Special Commentary — October 3, 2023

Exploring the Widening Gap Between GDP & GDI

Summary

While it is generally something of an anomaly, it is not unprecedented for growth in income to fall behind growth in expenditures. This can happen for any number of reasons from labor market challenges to corporate profitability concerns to external trade dynamics. This report looks at why it is happening now and what it says about the likelihood of recession.

Economist(s)

Tim Quinlan
Senior Economist | Wells Fargo Economics
Tim.Quinlan@wellsfargo.com | 704-410-3283

Shannon Seery
Economist | Wells Fargo Economics
Shannon.Seery@wellsfargo.com | 704-410-0369

Nicole Cervi
Economist | Wells Fargo Economics
Nicole.Cervi@wellsfargo.com | 704-410-3059

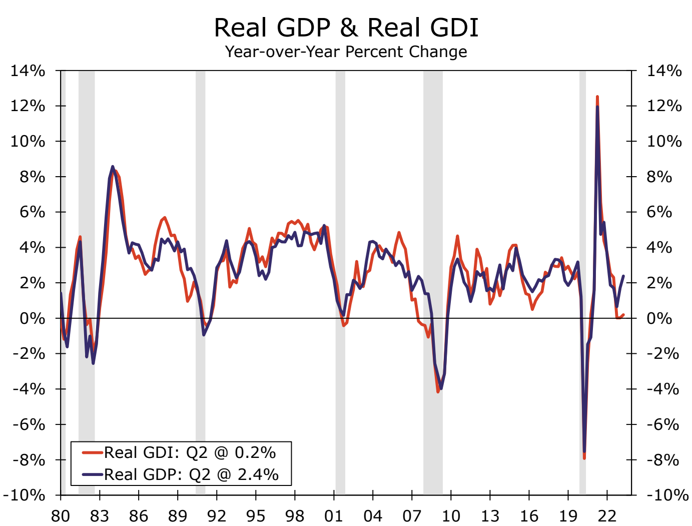
Q2 GDP Growth Held Steady, But Movement Under the Hood

The third estimate of real GDP growth released last week included benchmark revisions going back 10 years[1]. The data showed the U.S. economy expanding at a 2.1% annualized rate during the second quarter. While unchanged from the second estimate, there was some substantial movement in the underlying components. Growth in real personal consumption expenditures (PCE) was revised down 0.9 percentage points (pp) to just a 0.8% annualized rate, while the growth rate in gross private investment was revised up 1.9pp to a sturdy 5.2% annualized rate.

The marked deceleration in PCE appears to be mostly driven by benchmark revisions, but the reduction in PCE's contribution to Q2 GDP growth (0.55pp from 1.14pp previously) signals less momentum in consumer spending than previously thought[2]. Elsewhere, the revisions showed a 4.9pp boost to growth in non-residential construction, which helped lift growth in total business fixed investment to a 7.4% annualized rate, and an upwardly revised $14.9B inventory build translated into a neutral force on topline GDP growth. All these adjustments left real GDP up 2.4% on a year-over-year basis, in line with the second estimate and its 2019 average.

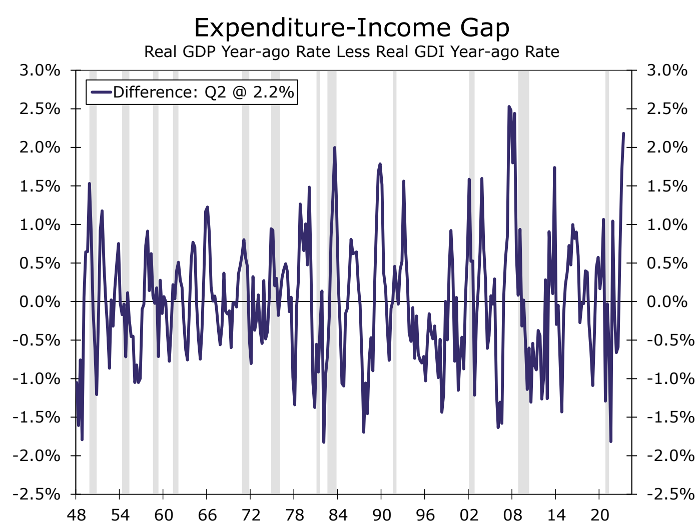
What is most interesting to us is that the gap between real GDP and real gross domestic income (GDI) remains unusually wide in this updated Q2 data. As seen in Figures 1 and 2, real GDI was up just 0.2% on a year-ago basis in Q2, leading to the widest gap (2.18pp) between real GDP and real GDI since 2008. In theory, the two measures should be the same, though in practice they can differ because they are constructed using independent source data. In the parlance of the BEA, this difference is called the statistical discrepancy[3]. GDP looks at the expenditure side of the economy, while GDI tallies the income side[4].

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 2



Source: U.S. Department of Commerce and Wells Fargo Economics

This Discrepancy Demands an Explanation

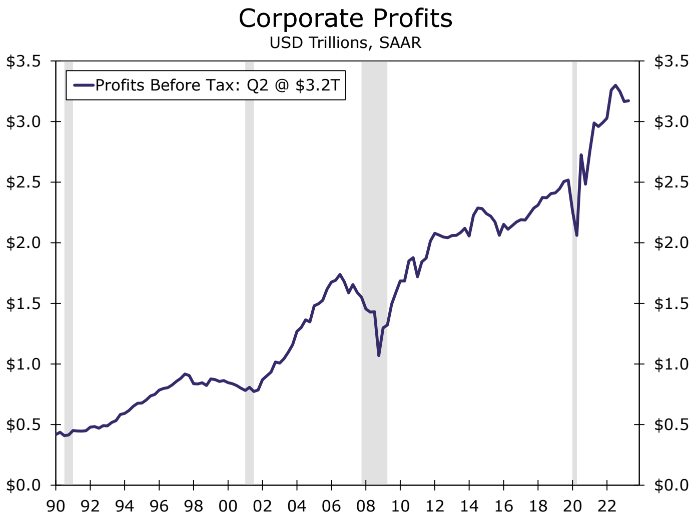
When GDI is not growing as fast as GDP, it can indicate an inflection point in the economic situation that merits attention. As GDI is an aggregation of income, the disconnect can reflect issues in the labor market and productivity. If wages are stagnant, for example, that could manifest itself through softer GDI. Wages and salaries, however, have continued to rise through the second quarter.

