (GDP) for second quarter 2011 reported that real output grew by only 1.3 percent annualized, below what most forecasters had predicted. Along with this disappointing reading on overall economic activity, GDP was significantly revised back to 2007. The revisions can be broken down into three periods: a deeper recession, a comparable recovery and a slower 2011 (*Chart 1*).

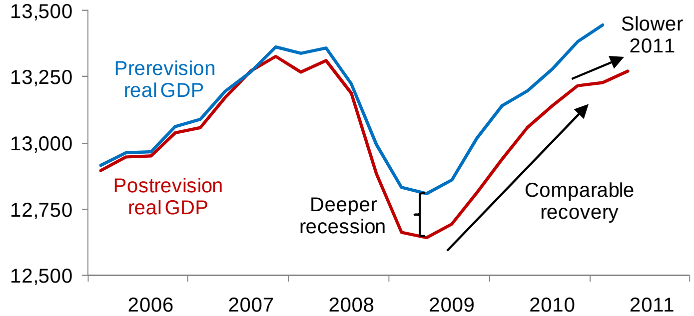
A Deeper Recession

From the peak in fourth quarter 2007 to the trough in second quarter 2009, real output is now estimated to have fallen 5.1 percent, compared with the prior estimate of 4.1 percent. Personal consumption expenditures accounted for about two-thirds of the downward revision. Consumers pulled back in the recession to an even greater extent than previously believed. The revision to the categories of goods and services was broad, with the largest downward revisions coming from financial and insurance services. Before the annual revisions of the previous two years, no one would argue that the drop in output wasn't large, but it wasn't large enough to explain the disproportionate rise in unemployment above its natural rate.[1] This statistical relationship between changes in the output gap and changes in the employment gap had previously been so consistent that it was dubbed "Okun's Law," after President Kennedy's economic advisor who identified it. The apparent breakdown suggested a possible shift in the way firms respond to cash flow pressures or even a substantial rise in the structural rate of unemployment. The annual GDP revisions in July 2010 and 2011 showed a deeper recession: The revisions almost completely erased the discrepancy between output and unemployment and the need for explanation (*Chart 2*).

A Comparable Recovery

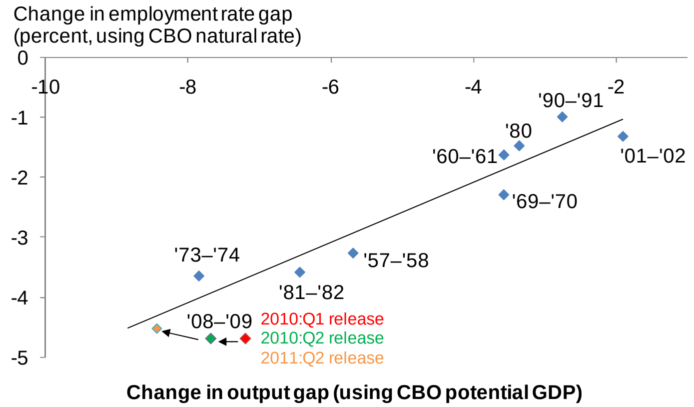
The total rate of recovery through 2010 was hardly revised. The average quarterly growth rate from second quarter 2009 to fourth quarter 2010 was revised from 2.95 to 3.00 percent annualized. The almost unchanged average masks the altered pattern of growth. Prerevision estimates showed a strengthening recovery that slowed down in second quarter 2010 but then regained its footing in the second half of the year. The revised data show a still strong recovery in second quarter 2010 followed by consistently decelerating growth. Some of this revision comes from a better adjustment for seasonal factors in oil imports. In other words, some of the volatility in reported GDP last year was normal seasonal variation (*Chart 3*).

Chart 1
Real GDP Has Been Revised Downward



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

Chart 2
Revision Corrects Breakdown in Okun's Law



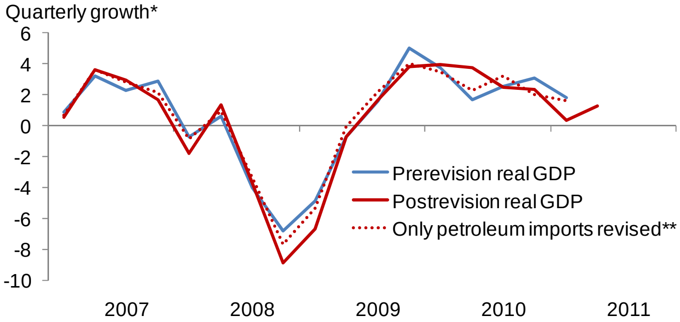
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics; Congressional Budget Office; author's calculations.

A Slower First Half of 2011

Real GDP growth in first quarter 2011 was revised down from 1.9 to 0.4 percent annualized. The composition of the revision is less troubling because a whole percentage point of the revision came from inventories, which can be traced back to now-fading supply chain disruptions. The fallback in government spending remained the key source of the slowdown in the first quarter, subtracting 1.2 percentage points from growth, with the federal government responsible for two-thirds of that. The second quarter was boosted by less of a drag from government and strong net exports, but personal consumption expenditures collapsed (*Chart 4*).

