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# Slowing GDP Growth in First Quarter: Disappointing, but Not Unexpected

Stephen P. A. Brown

According to data released by the U.S. Bureau of Economic Analysis on Friday, April 27, the growth rate of U.S. real gross domestic product (GDP) slipped to a disappointing 2.2 percent (at a seasonally adjusted annual rate) in first quarter 2012 (Table). Consumer spending drove most of the growth. Residential investment also continued to show improvement. Government spending, business fixed investment and net exports made negative contributions.

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

| | 2010 Q4 | 2011 Q1 | 2011 Q2 | 2011 Q3 | 2011 Q4 | 2012 Q1 |
|---|---|---|---|---|---|---|
| Real GDP (percent change annual rate) | 2.3 | 0.4 | 1.3 | 1.8 | 3.0 | 2.2 |
| Contributions to Real GDP Growth | | | | | | |
| Final Domestic Sales | 2.78 | 0.38 | 1.38 | 2.74 | 1.41 | 1.62 |
| Consumption | 2.48 | 1.47 | 0.49 | 1.24 | 1.47 | 2.04 |
| Business Fixed Investment | 0.82 | 0.20 | 0.98 | 1.49 | 0.53 | -0.22 |
| Residential Investment | 0.06 | -0.06 | 0.09 | 0.03 | 0.25 | 0.40 |
| Government Purchases | -0.58 | -1.23 | -0.18 | -0.02 | -0.84 | -0.60 |
| Net Exports | 1.37 | -0.34 | 0.24 | 0.43 | -0.26 | -0.01 |
| Exports | 0.98 | 1.01 | 0.48 | 0.64 | 0.37 | 0.73 |
| Imports | 0.39 | -1.35 | -0.24 | -0.21 | -0.63 | -0.74 |
| Inventory Investment | -1.79 | 0.32 | -0.28 | -1.35 | 1.81 | 0.59 |

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

Although strong consumer spending and employment growth were evident in the monthly data for first quarter 2012, a slowing of GDP growth was largely expected. The pace of growth in industrial production slipped during the quarter, and government and business spending were seen retreating. Although Wall Street investors were reported as having expected stronger GDP figures for first quarter 2012, U.S. stocks moved higher Friday—as upbeat profit reports for individual companies outweighed any concerns about the overall strength of the U.S. economy.

