



Popular Economics

Promoting the Popular Understanding of Economics

Popular Economics Weekly

Week of February 25, 2008

Prospects For Growth

The second 'estimate' of fourth quarter Gross Domestic Product growth, the sum of all goods and services produced domestically, was unchanged at just 0.6 percent. This caused interest rates to plunge one-quarter percent in a day, as fears of a further economic slowdown rose. But the report also showed us how growth is continuing, as the weakness lies in imports and consumer spending—areas that can turn around quickly—while exports that support our manufacturing sector continue to expand.

The slowdown, affecting about 80 percent of U.S. households, seems to be caused in large part by rising inflation. Exports, which make up about one-third of our economy including high technology, have been largely shielded from inflation since the falling dollar has made U.S. goods cheaper overseas.

Consumer spending is still rising at more than 2 percent, which would normally mean 2 percent + economic growth. But an inflation rate of more than 4 percent—mainly in food, energy and health care costs—is soaking up all the excess monies, bringing down the real, after inflation growth rate.

In addition, the Federal Reserve raised their interest rates seventeen consecutive times from 2004-2006, until the real estate bubble burst and damaged the credit markets. Consumers are out of sorts because real, after inflation household incomes have fallen 5.6 percent since 2000 while their borrowing costs rose along with the interest rates. And homeowners can't continue to borrow against their homes since the Fed's credit tightening moves.

So Bernanke, et. al., are now trying to undo the damage by dropping interest rates back to 2004 levels. This has already happened with fixed mortgage rates, which briefly dipped to 5 percent for 30-year conforming fixed. But the Fed's so-called funds rate, now at 3 percent, would have to near its 1 percent low in 2003 to really grease the wheels of a recovery.

Will all the talk make the 'R' word a self-fulfilling prophecy? Probably not, as inventories have declined as well, which took a huge 1.5 percent bite from growth. Had producers replenished their inventories at the normal rate, real GDP growth would have been above 2 percent. Exports rose 4.8 percent in Q4, contributing 0.9 percent to growth. "To the extent that the fourth-quarter mix includes stronger sales and weaker inventories than previously assumed, the figures were modestly good news for the economy," said one well-known economist.

The jury is out on when the inflation-caused slowdown will end because it requires some hard political choices to cure the inflation surge. This is because its major cause is the rising demand for energy at the same time that we have twin trade and budget deficits that have driven the dollar's value to new lows. This in turn has driven oil prices to new highs because oil producers are paid in dollars that have declined about 30 percent in value on the world markets.

What will bring the dollar's value back? Some very disciplined actions by a much

more fiscally conservative government that substantially reduces the budget deficit.
Need we say more?

Copyright © 2008