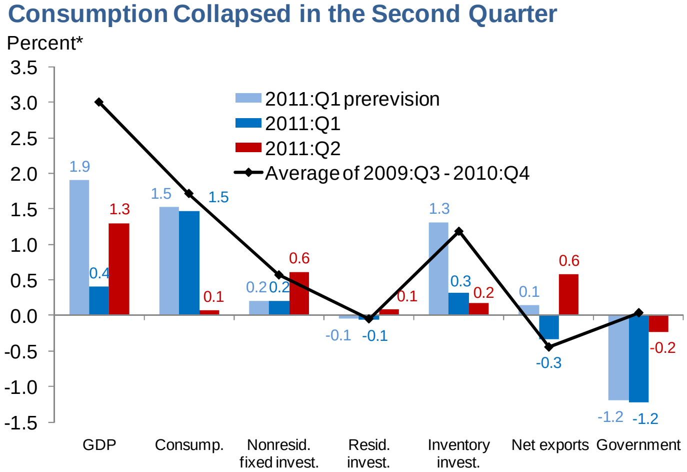
This too can be partly attributed to fading factors. Depressed

Chart 3
Revised Sequence of Growth in 2010



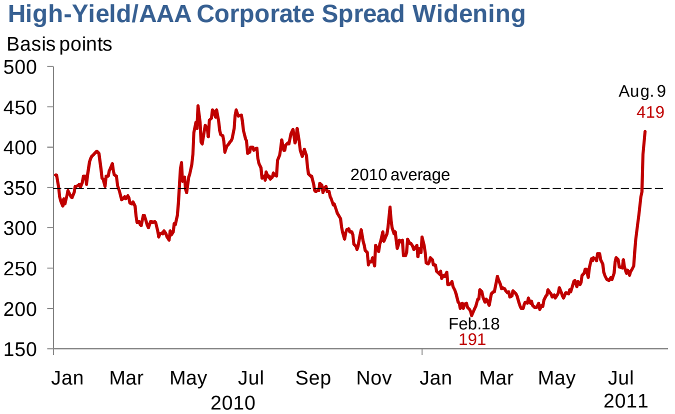
*Seasonally adjusted, annualized rate.
**Revision to growth contribution approximated.
SOURCES: Bureau of Economic Analysis, author's calculations.

Chart 4
Consumption Collapsed in the Second Quarter



*Contribution to real GDP growth, seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Chart 5
High-Yield/AAA Corporate Spread Widening



SOURCES: Federal Reserve Board of Governors, Bank of America/Merrill Lynch.

consumer spending on motor vehicles and parts subtracted 0.7 percentage points from second-quarter private consumption growth, while growth in consumer spending on nondurables and services was weak throughout the first half due to higher gasoline prices. Year-over-year real GDP growth is now at 1.6 percent, and total output is back below its prerecession peak. The past appears to be dimmer, but the details still do not rule out a brighter second half. Payroll Employment Improves

The better-than-expected July employment report was a welcome relief after a string of disappointing data. Nonfarm private payroll employment increased by 154,000 in July, and June and May were revised up to increases of 80,000 and 99,000, from the previous estimates of 57,000 and 73,000. Government employment continued to trend down, subtracting 37,000 jobs, some of which can be attributed to the temporary Minnesota state government shutdown. This left total nonfarm employment growth for July at 117,000, probably not enough to keep up with population growth, but consistent with a still-growing economy. The household survey reported a small decrease in employment that was offset by a larger decrease in the labor force, lowering the unemployment rate to 9.1 from 9.2 percent.

Financial Markets Unsettled

Financial markets have moved cautiously since disruptive geopolitical events early in the year, gauging the potential impacts of higher commodity prices on U.S. growth and the slowly unfolding European debt crisis. These concerns accelerated in the first week of August. Chart 5 shows the spread between yields on junk bonds and AAA-rated corporate bonds has been on the rise since its three-year low in February, increasing from 200 to 250 basis points at the end of July, and then jumping to 419 by Aug. 9. This is associated with increasing uncertainty. As the economic outlook deteriorates, there is an increased probability of default, and more-risky bonds have to pay a higher premium relative to bonds seen as safe.

Looking Ahead

Incoming data and revisions to past data dampened expectations. The relief of resolved U.S. debt negotiations was quickly replaced by questions regarding the strength of the global recovery. There are obvious reasons for caution, but leading indicators still point to growth, and employment continues to increase, however slowly.

—Tyler Atkinson

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About the Author

Atkinson is a research assistant in the Research Department of the Federal Reserve Bank of Dallas.

Notes

1. “Recent Unemployment Increases Break the Law,” by Nicole Ball and Evan F. Koenig, Federal Reserve Bank of Dallas National Economic Update, June 29, 2009.