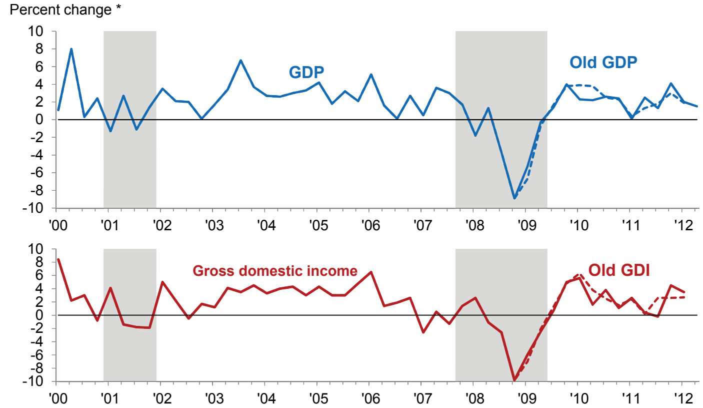
DALLASFED Economic Update
National

Recent Weakness Sets Pace for Uncertain Second Half

August 6, 2012

The U.S. economic recovery is facing a midyear pause. In the first half of 2012, real gross domestic product (GDP) grew at a 1.8 percent pace. Fears of a global slowdown and the sovereign debt situation in Europe remain big downside risks to the recovery and have the potential to drive down net exports while also negatively affecting financial markets. Government spending continues to be a drag on economic activity, yet anemic job growth remains the main concern in this phase of the recovery. In contrast to the employment figures, the core personal consumption expenditures (PCE) inflation rate remains just below the Federal Open Market Committee's (FOMC) 2 percent target rate. The recent national income and product accounts (NIPA) revisions—NIPA measures domestic product and income—may shed some light on the state of the economy.

Chart 1
Revisions Reveal Greater Deceleration in Economic Activity
Percent change *

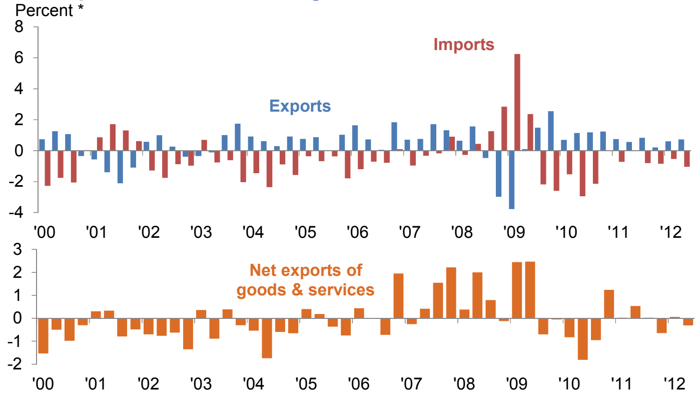


* Seasonally adjusted, annualized rate.
NOTE: Shaded areas indicate recession.
SOURCE: Bureau of Economic Analysis.

Net Effects of NIPA Revisions Limited

In its July 27 release, the Bureau of Economic Analysis published revisions dating back to first quarter 2009. The overall picture given by the data has not changed—the reported level of economic activity is only slightly below its prerevision level—although it appears that the initial stages of the recovery were in fact weaker, while growth in 2011 proved to be stronger than previously thought (*Chart 1*). This implies that the slowdown in the first half of 2012 is an even greater deceleration than first observed. Much of the weakness has been concentrated in durable goods, where nominal spending has fallen for four consecutive months. Gross domestic income (GDI)—another measure of domestic economic activity that theoretically should be equivalent to GDP but differs due to differences in measurement—shows a story similar to that seen in GDP. The new data, along with the revisions, are consistent with an economy growing very modestly, and one that may be facing a number of headwinds limiting growth potential.

Chart 2
Net Exports Exert Modest Drag
Percent *

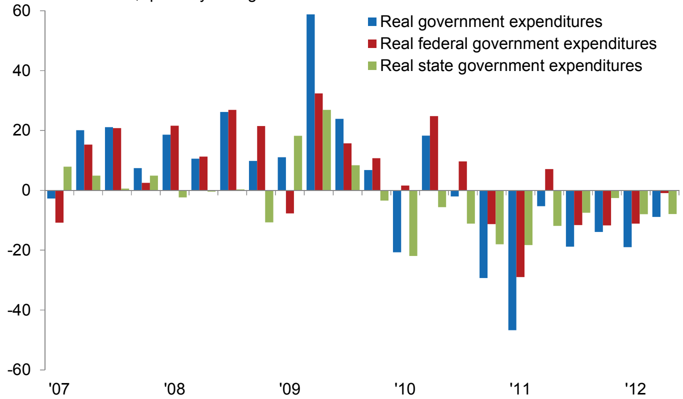


* Contribution to real GDP; seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Can Exports Continue to Be a Boon?

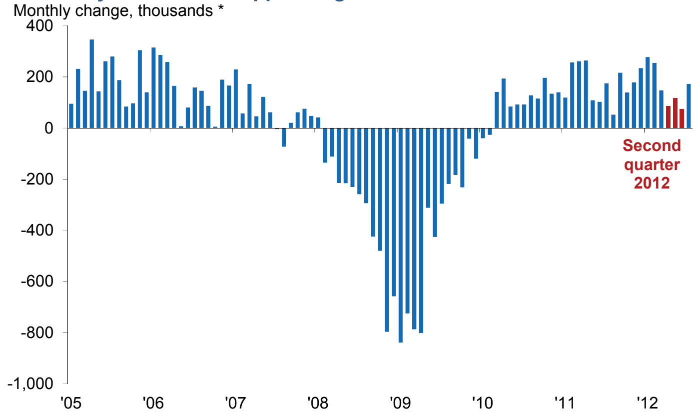
Net exports have tended to be a moderate drag on the economy during the recovery. While imports have been less of a drag on the economy over the past two years, the positive contribution of exports has been fairly consistent, with a slight downward trend (*Chart 2*). Over the past three years, real exports of goods and services have contributed an average of 1 percent to real GDP growth, though fourth quarter 2010 is the last quarter the annualized contribution was greater than 1 percent (1.2 percent). With the current conditions in Europe, it seems unlikely that exports will be able to continue to

