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INSIGHT

Understanding the Second-Quarter Fall in GDP

August 10, 2020

On June 8, 2020, the National Bureau of Economic Research (NBER), an independent, nonprofit research group, officially declared that the U.S. economy entered a recession in February of this year. On July 31, the U.S. Department of Commerce's Bureau of Economic Analysis (BEA) released estimates that the economy, as measured by gross domestic product (GDP), contracted at an annual rate of 32.9% in the second quarter of 2020 compared to the preceding quarter. In other words, if this pace of decline were to continue for four quarters, the economy would have shrunk by about one-third compared to the first quarter. It is expected that this figure will be adjusted slightly in the coming weeks, as is common with initial BEA advance estimates. Still, the decline in GDP is significant and is in addition to the 5.0% annualized contraction experienced in the first quarter of the year. As shown in **Figure 1**, the second-quarter contraction is the largest decline since BEA first started compiling data in 1948, and more than three times larger than the second-largest quarterly decline, which occurred in 1958. The second-quarter 2020 decline was driven by COVID-19, which caused widespread disruptions to supply (production) and suppressed private demand (spending). However, BEA cannot isolate the precise effects of COVID-19 on GDP.

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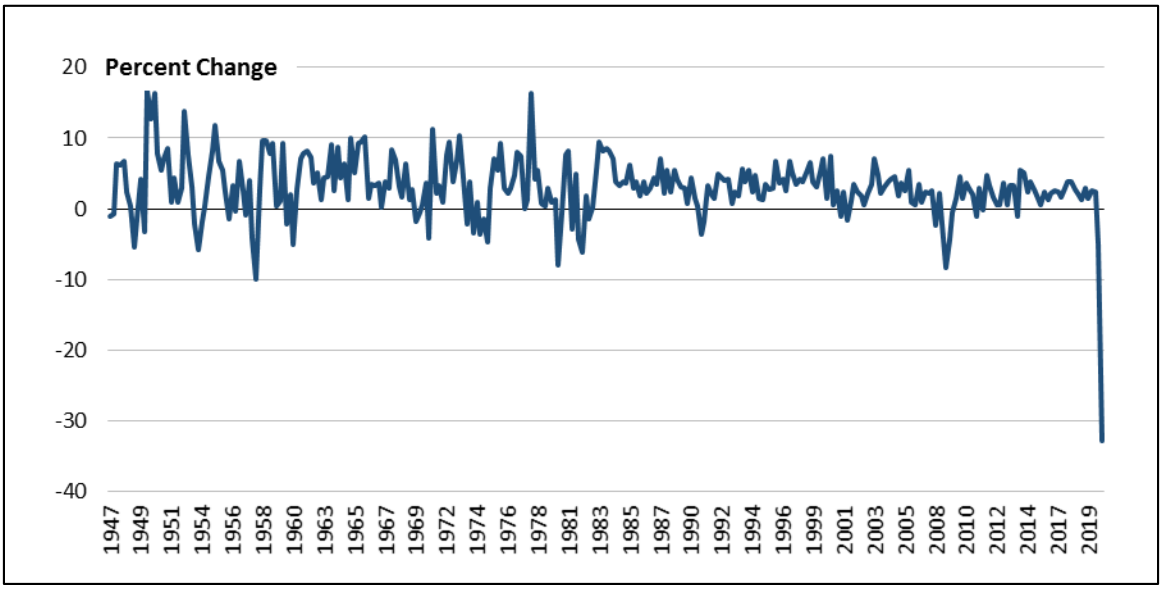
Figure 1. Quarterly Percentage Change in GDP, 1948-2020

(Annualized)



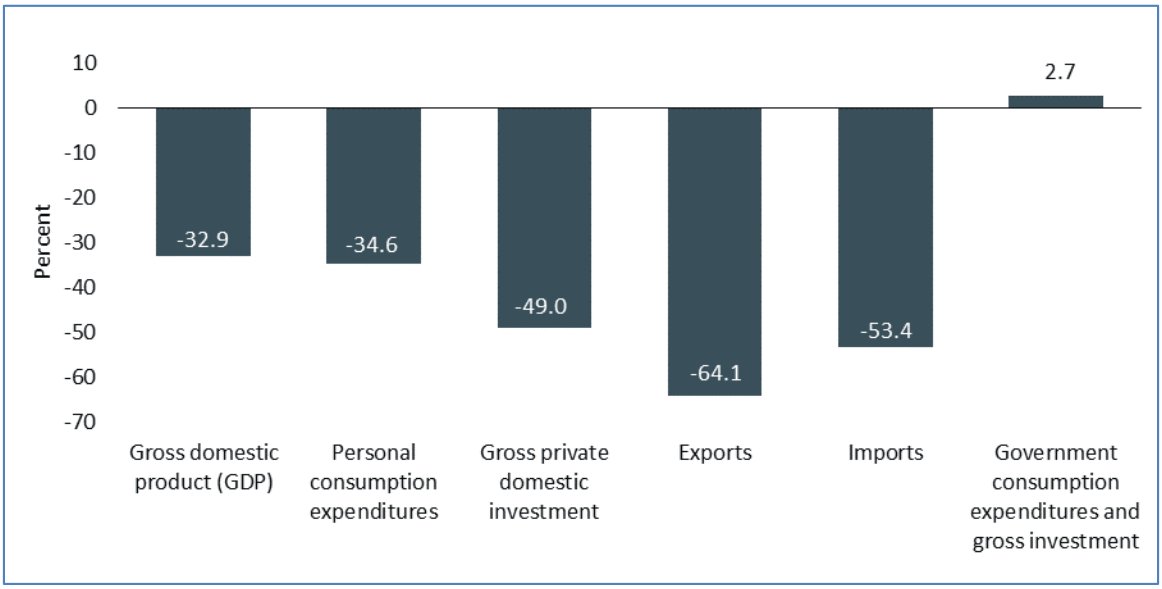
Source: BEA.

