Misleading growth statistics give false comfort

By Martin Feldstein

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Prepositions matter. The recent government report that US gross domestic product increased 0.6 per cent *in* the first quarter was **very misleading**. It implied that economic activity was rising in January, February and March. But the increase actually refers to the rise *from* the average level in the fourth quarter of 2007 to the average level in the first quarter. Monthly data since January indicate that economic activity and GDP have been declining since the start of this year.

Private sector **payroll employment** peaked last November and has fallen five months in a row, shedding more than 300,000 jobs. Industrial production was lower in March than in December and January. Real personal income net of taxes and transfers is also lower than in January. Real retail sales have fallen since the start of the year. Private housing starts are down 13 per cent in just the two months since January and 36 per cent from a year ago.

Although the government does not provide monthly estimates of GDP, Macroeconomic Advisers, a private forecaster, constructs them using the same conceptual approach as the government uses for its quarterly estimates. The company estimates real GDP based on the price level of the year 2000. Its most recent estimates (revised figures to be published this month) show that real GDP rose from an annual $11,649bn last October to $11,701bn in December and $11,777bn in January but fell to $11,686bn in March, a decline of about $100bn in two months. Although GDP declined during the first quarter, the average of the monthly figures in the first quarter ($11,711bn) is higher than the average of the monthly figures for the final quarter of 2007 ($11,675bn).

The misstatement that the economy expanded in the first quarter creates an inappropriately sanguine view of the months ahead and therefore reduces the prospect of strong action to prevent the deep decline that may otherwise occur. Carlos Gutierrez, the commerce secretary, whose department produces the GDP estimates, said the 0.6 per cent increase supported the administration’s view that growth would be slower but positive in the first half. The administration predicts that after this slowdown the economy will grow more rapidly in the second half and in 2009.

Although the tax rebates now under way may provide some temporary help, the combination of falling real incomes, declining household wealth and a dramatic drop in consumer confidence suggests further falls in consumer spending and GDP. But the most serious risk is that the rapid fall in house prices – down more than 12 per cent in the past year and falling at a 25 per cent rate in the past three months – will raise the number of negative-equity mortgages, leading to widespread defaults and foreclosures.

Because US mortgages are "no-recourse" loans (lenders have no recourse to the house's owner beyond the value of the house), individuals with negative equity have an incentive to default. There are now an estimated 8m negative-equity mortgages – more than 15 per cent of all outstanding mortgages. Defaults are rising and foreclosures are now at twice the rate of a year ago. A downward spiral in house prices would cause a fall in household wealth and in the capital of financial institutions, potentially resulting in a deeper and longer recession than any seen in the past several decades.

Now is the time for policy action to forestall such a house price collapse. There is nothing more the Federal Reserve can do by lowering short-term interest rates or by creating new credit facilities. The Treasury proposal for voluntary negotiations between creditors and negative-equity homeowners has had relatively little success because a large share of mortgages have been securitised. **Congressional proposals** aim at helping homeowners with negative-equity mortgages and would at best help no more than 10 per cent of that group.

What is missing is action to prevent positive-equity mortgages from becoming negative-equity mortgages. The federal government could achieve that by providing low-interest loans with full recourse that would allow any homeowner to pay down a significant fraction of his mortgage. Homeowners would be in effect giving up the potential to default on their mortgage loans in exchange for lower interest costs.

Although political tensions make it difficult to achieve such a policy, a mistakenly benign view of first-quarter growth contributes to this stalemate. Policymakers must recognise the real economic condition and act quickly.

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