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Discouraging Economic Growth Brings Mild Monetary Response

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According to data released by the U.S. Bureau of Economic Analysis on Friday, July 27, the annualized growth rate of U.S. real gross domestic product (GDP) slipped to a discouraging 1.5 percent in second quarter 2012. Because weak consumer spending and employment growth were evident in the monthly data for second quarter 2012, a substantial slowing of GDP growth was largely anticipated. Wall Street investors had expected a weaker GDP figure for second quarter 2012 than was released, and U.S. stocks moved higher on the day.

Consumer spending drove most of the growth in GDP, but it slipped considerably from first quarter (Table). Business fixed investment and residential investment made smaller contributions than in previous quarters while government spending and net exports made negative contributions. Government spending decreased for the eighth consecutive quarter. Business spending increased for the fifth consecutive quarter, but at a slowing rate over the past three quarters.

Table. Contributions to the Growth of U.S. Real GDP

	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2
Real GDP (percent change annual rate)	2.4	0.1	2.5	1.3	4.1	2.0	1.5
Contributions to Real GDP Growth							
Final Domestic Sales	2.76	0.59	1.93	2.32	2.21	2.29	1.53
Consumption	2.84	2.22	0.70	1.18	1.45	1.72	1.05
Business Fixed Investment	0.83	-0.11	1.30	1.71	0.93	0.74	0.54
Residential Investment	0.03	-0.03	0.09	0.03	0.26	0.43	0.22
Government Purchases	-0.94	-1.49	-0.16	-0.60	-0.43	-0.60	-0.28
Net Exports	1.24	0.03	0.54	0.02	-0.64	0.06	-0.31
Exports	1.24	0.75	0.56	0.83	0.21	0.60	0.73
Imports	-0.01	-0.72	-0.02	-0.81	-0.85	-0.54	-1.04
Inventory Investment	-1.61	-0.54	0.01	-1.07	2.53	-0.39	0.32

Note: Data are reported at seasonally adjusted annual rates.
Source: U.S. Bureau of Economic Analysis

