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## The Truth Behind Much-Vaunted U.S. GDP Growth

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Global stock markets are on a tear and economists are busy revising up their growth forecasts for America for this year and next. Yet, more Americans are without jobs today than they were three years ago and there is no imminent sign of a turnaround in the labor market. Faced with this contradiction, most have taken the easy way out of the contradiction. They predict a lagged recovery in the labor market next year. They may yet be disappointed.

Compared to previous recessions, the current recovery has not added jobs because there is no genuine recovery yet.

Statistics have clouded the picture and concealed the underlying poor quality of growth in America. This has also resulted in unfair comparisons that depict European economies in poorer light relative to America.

Deeper examination reveals a different picture. The second-quarter real gross domestic product (GDP) growth was 3.1 per cent (annualized). In dollar terms, America added US\$73.5 billion to its GDP in constant 1996 dollars. More than US\$40 billion of this increase in real GDP came from the increase in national defense expenditure.

It was clearly due to the war on Iraq and unlikely (one hopes) to repeat itself every quarter. Another US\$38.5 billion came from real expenditure on computers and peripheral equipment or information technology (IT) equipment.

However, it is not possible to argue that real spending on computers and peripheral equipment contributed 52 per cent to the second-quarter real GDP change (US\$38.5 billion out of US\$73.5 billion). The Bureau of Economic Analysis warns us that while the chained-dollar estimates for computers could be used to accurately measure its real growth rate over time, the chained-dollar estimates should not be used to measure the component's relative importance or its contribution to the growth rate of more aggregate series.

The reason is that computers and similar components exhibit rapid price changes relative to other prices in the economy. Indeed, Table 8.2 of the National Income Tables published by the Bureau of Economic Analysis shows that the annualized contribution of computers and peripheral equipment is 0.34 per cent out of 3.1 per cent.

That is a significantly smaller 11 per cent contribution to second-quarter growth and not 52 per cent. However, a strong case still exists that statistical adjustments to IT spending considerably distort and inflate U.S. real GDP growth.

Let us look at the last three years since the U.S. technology bubble - both in terms of the stock market and technology spending - burst in the second quarter of 2000. Nominal value of investment in computers and

peripheral equipment stood at US\$95.7 billion at the end of Q2 2000. By the end of the second quarter of this year, this figure has shrunk to US\$82.6 billion.

That is a contraction of 13.7 per cent over three years or a compounded annual contraction of 4.8 per cent. In contrast, the 'real value' of investment spending (more precisely, as calculated by the statisticians at the Bureau of Economic Analysis) in computers and peripheral equipment has climbed from US\$249.2 billion to US\$357.5 billion - an increase of 43.5 per cent - during the same three-year period.

That is, quality-adjusted price deflation in computers and peripheral equipment has turned a nominal contraction of 13.7 per cent into a real increase of 43.5 per cent. That is a hefty swing of 57.2 per cent.

What accounts for such a swing? While most countries only adjust for price changes, the U.S. government factors in the quality improvement in IT equipment and recalculates a quality-adjusted price, which enhances the deflation rate for this category. That, in turn, boosts the real investment in IT equipment shown in national income accounts.

How much of a boost has this 'innovative' growth accounting contributed to U.S. real GDP? Between Q2 2000 and Q2 2003, American real GDP has grown by a cumulative 4.6 per cent. As seen above, real investment in IT equipment has increased 43.5 per cent in this period. Further, the average contribution of computers and peripheral equipment to US real GDP growth - based on Table 8.2 of the National Income Tables - works out to 11.4 per cent over the last three years.

That is, 'real investment' in computers and peripheral equipment has contributed 5 per cent (43.5 per cent multiplied by 11.4 per cent) to U.S. real GDP growth over this three-year period. This exceeds the real GDP growth rate of 4.6 per cent. In other words, but for the hedonic adjustment to prices (quality-adjusted price change) of IT equipment, American real GDP over the last three years would have stagnated at best or contracted at worst. So should one be surprised that the American economy still sheds jobs?

Further, it reveals the truth behind the recent surge in productivity numbers: output boosted by hedonic accounting and divided by a shrinking labor input would naturally result in a higher productivity rate. It is just a statistical artifact.

Not only are these tales not being fully told, these statistics are used to berate the economic performance of other countries and regions in the world. In fairness, comparisons should be made only after removing the effect of quality-adjusted deflation in the U.S. data.

However, that is rarely the case and hence one really is comparing apples with oranges when headline European and U.S. real GDP growth rates are compared.

The perception that has been created by talking heads is one of a resurgent America and stagnant Europe. The disinformation becomes more farcical when we learn that, since the creation of the single currency, nominal GDP in the Eurozone has grown faster than in America (see chart above).

Whatever little growth there is in the economy, its underpinnings are not healthy either. The Federal Reserve just released the Flow of Funds data for the second quarter. At 14.2 per cent, the (annualized) growth rate of home mortgage debt was the highest since 1979.

In dollar terms, households added US\$397.6 billion of debt through mortgages and another US\$40 billion in revolving credit. Net worth of households (and non-profit organizations) has increased by 3.7 per cent annually since 1997 but their debt has grown at an 8.8 per cent annual rate.

It is no surprise that consumer spending has remained resilient through the shallow recession and into the recovery. The surprise is the facile consensus assumption that it would continue forever.

It is difficult to predict the arrival of the payback time for the American economy. However, it is even harder to deny that there won't be any. As Abraham Lincoln famously noted: It's not possible to fool all the people all the time.

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