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Economic Outlook

Weaker Capital Spending Cuts Growth Forecast

By John H. Makin

On Friday, April 13, the *Wall Street Journal's* lead story on the unlucky U.S. economy was "Economy Enemy No. 1: Soft Capital Spending." The nation's leading business newspaper was acknowledging a six-month slowdown in capital spending that has, along with the drag from the housing sector, been lowering U.S. growth.

Economic forecasters watch capital spending (also called "capital expense," "capital expenditures," and "CAPEX") closely for good reasons. While it is a relatively small part of overall GDP (about 11.5 percent), it is volatile, offering substantial information about the views of businessmen on the outlook for the economy. Higher capital spending means that businesses are looking for more productive capacity based on an improved outlook for their ability to sell the goods produced with new capital equipment or facilities. Beyond that, a key part of the Federal Reserve's hope for sustained U.S. growth has been tied to the expectation that capital spending would continue to expand based on relatively low interest rates and credit spreads coupled with plenty of available funding.

The emerging weakness in capital spending has complicated the Federal Reserve's policy problem, as lower spending on capital goods has reduced the overall growth outlook while stubbornly high core inflation has forced the Fed to eschew any possible easing of policy.

CAPEX Fundamentals

Capital spending is best characterized as a relatively small but volatile component of GDP growth. In the long run, on average, capital spending contributes about a half a percentage point of the average GDP growth rate of 3.0 to 3.5 percent. However, the volatility is significant: the standard deviation of its half a percentage point contribution to growth is 1.1 percentage points. It can be quite a drag on overall growth during periods of slowdown and quite a boost during pickups.

After the late 1990s capital spending boom, business fixed investment (yet another term for "capital spending") turned negative in the first quarter of 2001 and remained so for nine consecutive quarters. On average, it subtracted 0.9 percentage points from growth during that period, providing a major source of the drag on overall GDP growth. In the current environment, with the main component of GDP growth—consumption—contributing about 2 percentage points to growth, a 1 percentage point drag from housing construction along with a half a percentage point drag from capital spending takes overall growth well below 1 percent unless government spending, net exports, and inventory investment raise it. On average since 2001, however, the combination of net exports, inventory investment, and government spending has contributed only about 0.3 percentage points to growth.

Part of the new concern about capital spending is related to its sudden fall at the end of last year. During the first three quarters of 2006, business fixed investment grew at an annual rate averaging over 9 percent, thereby contributing almost a percentage point of growth during those three quarters. With overall GDP growth running at about 2 percent, thanks to a drag of over a percentage point of growth from housing, the emergence of

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another drag of close to a percentage point from capital spending threatens very low growth rates. In the fourth quarter of 2006, business fixed investment fell at a 3.1 percent annual rate, subtracting 0.3 percentage points from growth. So far in 2007, capital spending looks to be dropping at a rate in excess of 6 or 7 percent, thereby threatening to impose another drag on growth of about 0.6 or 0.7 percentage points.

If the growth of unit labor costs remains at about 3.5 percent while nominal GDP growth drops to 4.5 percent or below, the year-over-year growth rate of profits will fall sharply and will probably become negative by midyear.

Why CAPEX Is Slowing

The Fed and numerous private forecasters have expressed surprise along with discomfort over the slowdown in U.S. capital spending. Actually, there are some fairly straightforward explanations for that slowdown, some of them tied to economic events in the United States, while others are tied to the remarkable expansion of productive capacity in China and much of Asia.

An equation that relates year-over-year growth of business fixed investment to year-over-year U.S. profits growth strongly suggests that the history of profits growth has a strong positive relationship to business fixed investment. Profits growth, in turn, is positively linked to the year-over-year growth rate of nominal GDP and negatively tied to the year-over-year growth rate of unit labor costs. Faster GDP growth is associated with a larger economic pie to be divided between capital and labor, and so faster nominal GDP growth means faster profit growth, while simultaneously, labor income gains can continue. Higher unit labor costs result when real wage growth exceeds productivity growth, so that the real cost of labor for producers goes up, reducing profits unless companies can pass on the higher costs to consumers.

In the United States, slowing productivity growth and strong wage increases have boosted the year-over-year growth rate of unit labor costs to 3.4 percent, well above the five-year average of 1.5 percent. Meanwhile, the slowdown in GDP growth has lowered the year-over-year growth rate of nominal GDP to about 4.5 percent during the first half of 2007.

If the growth of unit labor costs remains at about 3.5 percent while nominal GDP growth drops to 4.5 percent or below, the year-over-year growth rate of profits will fall sharply and will probably become negative by midyear. U.S. profits growth has been spectacular, but it started to weaken during the second half of 2006. Year-over-year corporate profits growth probably peaked in the third quarter at a 30 percent rate, dropping to 18 percent in the fourth quarter. Thereafter, however, the profits deterioration has persisted, with year-over-year profits growth unlikely to exceed 3–4 percent during the first half of 2007. Profits will start to fall year-over-year in the third quarter unless the growth rate of nominal GDP rallies strongly. That outcome seems less likely now that weaker capital spending has added to the drag on growth already emanating from a collapse in residential construction.