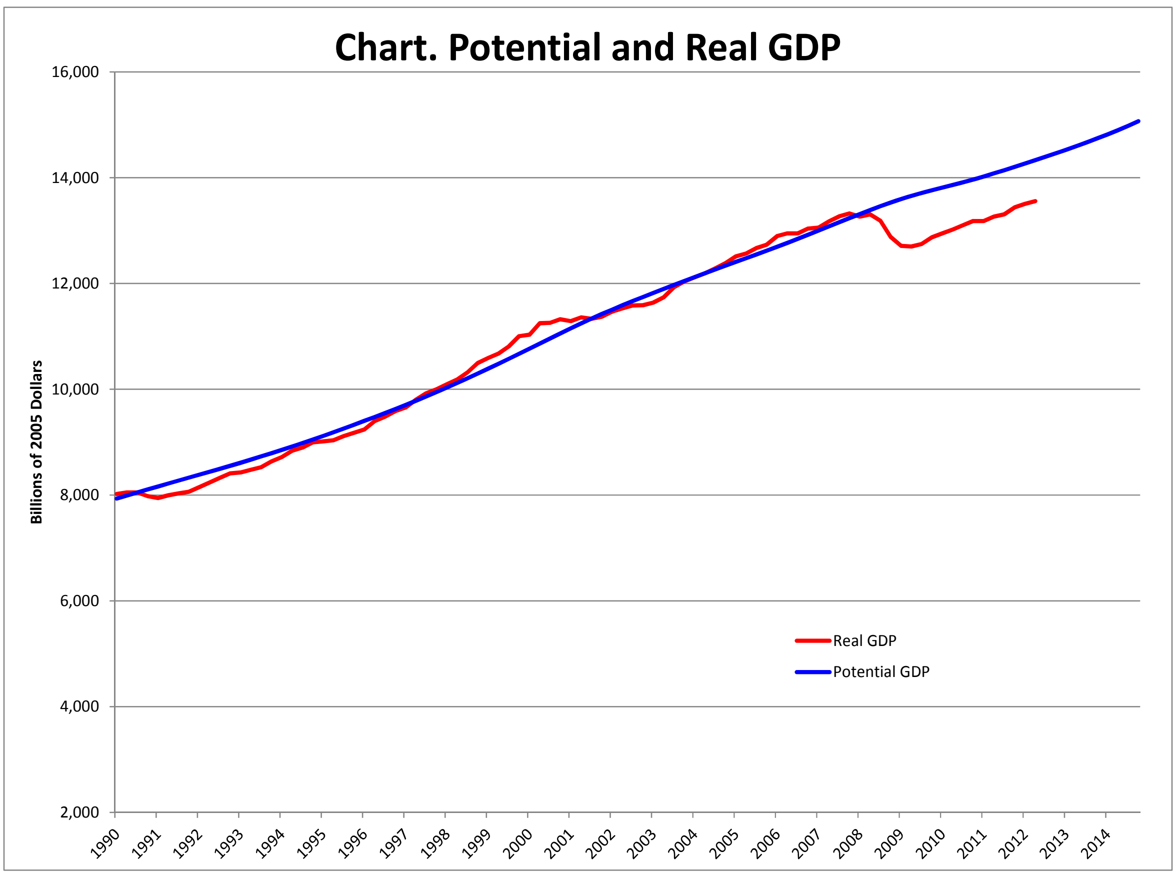
Looking Ahead

Looking ahead to the second half of 2012, concerns can be found in the weak contributions of consumer spending and business fixed investment and the negative contribution of government spending. All three developments portend continued weakness in economic growth.

The weakest area of business investment spending was structures, but investment in computers and industrial equipment also was weak by historical standards. The weak investment spending represents a continued trend through the last three quarters, which shows firms either don't see much need to invest in expansion or are having difficulty obtaining financing. Neither is conducive to economic growth. The record level of corporate profits provides plenty of internal financing, but the lack of outstanding commercial paper is indicative of a weak investment environment.

The austerity in government spending, driven by lower tax revenues, has been another area of weakness for economic growth. State and local governments continue to see spending cuts. Some plans for federal spending call for increased austerity.

The GDP growth attributable to inventory investment also is a concern. Inventory investment contributed 0.32 percentage points in second quarter 2012. By the standards of the last decade, a contribution of 0.32 percentage points is a little high, but the inventory-to-spending ratio is very high, given weak consumer and investment spending. Firms may scale back their inventory investment in future quarters, which will decrease the contribution to GDP growth.



Sources: U.S. Bureau of Economic Analysis; Congressional Budget Office

U.S. Economy Operating Below Potential

The weak growth in real GDP means that U.S. economic activity remains well below potential (Chart). In fourth quarter 2011, U.S. real GDP was 5.40 percent below potential. First quarter showed a slight improvement to 5.35 percent below potential. Second quarter showed slippage to 5.41 percent below potential. Such gaps are indicative of underutilized resources in the economy, and that a substantial acceleration of economic growth is necessary for U.S. real GDP to meaningfully close the gap with its potential in the next few years.

Not Much Response in Fiscal Policy

We are unlikely to see much of a fiscal stimulus in response to slowing economic activity. Over the past eight quarters, large negative contributions to GDP growth have come from government spending. State and local governments are constrained by balanced budget requirements. They have cut spending to match declining revenues.

The U.S. government is free to run a deficit, but the U.S. government's debt has grown alarmingly large in recent years. As a consequence, the current political environment in Washington, DC does not seem to be conducive to much of a change in fiscal policy in advance of the November election. We may see some softening of the automatic spending cuts and an extension of some Bush-era tax cuts, but no long-term solution.

Perhaps surprisingly, the November election may not change that calculus. If Obama is reelected, he is unlikely to be able to engineer a fiscal stimulus through increased spending. If Romney is elected, he is unlikely to be able to pursue fiscal austerity while preserving defense and entitlements spending.

A Mild Monetary Policy Response

In response to slowing economic activity, the Federal Open Market Committee (FOMC) voted today (August 1, 2012) to keep the target range for the federal funds rate in a range of 0 to ¼ percent. The FOMC expects that a continuation of weak economic conditions and an economy below its potential will likely warrant exceptionally low levels for the federal funds rate at least through late 2014. The FOMC also announced an intention to continue extending the average maturity of its holdings of government bonds—an action that is designed to lower long-term rates.

In taking these actions, the FOMC recognized its dual mandate of fostering maximum employment and price stability. Because inflation is low and the FOMC sees underutilized resources as keeping inflationary pressure low, it sees little downside in pursuing monetary policies designed to stimulate the economy toward maximum employment.

Unfortunately, neither the continuation of current monetary policy nor a much more aggressive monetary policy is likely to do much to promote a rapid recovery of economic activity. In the aftermath of a financial crisis and its discouraging effects on business relationships, low interest rates do not do much to stimulate the consumer and investment spending necessary to drive gains in economic growth. The best that the FOMC can do is assure that monetary policy does not prevent economic growth, and that it has not extended so much liquidity into the market that inflation becomes a concern when the economy strengthens.

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