Today, the gap looks to be traced to declining corporate profits and firms' net interest expense. As seen in Figure 3, corporate profits have rolled over, and on a year-ago basis profits have slipped into negative territory as costs have exceeded revenue. This could be due to increased competition, rising production/labor costs, or a saturated market, affecting business profitability. Further, even as the Federal Reserve has ratcheted up rates quickly to cool the economy, firms have seen their interest expense *fall*.

Net interest expense, or the difference between what firms pay in interest on their liabilities (interest payments) and the interest they take in on their assets (interest receipts), has declined rapidly. The decline in net interest expense is likely happening because higher rates only immediately affect new debt or maturing debt refinanced at these higher rates, meaning it takes time for higher rates to materially impact interest payments. At the same time, firms have been able to boost their interest receipts by earning more on their cash and assets as rates have risen.

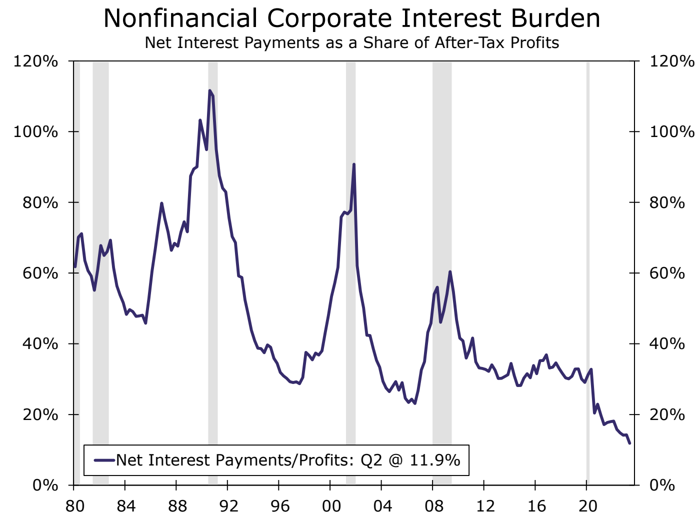
Firms' net interest payments look even more manageable in the context of still elevated profits (Figure 4). As net interest expense has fallen, it has weighed on overall GDI and can explain some of the gap between GDP and GDI seen today. Notably, declining interest expense at the macro level may be freeing up some cash and allowing firms more flexibility in their balance sheet management.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 4



Source: U.S. Department of Commerce and Wells Fargo Economics

Lastly, international trade can also influence the relationship between GDI and GDP. A strong domestic currency or global economic downturns can affect the balance between income and production, leading to divergent growth rates. The dollar has been on a tear since July, although it is admittedly only incrementally higher since the fourth quarter of last year when this GDP/GDI divergence first manifested itself. A somewhat more compelling argument is the trend narrowing in the trade deficit. From its widest gap last year through June of this year, the trade deficit is a third smaller than what it was. The relative trade improvement does not immediately translate into improved income, so this could indeed be another explanatory factor.

Trouble On the Way

Bottom line, when GDI is not growing as fast as GDP, it can reflect labor market challenges, corporate profitability concerns or external trade dynamics. We closely monitor these disparities to gain insights into the health and sustainability of the economic cycle. Note back in Figure 1, how in the lead up to the recession of the 1990s and again in the months that preceded the financial crisis, GDI broke below the zero line just before the economy succumbed to recession. Both of those periods were analogous to today in that they also marked the end of a Fed tightening cycle, a period of dollar strength and (at least in the case of the 2008 period) a sharp narrowing in the trade deficit.

Endnotes

1 - Every five years, the Bureau of Economic Analysis (BEA) revises the National Economic Accounts (NEAs) to incorporate the results of the Census Bureau's twice-a-decade Economic Census, which provides a comprehensive look at the composition and activities of the business sector. The BEA's benchmark update affects the past 10 years of data and often includes improvements to accounting methodologies and reclassifications of certain activities—changes that can have meaningful effects on the GDP data. (Return)

2 - The third estimate's downgrade to Q2 PCE growth stemmed largely from softer services outlays, led lower by housing & utilities and transportation services. The benchmark revisions included a methodological change to the estimation of housing services, which may explain some of the sharp deceleration in services spending relative to the second estimate. (Return)

3 - The BEA calculates the statistical discrepancy as the net sum of the measurement errors in the components of both GDP and GDI. When expressed as a share of nominal GDP, the statistical discrepancy was 1.6% in Q2, which is the highest since Q3-2020. In this report, we use the percentage point gap between real GDP and real GDI on a year-over-year basis as a simplified measurement of the expenditure-income gap. (Return)

4 - GDI is the sum of incomes earned and costs incurred in the production of goods and services. GDP is the sum of all final expenditures in the economy plus the change in inventories. (Return)

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Seery	Economist	704-410-0369	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Aubrey George	Economic Analyst	704-410-2911	Aubrey.B.George@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures