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WHICH SECTORS STRENGTHEN THE ECONOMY AND WHICH ONES WEAKEN IT?

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The current recession began in late 2007. Many regard it as the worse setback since the Great Depression of the 1930s. Whether it is or not -- there are no reliable estimates of unemployment before the early 1940s -- there is virtually universal agreement that it is the worse slump since the early 1980s. Using estimates of GDP by economic sector to identify which sectors weakened and which ones strengthened the economy, Mayo Research Institute was able to measure each sector's impact on the annual percent change in GDP in 2007, 2008, and 2009.

GDP is based on four expenditure estimates: household consumption, business investment, net exports (exports minus imports), and government. We examined household consumption in two parts: goods and services. We looked at business investment in terms of fixed investment spending and private inventories, and government in terms of federal defense expenditures, federal nondefense expenditures, and state and local government. We approached our task by asking this question: What happens to the annual estimate of the percent change in GDP when a sector is removed from the total estimate? This approach allows us identify which sectors made a positive contribution to GDP and which ones made a negative contribution.

A sector *weakens* the economy whenever a percent increase in GDP (2007, 2008) would have been even larger without that sector or whenever a percent decrease in GDP (2009) would have been smaller without that sector. A sector *strengthens* the economy whenever a percent increase in GDP would have been smaller without that sector or whenever a percent decrease in GDP would have been larger without that sector.

The sector with the greatest overall weakening effect on the economy was business investment. Specifically, fixed investment had greatest weakening impact in 2007 and 2008 and inventory change in 2009. In a downturn, goods-producing enterprises are able to cut costs by reducing current production, laying off workers, all the while meeting customer demand by selling from their inventories of finished goods.

Household expenditures on services contributed more to GDP in 2007 than any other sector. Exports contributed the most in 2008 and 2009. A weaker dollar made U.S. produced goods and services cheaper against foreign produced goods and services. Notice how the dollar weakened between October 10, 2008 when one euro exchanged for $1.2446 and December 1, 2009 when it exchanged for $1.5099, effectively making U.S. produced goods and services cheaper compared to goods and services from the European Union.

The weaker dollar had another effect on foreign holders of securities issued by the U.S. Treasury. The dollars invested in and earned on those securities bought less in terms of goods and services produced in, for instance, the European Union because on October 10, 2008 €100 in EU goods and services cost $124.46 whereas the same €100 in EU goods and services cost $150.99 on December 1, 2009. To protect themselves against the weaker dollar foreign holders of U.S. Treasuries in China, the oil-exporting countries, the Caribbean banking centers (Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, and Panama), Russia, Singapore, and many other countries including Mexico last year actually reduced their holdings of those securities.

	Percent Change in GDP		
	2007	2008	2009
Official GDP estimates	+2.10	+0.40	-2.40
GDP estimates ***without*** …			
Household goods	+1.35 strengthen	+0.90 weaken	-1.94 weaken
Household services	+1.01 ***strengthen***	+0.08 strengthen	-2.46 strengthen
Fixed investment	+2.45 ***weaken***	+1.21 ***weaken***	+0.35 weaken
Inventory change	+2.40 weaken	+0.77 weaken	-1.66 ***weaken***
Net exports	+1.47 strengthen	-0.80 ***strengthen***	-3.48 ***strengthen***
Federal defense	+2.00 strengthen	+0.03 strengthen	-2.68 strengthen
Federal nondefense	+2.11 zero	+0.24 strengthen	-2.51 strengthen
State and local	+1.87 strengthen	+0.34 strengthen	-2.39 zero

How best, then, to strengthen the one sector -- business investment -- which has had the biggest weakening effect on the U.S. economy over the last three years? In this matter, there are two major schools of thought. The first school recommends compensating for this weakness by stimulating aggregate demand mainly through increased federal expenditures. Leaving aside federal defense expenditures, which are driven by national security concerns, the data indicate that federal nondefense expenditures had zero impact on GDP in 2007, and only a very small positive impact in 2009 when the $787 billion stimulus package was signed into law.

The second school recommends stimulating aggregate supply -- incentivizing producers -- by cutting taxes on payrolls, profits, and capital gains. The supply-side school did not win favor last year with the Obama administration in part because the president's left-wing constituent base objects to cutting taxes on the rich. This liberal/progressive resistance is reinforced by new federal budget proposals, which would increase taxes on the rich.

The remedies proposed by both schools are vulnerable to the same serious side effect. If the economy does not respond, spending will exceed revenues, producing even bigger budget deficits. Facing a weaker dollar, the Treasury will find it more difficult to sell securities to foreign creditors. Finding the right way to grow the economy in order to reduce the jobless rate to a more acceptable level without unleashing inflationary forces and without growing the deficit is the challenge facing Washington today. We will know more as 2010 unfolds as to whether or not Congress and the White House are up to the task.

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