Chart 3
Government Expenditures Approaching Bottom?
Billions of dollars, quarterly change*



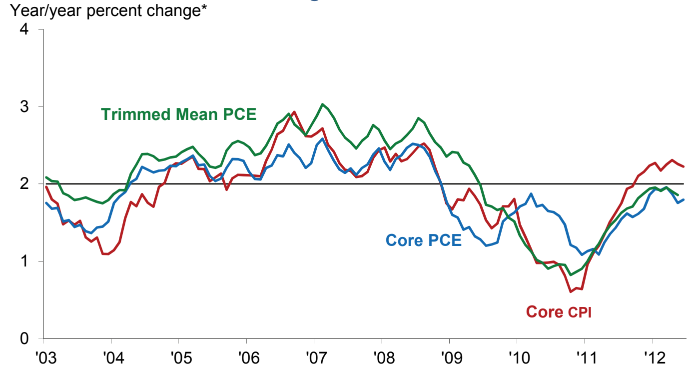
*Seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Chart 4
Weak Payrolls Less Disappointing
Monthly change, thousands *



* Seasonally adjusted.
SOURCE: Bureau of Labor Statistics.

Chart 5
Inflation Stabilizes Around Target
Year/year percent change*



*Seasonally adjusted
NOTE: Black line indicates the Federal Open Market Committee's inflation target of 2 percent.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

contribute to economic growth. Meanwhile, the drag caused by government spending may be bottoming out.

Government Sector Less of a Drag

Real government spending and investment has fallen for eight consecutive quarters (*Chart 3*), subtracting an estimated average of 0.6 percentage points from GDP growth each quarter. Real federal government consumption and gross investment has slowed its decline. The way in which the looming fiscal cliff is resolved will affect fiscal policy. A positive outcome may continue the current trend and lead to small increases—or at least no more decreases—in government spending. Reduced government spending is also hurting the job market; since the recovery began in June 2009, government employment has fallen by 698,000 jobs.

Stalled Improvement in the Labor Market

In its July snapshot of the labor market, the Bureau of Labor Statistics counted 172,000 more jobs on total nonfarm private payrolls than it did in June, slightly less disappointing than readings in recent months (*Chart 4*). Second quarter 2012 was a substantial slowdown from the average monthly gain of 226,000 jobs in first quarter 2012—the average second quarter gain was only 91,000 jobs per month. Sluggish employment growth bumped the unemployment rate up to 8.3 percent.

Inflation on Target

While achieving maximum employment has been elusive, it seems that prices have stabilized. After the FOMC in January officially announced a long-run inflation target of 2 percent in the PCE index (see Longer-Run Goals and Policy Strategy), core PCE has remained very close to the target (*Chart 5*). The core consumer price index (CPI) increased by 0.2 percent for the fourth consecutive month, and the change from a year ago dipped to 2.2 percent. The core PCE index held steady at 1.8 percent. The Dallas Fed's Trimmed Mean PCE measure has also been very consistent with core PCE over the past year. Despite the price stability, other uncertainties loom as financial market weakness increased in second quarter 2012 concurrently with growing economic and political uncertainty.

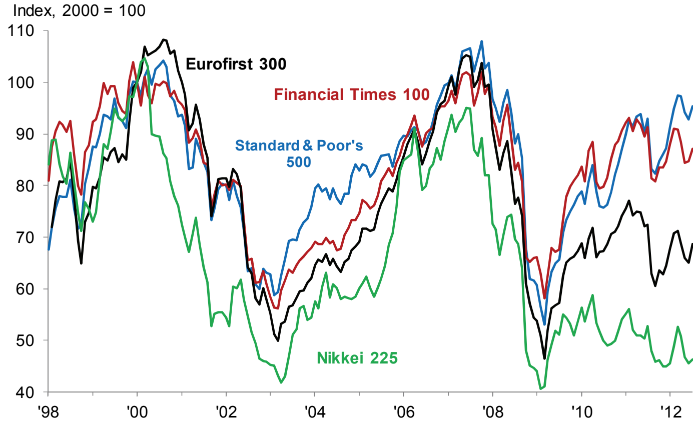
Uncertainty Plagues Financial Markets

A deterioration in sentiment toward the U.S. and Europe significantly decreased equity prices in second quarter 2012, yet there was a surprising bounceback in July (*Chart 6*). Uncertainty surrounding the upcoming election, the approaching fiscal cliff at year-end and the issues plaguing the euro area has manifested itself in stock prices; stock indexes almost all declined throughout second quarter 2012 (for instance, the Standard and Poor's 500 Composite was down 4.7 percent after being up 11.7 percent in first quarter 2012). Whether stock prices can continue their recent upward momentum in the face of significant headwinds will be interesting to see.

With the U.S. economy muddling along, the NIPA revisions reinforced the perception of weakness so far in 2012. Exports and financial markets both face headwinds coming from Europe; financial markets likely will also face domestic uncertainty in much of the second half of 2012. While net exports and the financial markets could be pulling back growth, government spending may become less of a drag once some of the political uncertainty recedes. Although employment has been very weak of late, there has been considerable strength in price stability.

—J.B. Cooke

Chart 6
Stock Indexes Decline



SOURCE: *Financial Times*; *Wall Street Journal*.

About the Author

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