Another reason for the weakness of capital spending in the United States is that a substantial portion of the capital spending being undertaken by American and Asian firms is in China, Korea, and Japan. The rapid growth of productive capacity in Asia, especially in China, given its large scale, is depressing the need for more capital spending inside the United States.

China's currency policy and the huge liquidity surge it creates, both inside China and globally, have helped to sustain a high level of capital spending—some say overinvestment—in China. China's efforts to keep its currency from appreciating have resulted in massive reserve accumulation, reaching an annual rate of $600 billion during the first quarter of 2007. The resulting huge increase in Chinese liquidity is pushing overinvestment both in real and financial capital inside China. Inflation pressures are rising in China while part of the liquidity surge resulting from China's massive dollar buying—$135 billion during the first quarter of 2007 alone—is flowing back into U.S. capital markets. The liquidity boost in the U.S. has supported consumption more than it has supported investment.

Part of the reason that the Chinese liquidity surge supports more investment in China than in the United States is the relatively low cost of labor in China. As a larger stock of capital located in China combines with Chinese labor to produce exports flowing out of China into Europe and the United States, the need to add to the capital stock, especially in the United States, is reduced. Further, there is negative pressure on U.S. employment from two sources: the capital equipment not being produced in the United States does not require the employment of American labor in the capital equipment

industries, and China's direct exports to the U.S. cause shrinkage of American traded-goods industries, such as automobile and appliance manufacturing.

Protectionist Pressure in the U.S.

It is no surprise that much of the rising pressure for protection of U.S. producers comes from the Midwest, where producers of capital equipment tied to the production of automobiles have suffered, as has employment in the automobile and related industries. In March, the Senate Finance Committee held hearings directed at China's trade and currency policies and the burden they place on American workers in traded-goods industries such as automobiles and machine tools. The fact that the weakness in capital spending, which is slowing the economy, creates a burden that falls disproportionately on workers in capital-equipment and related industries results in political pressure for protectionist measures.

The new Democratic leadership in the Congress appears ready to press forward with protectionist legislation that, while it may be emotionally satisfying for those discussing and enacting it, will do little to relieve the negative pressure on U.S. capital spending and workers in those industries. Pressing China to allow its currency to appreciate has not been successful in the past, and the Chinese give little sign that they will start responding to additional pressure. Meanwhile, unilateral trade-constraining measures offered by possible legislation would be very slow to take effect. Such measures typically do not comply with World Trade Organization rules and can be protested by the nations at which they are targeted. While supporters in Congress of new trade-legislation aimed at China, and possibly at Japan, claim the legislation will be WTO-compliant, it is difficult to imagine how that will be possible. Furthermore, trade restricting measures are stagflationary, causing lower growth and higher inflation, neither of which the Fed would like to see as it struggles to set monetary policy in a U.S. economy in which growth is already slowing and inflation is rising.

The Outlook for CAPEX

The minutes from the March 20–21 meeting of the Federal Reserve's Open Market Committee focused on the capital spending dilemma by noting:

> Declines in spending for capital equipment that is used heavily in the construction and motor vehicle industries accounted for an outsized share of the drop in orders and shipments at manufacturers outside high-tech and transportation in January.

That said, the minutes also acknowledged that "investment in goods and services other than transportation and high-tech equipment softened more than fundamentals had suggested." Yet the Open Market Committee remained hopeful that "financing conditions and other fundamentals remained favorable for a pick-up in capital spending."

A pickup in capital spending in the near term, notwithstanding the Fed's hopes, seems unlikely. Slowing nominal GDP growth and rising unit labor costs are depressing profits. The result will likely be to put downward pressure on business fixed investment. Further downward pressure comes from the huge stock of productive capacity already in place in China and Asia that lowers the prospective returns to installing new capital equipment in the United States.

If the combined drag on GDP growth from the weakness in residential investment and weaker capital spending reaches 2 percentage points of growth, then a combination of strong (say, 4 percent) consumption growth along with firm net exports from inventory building and strong government spending will be necessary to hold overall growth numbers close to the current forecast of 2 percent. While possible, that is not the most likely outcome. More likely, consumption will contribute 2 percentage points to growth, so that combined with the housing and CAPEX drag, we get zero GDP growth with the only positive offsets coming from inventory accumulation, government spending, or net exports. Those last inputs are likely to total between a half a percent and 1 percent.

If that is the outcome, the Fed needs to hope for lower inflation to appear quickly so that it can start to reboost the economy with easier monetary policy. Right now, however, it looks like the growth slowdown will come more quickly than the inflation slowdown, keeping the Fed in check until the end of the year. Capital spending could remain a drag on growth for a while, in spite of the Fed's hope that it will somehow spontaneously recover.