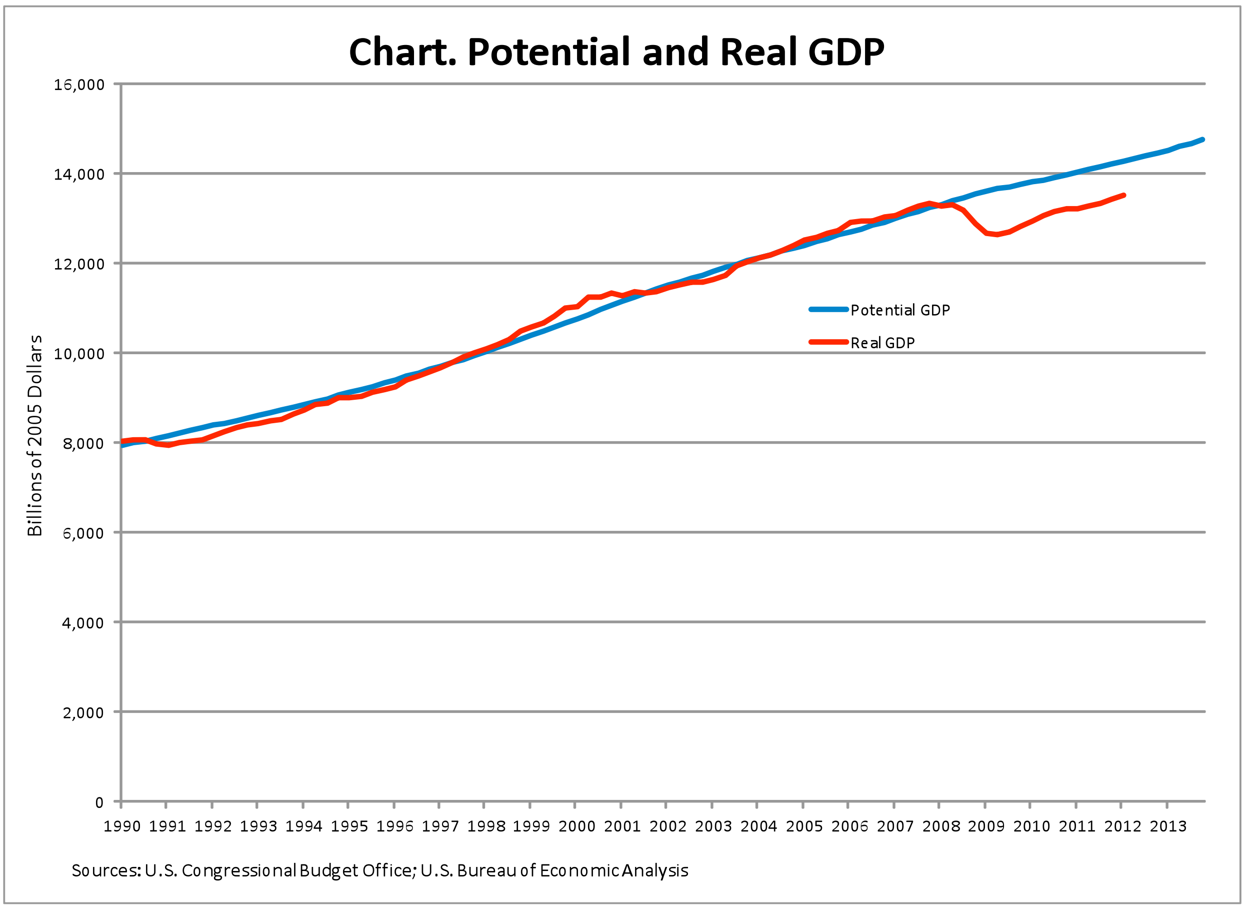
## Looking Ahead in 2012

Looking ahead, concerns can be found in the negative contributions of business fixed investment and government spending and the *growth* of inventories. All three developments portend continued weakness of economic growth during 2012.

Among the weakest areas of business investment spending were structures, computers and industrial equipment. The decline in investment spending represents a reversal that shows firms either don't see much need to invest in expansion or are having difficulty obtaining financing. Neither is conducive to economic growth. Corporate profits are at record levels, which provides plenty of internal financing for big firms. It's a different picture for small businesses. A recent survey conducted by the National Federation of Independent Businesses found small businesses are having trouble convincing financial institutions to support their investment plans.

The austerity in government spending, driven by lower tax revenues, has been another area of weakness for economic growth. State and local governments may have nearly reached the bottom of their spending cuts. Some plans for federal spending call for increased austerity.

The GDP growth attributable to inventory investment over the past two quarters remains another area of concern. Inventory investment contributed 1.8 percentage points to GDP growth in fourth quarter 2011 and 0.6 percentage points in first quarter 2012. A contribution of 0.6 percentage points is high by the standards of the past decade. Even if firms have yet to see inventories rise above desired levels, they are likely to scale back their inventory investment, which will reduce the contribution to GDP growth.




## 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. GDP was 5.48 percent below potential. First quarter showed a slight improvement to 5.38 percent below potential. Although declining labor force participation has led the Congressional Budget Office to reduce the projected growth of potential GDP to 1.9 percent over the next two years, an acceleration of growth is necessary for U.S. real GDP to meaningfully close the gap with its potential in 2012.

**Likely Monetary Policy Responses**

With most of the Federal Reserve System's policymakers taking the perspective that inflation will not accelerate until the economy is operating much closer to its potential, Fed Chairman Ben Bernanke recently said that there is little reason to expect a meaningful change in U.S. monetary policy for the foreseeable future. Asked to clarify, Chairman Bernanke said that his statement must remain somewhat vague because different members of the Federal Open Market Committee (FOMC) have different understandings about what is meant by no meaningful change and the foreseeable future.

As far as short-term interest rates are concerned, the clearest statement of likely monetary policy is provided by the majority view on the FOMC that a federal funds target of 0.25 percent is likely to be appropriate over the next few years.[1] With inflationary expectations in a range of 2 to 3¼ percent, real short-term interest rates seem likely to remain decidedly negative for the next few years.

**Likely Fiscal Policy Responses**

The negative contributions of government spending to GDP growth have come from state, local and federal governments. State and local governments are constrained by balanced budget requirements. They must cut spending to match declining revenues.

The U.S. government is free to run a deficit, and it has made impressive use of that freedom over recent years. The questions in most people's minds are whether increasing deficit spending or cutting it would boost U.S. economic activity, and what policy direction is likely in the current environment. The answers to both questions are decidedly partisan.

According to conservative economists, deficit spending leads to offsetting decreases in private investment and consumption spending. Consequently, closing the deficit by cutting spending is a priority. According to liberal economists, an increase in deficit spending will stimulate economic activity as long as the economy has excess capacity and monetary policy is holding interest rates at extremely low levels. Consequently, increasing deficit spending is a priority. Both groups are well armed with well-articulated theories and empirical studies.

Whichever side is correct, the current political environment in Washington, DC doesn't seem to be conducive to either more fiscal stimulus or further austerity. Shifts in the political landscape may change that calculus.

Stephen P. A. Brown, Ph.D.
Director, Center for Business and Economic Research
University of Nevada, Las Vegas

[1] See http://www.federalreserve.gov/newsevents/press/monetary/20120425b.htm.