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Needed: Better GDP Growth

By GENE EPSTEIN

The latest GDP Report was disappointing, but better real GDP must be higher for the recovery to be over and expansion to begin.

"**THE GDP REPORT MAY EASE** some fears that the U.S. is heading for a double-dip recession....But it also confirms widespread concerns about a sharp economic slowdown," commented The Wall Street Journal.

That news item could have been responding to Friday's report on GDP growth in this year's second quarter. But it actually appeared in early February 2003. Widespread concerns about an economic slowdown seemed even more warranted at the time, because growth in gross domestic product had been running much slower. We know now that the sharp economic slowdown then expected turned out to be a sharp acceleration by the second half of 2003.

The point is not that a sharp acceleration will necessarily occur in the second half of 2010. But quarterly GDP growth is littered with examples of slowdowns—and speed-ups—that turn out to be short-lived, while often inspiring economic commentators to regard them as long-lived.

THAT KIND OF OVERREACTION seems to be occurring now. The slowdown in GDP growth, to an annual rate of 2.4% in second quarter 2010, tells us nothing decisive about prospects for the second half. Components of the report can be interpreted to mean faster or slower economic expansion to come, depending on your inclination. What the report does confirm is that the recovery that began in the third quarter of last year continues, and that a double dip seems increasingly unlikely. In all, there have been four quarters of consistent growth, accompanied by not-unusual volatility.

Based on revised figures released in Friday's report, real GDP climbed at an annual rate of 1.6% in the third quarter, 5.0% in the fourth and 3.7% in the first, before slowing to 2.4% in the second. Since this four-quarter performance averages to 3.2%, it would not be surprising if future quarters revert to this trend. While 3.2% would still be disappointingly subpar, it would at least be fast enough to bring a continued decline in the unemployment rate.

Those who think differently might emphasize that, while 2.4% was roughly in line with the consensus expectation for the second quarter, the mix was much worse than expected. Real consumer spending rose at an annual rate of just 1.6%, against an expectation of 2.4%.

But goods consumption was up a reasonably healthy 3.4%, while consumption of durables—generally bought on credit—rose 7.5%, again belying the myth that consumers have stopped buying with borrowed money. Consumption of services was the real drag, advancing only 0.8%. But that component of consumption should pick up in the current quarter, partly driven by an increase in utilities services due to the heat wave.

Revisions to consumer spending reaffirmed the ineffectiveness of fiscal stimulus to boost consumption. In response to both the cash-rebate program under Bush in 2008 and the stimulus package under Obama in 2009, consumers perversely cut consumption. And personal savings rates were revised up, thus underscoring that consumers squirreled away the government-bestowed cash, possibly out of concern that the deficits could mean higher taxes later on.

For the recovery to end and the expansion to begin, real GDP must be higher than its previous peak, reached in fourth-quarter 2007, and we are not there yet. For that to happen, growth in the current quarter must run at annual rate of 4.5%.

Don't bet on it, but maybe hesitate to bet against it.

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