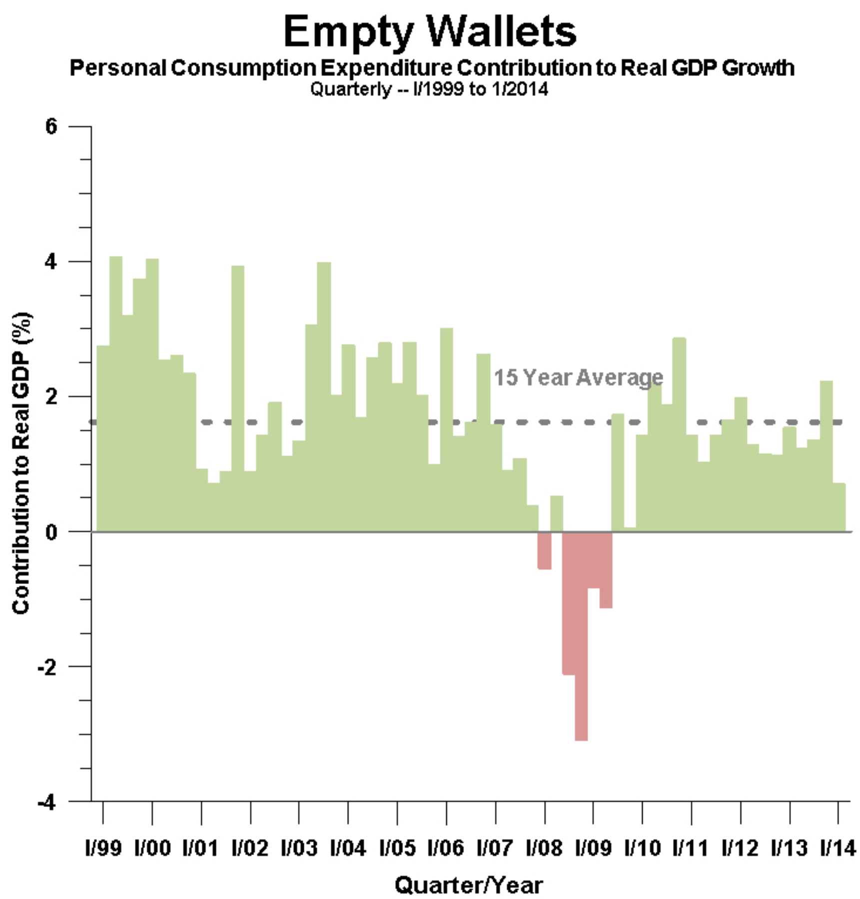
Straight from the Muse

Reflections of a Worldly Philosopher

That Stagnating Feeling



Notes:

Chart illustrates the percent contribution of personal consumption expenditures to real GDP growth (adjusted for changing prices) by quarter. Statistics are expressed as seasonally adjusted annualized rates (SAAR). All data obtained from the Bureau of Economic Analysis (BEA).

(Sources: BEA; Worldly Philosopher estimates.)

On Wednesday, June 25, the Bureau of Economic Analysis (BEA) released the third and final estimate for the real gross domestic product (GDP) for the 1st quarter of 2014.

In its flash report — released April 30th — the BEA's economists computed the US economy (in inflation adjusted terms) grew a smidgen (0.11 percent) during the first three months of the year on a seasonally adjusted annualized rate (SAAR).

In the first revision (dated May 29th), modest growth gave way to a 1.0 percent contraction. By its final estimates, the BEA concluded the US economy shrank by 2.9 percent (SAAR).

For some perspective, the 1st quarter's contraction is the worst performance for the economy since its collapse in the 4th and 1st quarters of 2008 and 2009. While real GDP growth has been anemic since the recovery began in the 2nd quarter 2009, the pace, though torpid, has at least been in the

"What is bureaucracy? An arrangement of individual incompetences for the purpose of general responsibility."

Anton Kuh (1890 to 1941), Austrian Journalist and Commentator

"By continuing a process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens."

John Maynard Keynes (1883 to 1943), British Economist and Political Commentator

"Corporation, n. An ingenious device for obtaining individual profit without individual responsibility."

From the *Devil's Dictionary*

Ambrose Bierce (1842 to 1913?), American Journalist and Writer

Yeah, I am on Twitter too. Follow my sporadic tweets at *mymuseclio.*

"A good politician is quite as unthinkable as an honest burglar."

H.L. Mencken (1880 to 1956), American Man of Letters

"I am a firm believer in the people. If given the truth, they can be depended upon to meet any national crisis. The great point is to bring them the real facts."

Abraham Lincoln (1809 to 1865), 16th President of the United States

right direction. Weather is blamed as the culprit. But this correspondent fears other forces besides the winter's polar vortex and "sno-pocalypse" are responsible. Pinning the blame on the severe winter may be convenient but an analysis of the numbers suggests the spring and summer may bring little relief to the struggling US economy.

Already — weeks before the flash report for the 2nd quarter is out on July 30 — there are signs that economic activity is unlikely to rebound in the current quarter. On Thursday, the BEA released personal income and consumption expenditure estimates for May. In real terms, personal consumption expenditures declined 0.1 percent (from April) which follows a 0.2 percent decline in April. Unless consumers suddenly become fast and loose with their wallets in June then the probabilities are against a robust gain in personal consumption spending in the 2nd quarter. Of course, there is always the chance the April and May numbers may be revised upwards. But behind an optimistic forecast there must be a better reason for it, then the belief a government bureaucrat has neglected to carry a "one" in his sums. That errors abound in all economic statistics is not a compelling argument.

Without strong consumption spending, there is little hope for a healthy gain in overall economic activity. Why? As goes personal consumption, so goes the overall economy.

