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GDP: The Economy Surprises Again

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Real Gross Domestic Product (GDP), the most basic and comprehensive measure of economic growth in the U.S., grew 4.9% in the third quarter last year. This was a major surprise, far exceeding estimates. Then, it did it again in the fourth quarter, growing 3.3% compared to expectations of 2.0 to 2.5%. These two quarters are even more impressive when compared to the widely accepted sustainable growth rate for the economy of 1.8%. What is going on?

Looking back, last year was notable on several fronts, each positive. Not only did Real GDP grow 3.1% for the full year, but this occurred while unemployment remained near record lows and inflation fell dramatically. It was a stellar year for the economy, one that defied widespread predictions that the economy would suffer under restrictive monetary policy and fall into a recession. Indeed, it was a happy outcome, and in retrospect one can only assume that the U.S. economy is in very good shape.

As a quick reminder, Real GDP measures the combined inflation-adjusted growth from four sectors: 1) consumption (the consumer), 2) investment, 3) government spending, and 4) net imports/exports. The consumer is by far the most important, accounting for almost 70% of total GDP. And it was another remarkable achievement by the consumer that led to the quarterly growth of 3.3%. Of that 3.3% growth, consumption accounted for 1.91%, while investment, government, and net imports/exports accounted for 0.38%, 0.56%, and 0.43% respectively. The consumer is not the whole ball of wax, but it is the biggest player by far in the GDP calculation.

It is often said that it is not wise to bet against the American consumer. In the third and fourth quarters of last year it certainly would have been a bad bet. The real issue at this point is, can they keep it up? Considering that most consumers have a high propensity to consume, if they have the money it is a reasonable assumption that they will. A lot of the money that they have used to spend came from stimulus checks and savings that accumulated during the Covid shutdown period. It is very difficult to know how much of those accumulated savings still exist, but it is probably safe to assume that the rapid pace of consumer spending has eaten into those savings, suggesting that consumption may weaken somewhat as we move through this year. On the other hand, wages are now growing faster than inflation, thereby creating real, after-inflation spending power.

The most powerful element in consumption is employment. As long as unemployment remains low, consumption should remain healthy, if not as strong as recently. When people have jobs, they spend, especially if plenty of jobs are available should they lose theirs. The Federal Reserve (Fed) has been

attempting to reduce demand and bring inflation down to the 2% target. The assumption was that higher interest rates would weaken demand and cause unemployment to rise. As it has turned out, tight monetary policy has yet to do either. Unemployment has risen only slightly, and demand has not been reduced.

We would assume that at some point the lagged effect of restrictive monetary policy will begin to reduce demand and increase unemployment. One of the great economic unknowns is how long it takes for changes in monetary policy to take effect. In this cycle the buildup of excess savings in the pandemic has likely extended the lagged effect of restrictive monetary policy. And unless there is a major error in the assumptions surrounding the natural rate of interest, it seems best to assume that at some point higher interest rates will make an impact on the economy. This is why forecasts for this year assume slower growth.

We would like to think that GDP growth in the last two quarters is the beginning of a sustainable, high-growth phase for the economy. Perhaps this can be the case for the short-to-intermediate term, but we believe that over the longer term, structural elements are likely to limit growth in that area to around 2%. Demographic issues are a headwind. Both population growth and the aging of our population imply slower growth, and any changes in these trends are very slow moving. High government debt is another limiting factor, as servicing the debt reduces resources that could be committed to investment. High government debt could also imply less deficit spending in the future.

For now, we celebrate the outstanding performance of GDP. It certainly raises confidence in the adaptability of our economy and augurs well for rising standards of living in the future. The future is not risk free, but for now, the present is pretty good.

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