GDP and its Components

Figure 2 displays the percentage change in GDP from the preceding quarter for the second quarter of 2020 along with the percentage change in the five major categories used in the BEA's "expenditure approach" for computing GDP. The expenditure approach measures GDP as the purchases of final goods and services in the economy by households (personal consumption), businesses (private investment), foreigners (exports), and federal, state, and local governments (government consumption and investment). The purchases by Americans of foreign-produced goods and services are subtracted to capture domestic production. Summing the five categories displayed in **Figure 2** captures the demand side of the economy.

Figure 2 shows that all of the individual components of GDP declined significantly in the second quarter, with the exception of government spending, which increased slightly (2.7%). Although exports (-64.1%) and imports (-53.4%) declined the most in **Figure 2**, it is the value of exports minus the value of imports (i.e., net exports) that is a component of GDP. Both government spending and net exports tend to be relatively stable over short periods. In the second quarter, a large increase in federal spending was partly offset by a large decrease in state and local spending. This trend is likely to continue in the second half of the year, as COVID-19 continues to put pressure on state and local budgets and federal stimulus already enacted will continue to be spent.

Figure 2. Real Gross Domestic Product and Related Measures: Percentage Change in Q2
(Annualized)



Source: BEA.

Although a large decline in personal consumption was expected as consumers' fears, along with lockdown policies, kept shoppers home, the 34.6% decline was unprecedented in the post-WWII era. Consumption accounted for nearly two-thirds of GDP in the second quarter and has historically been quite stable, staying between 65% and 70% of the economy over the past two decades. The decline in consumption was concentrated in a 43.5% decline in spending on services, but spending in most categories of goods also declined.

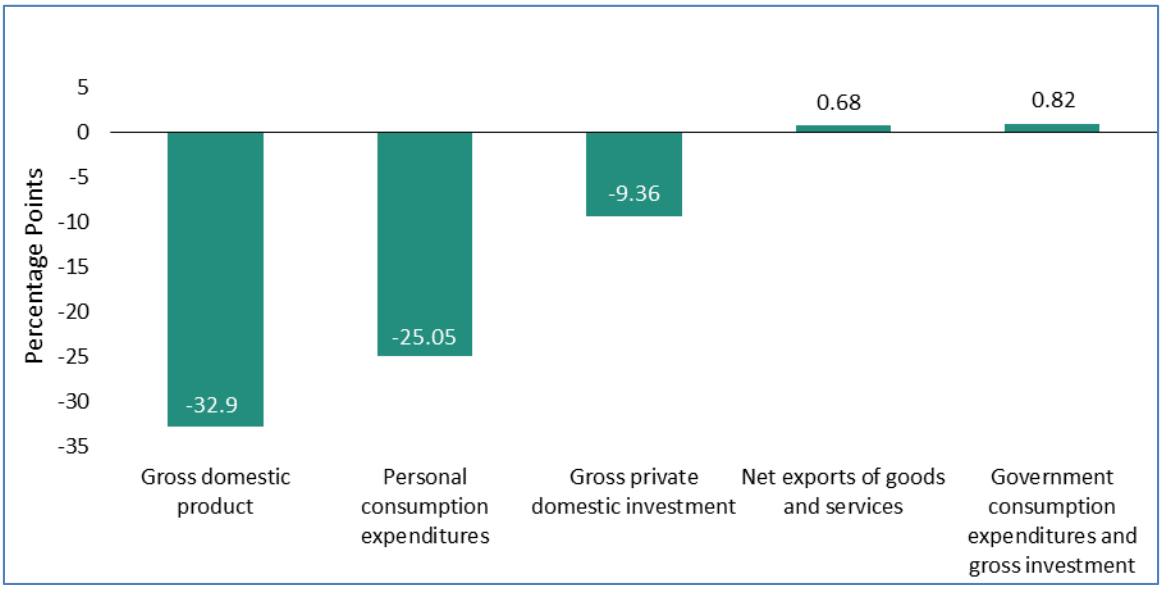
Gross private fixed investment, which consists of business and residential investment, declined by 49.0%. Investment is typically one of the primary sources of fluctuations in GDP, and its variability is well documented. Investment accounted for about 16% of GDP in the second quarter, implying its large decline was a significant contributor to the overall decline in GDP. Both business and residential investment experienced large declines.