Seeing Red

Revisions in Percent Contribution to Real GDP

1st Quarter 2014

		CHANGE		
	FLASH	**1st**	**2nd**	**FINAL**
GROSS DOMESTIC PRODUCT	0.11	(1.11)	(1.93)	(2.93)
PERSONAL CONSUMPTION	2.04	0.05	(1.38)	0.71
Goods	0.08	0.08	(0.12)	0.04
Services	1.96	(0.03)	(1.26)	0.67
GROSS PRIVATE DOMESTIC INVESTMENT	(1.01)	(0.98)	0.02	(1.97)
Nonresidential	(0.25)	0.05	0.06	(0.14)
Residential	(0.18)	0.02	0.03	(0.13)
Change in Private Inventories	(0.57)	(1.05)	(0.08)	(1.70)
NET EXPORTS	(0.83)	(0.12)	(0.58)	(1.53)
Exports	(1.07)	0.24	(0.29)	(1.12)
Imports	0.24	(0.36)	(0.17)	(0.29)
GOVERNMENT SPENDING	(0.09)	(0.06)	0.01	(0.14)
Federal	0.05	0.00	0.00	0.05
State & Local	(0.14)	(0.06)	0.02	(0.18)

Notes:

Table shows the changes in the estimates for 1st quarter 2014 real GDP growth, as well as, variations in the contribution of its major components to overall economic activity during the quarter. Change columns reflect the magnitude of the first and second revisions; summing across the flash and change columns results in the final estimate.

All statistics are adjusted for changing prices, or, inflation. And, all statistics reflect seasonally adjusted annualized rates (SAAR). The table was constructed using data obtained from the Bureau of Economic Analysis (BEA).

(Sources: BEA; Worldly Philosopher estimates.)

In the 1st quarter, consumption spending accounted for a bit more than two-thirds of the nation's real GDP. This proportion has remained relatively stable for the past two decades or so. Within consumption spending, service expenditures account for about two-thirds. The obvious conclusion is a change, higher or lower, in spending on personal services has a disproportionate impact on GDP growth.

And such was the case during the 1st quarter. Out of the gate, it initially seemed strong consumption spending growth could compensate for weakness elsewhere. While overall economic activity was anemic for the quarter — 0.11 percent growth in real GDP — personal consumption spending (led by services) made a large, positive contribution to economic activity. But in the second revision, consumption was marked down, driven by a sharp revision lower in service spending.

In the final tally, lackluster spending growth on goods and services could not compensate for a sharp drop in inventory investment and a deceleration in export growth.

Now the key reason for the large negative revision in service spending — a contraction in health care spending — gives cause for concern. In the flash report, BEA economists estimated health care spending contributed 1.10 percent to GDP. But in the final revision, health care spending actually declined 0.16 percent. The large swing reduced the original GDP figure by 1.26 percent.

What explains the reversal? Well, it certainly was not an outbreak of general wellness in the United States, obviating visits to the doctor and trips to the hospital.

Weather may have been a factor. But bear in mind during the past fifteen years, health care spending has detracted from GDP growth in only three other quarters. In the preceding fifteen year period — 1984 to 1998 — health care spending detracted from overall economic activity in just four other quarters. Over the past thirty years, health care spending has relentlessly increased with few interruptions — none sustained.

I suspect other factors are involved. One possibility is what I term the Obama-care shock. Anecdotal evidence suggests American households opted for higher deductibles and co-pays to keep health care insurance premium increases reasonable. The realization that a trip to the doctor now demands a large, upfront payment may have a deterrent effect, giving Americans occasion to pause before seeking routine medical care.

If so, this is not necessarily a bad thing long term: especially if a change in behavior helps to moderate health care inflation. In the short-term though a sudden penchant for economy may temporarily retard growth.

From a payrolls perspective, health care has been one of the few bright spots in the labor market. Employment grew throughout the recession; and continued to grow at a more rapid pace in the recovery. At this point predicting just how a sudden shift in consumer spending will effect economic growth is difficult. If it frees up money to be spent on other goods and services, the overall impact may be negligible.

But if it is an indication of tight household finances, then the prognosis is not favorable. And, the sharp increase in housing and utility expenditures during the 1st quarter suggests consumers may have been forced to pick and choose.

Consumer spending on these services grew by 1.60 percent in the first three months of the year. The increase reflects in part double-digit year-over-year jumps in propane and piped natural gas prices in January, February and March. My conjecture is rapidly rising seasonal energy costs strained budgets forcing savings elsewhere.

"Nature abhors a moron."

H.L. Mencken (1880 to 1956), American Man of Letters

"An unlimited power to tax involves, necessarily, the power to destroy."

Daniel Webster (1782 to 1852), American Senator, Statesman and Jurist

"It will be to little avail to the people that the laws are made by men of their own choice if the laws are so voluminous that they cannot be read, or so incoherent that they cannot be understood."

James Madison (1751 to 1836), American Political Theorist and 4th President of the United States

"You have not, I suppose, ever mixed with politicians at close quarters. They are awful…their stupidity is inhuman…"

John Maynard Keynes (1883 to 1943), British Economist and Political Commentator

"Every revolution evaporates and leaves behind only the slime of a new bureaucracy."

Franz Kafka (1883 to 1924), Czech Author and Man of Letters

If economies are needed, higher deductibles and larger co-pays provide an incentive for consumers to forgo routine medical care, unless urgent.

This hypothesis implies households — on average and in the aggregate — have little leeway to absorb price shocks. Furthermore this suggests there is little free, discretionary purchasing power available to drive economic growth. Warm weather may bring a respite unless it is accompanied by surging gasoline and electricity prices.

I hope I am proven wrong. But if my hypothesis is correct, then stretched household finances leave the nation vulnerable to future periods of stagnating GDP growth.