Decomposing the Decline

The individual components displayed in **Figure 2** influence GDP differently because they differ in terms of their shares of the overall economy. To account for this, **Figure 3** decomposes the 32.9% second-quarter decline in GDP into the contribution of each of its components. That is, **Figure 3** accounts for both the size of the decline in the individual components (**Figure 2**) and the share of each component as a fraction of the overall economy. It is clear that the declines in consumption and gross private investment accounted for the entire decline in GDP. Specifically, personal consumption accounted for 76% (-25.05% divided by -32.9%) of the decrease in second quarter GDP, while private domestic investment accounted for 28% (-9.36% divided by -32.9%) of the decline. The sum of the two exceeds 100% of the decline in GDP because net exports and government spending made positive contributions to growth in the second quarter, but these contributions were small compared to the declines in consumption and investment. Although exports and imports both experienced large declines, because imports declined more than exports (in dollar terms), net exports made a positive contribution to growth.

Figure 3. Contributions to Second Quarter Percentage Change in Real Gross Domestic Product

(Annualized)



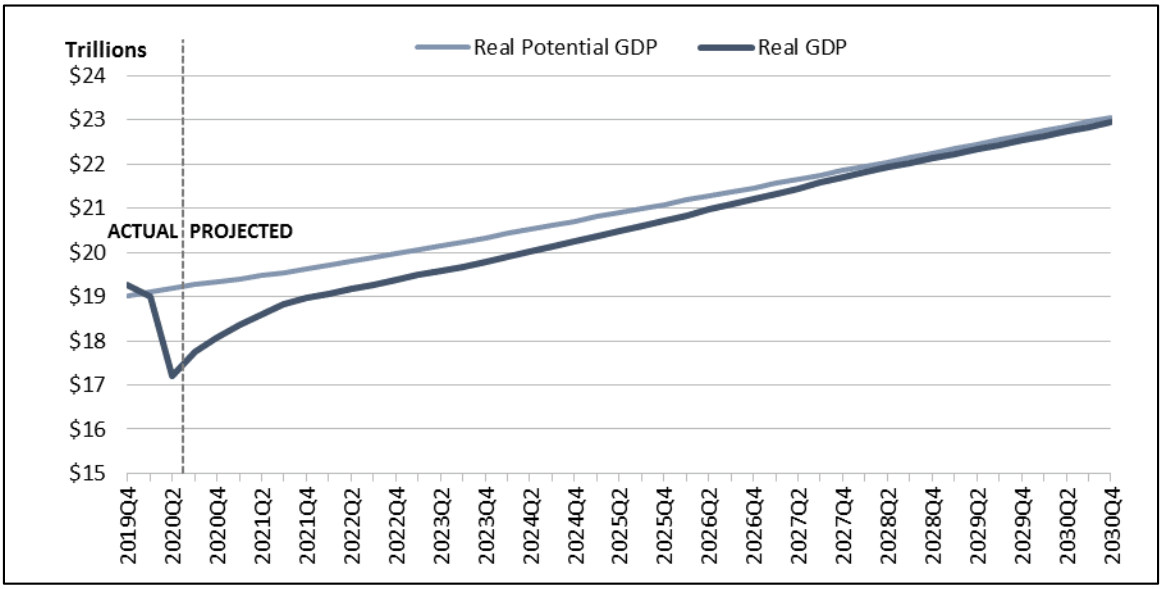
Source: BEA.

Looking Forward

Looking forward, forecasters expect GDP to grow rapidly once the pandemic has subsided, as unemployed workers and idle resources return to work. It is, however, highly uncertain when that will be. For example, the Congressional Budget Office (CBO) projected that the economy would grow 17% in the third quarter. But even if the economy grows rapidly in future quarters, forecasters expect it to take several years before GDP returns to its potential and unemployment returns to full employment. Potential GDP is an estimate of what output would be if the economy were operating at full capacity. If growth were 17% in the third quarter, it would leave GDP about $1.5 trillion below its pre-pandemic level. Longer term, GDP would not return to within 1% of its potential until 2027, according to CBO's projections (see **Figure 4**).

Figure 4. Actual and Projected GDP

2019:Q4-2030:Q4



Source: BEA, CBO.

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