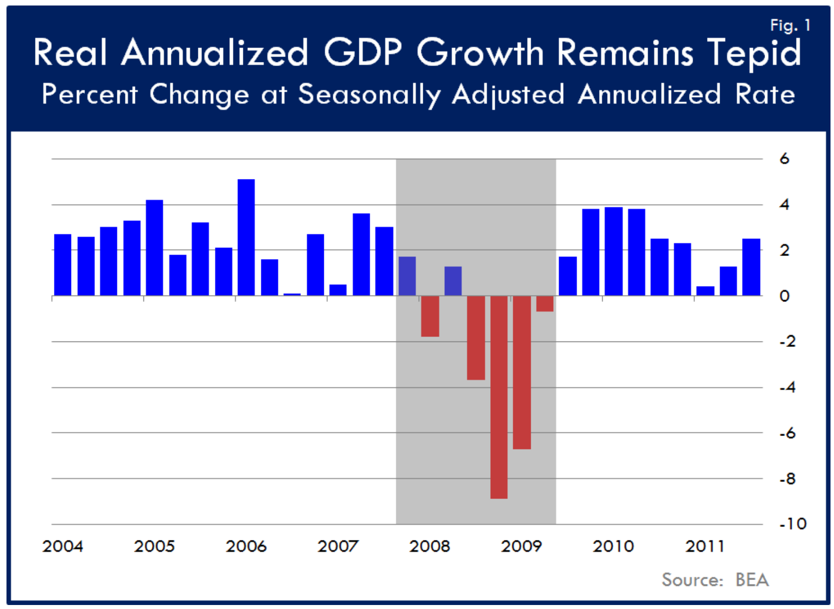
Joint Economic Committee
Republicans
Representative Kevin Brady
Vice Chairman

REPUBLICAN STAFF COMMENTARY

Real GDP Advances 2.5% in 3rd Quarter

Private Investment Still Missing in Action, Key to Job Growth

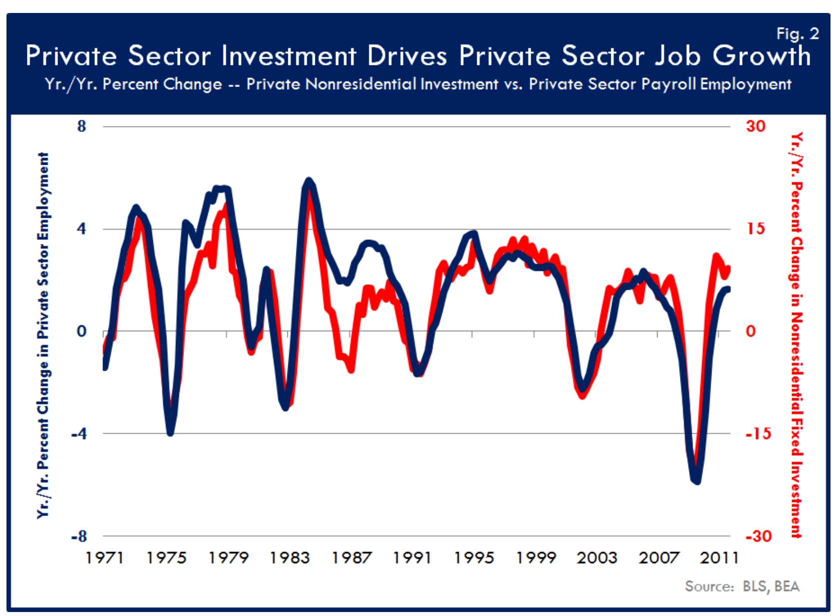
October 27, 2011



At 8:30 a.m. this morning, the Bureau of Economic Analysis (BEA) reported that real gross domestic product (GDP) rose at a seasonally adjusted annualized rate of 2.5% during the 3rd-quarter of 2011. Despite the improvement in quarterly annualized growth, real GDP has risen by only 1.6% over the past year – the same year-over-year reading as in the 2nd – quarter.

The largest contributors to the growth in real GDP in the 3rd-quarter were: consumer spending (PCE) added 1.7 points, private nonresidential fixed investment added 1.5 points, and exports contributed 0.6 points. The largest subtractions from real GDP were: the change in private inventories -1.1 points and imports -0.3 points.

Perhaps the most encouraging aspect of today's report was the 16.3% annualized increase in real private nonresidential fixed investment (i.e., business investment in buildings, equipment, and software). This key element has been largely absent from the recovery.



Private Sector Investment Growth = Private Sector Job Growth

President Obama has proposed yet another stimulus package designed to give the economy a "boost." The President fails to understand that current administration policies and proposals are discouraging the one element that will kick start private sector job growth – private investment.

Historically, the year-over-year change in private nonresidential fixed investment is highly correlated with the change in private sector payroll employment. Figure 2 shows that the relationship has been consistent throughout recent history. On the other hand, federal government consumption and investment has proven to be negatively correlated with private sector job growth.

Real GDP has finally recovered to pre-recession level

As Figure 3 shows, real Gross Domestic Product (GDP) has finally recovered past its level in the 4th-quarter 2007; the official start of the recession was in December 2007. While the consumer represents about 70% of GDP, other components are private investment, government consumption and investment and net exports. With all the emphasis that the Obama Administration has placed on increasing aggregate demand by putting more money in the hands of consumers, they have missed a critical point – investment, not the consumer or government, is what is missing from the current recovery.

Consumers

Consumer spending, as measured by the personal consumption expenditures (PCE) component of GDP, surpassed its 4th-quarter 2007 levels both in real and nominal dollars. Real PCE peaked in the 4th-quarter 2007 at \$9.3 trillion (2005 dollars). During the recession real PCE declined to \$9 trillion (2005 dollars) or by 3.3%. Real PCE first surpassed pre-recession levels in the 4th – quarter 2010. As of today's report on GDP from the BEA, real PCE stands 1.5% above pre-recession levels (See Fig. 4).

Government

In real terms, government consumption and investment remains 2.2% higher than its pre-recession level (See Fig. 5). Government consumption and investment continues to represent a greater share of real GDP at 18.9% than it did prior to the recession (18.4%). The government component peaked at 20.1% of GDP in the 2nd-quarter 2009.

Fig. 3

Real GDP Finally Above Pre-recession Level

(2005\$, Billions)

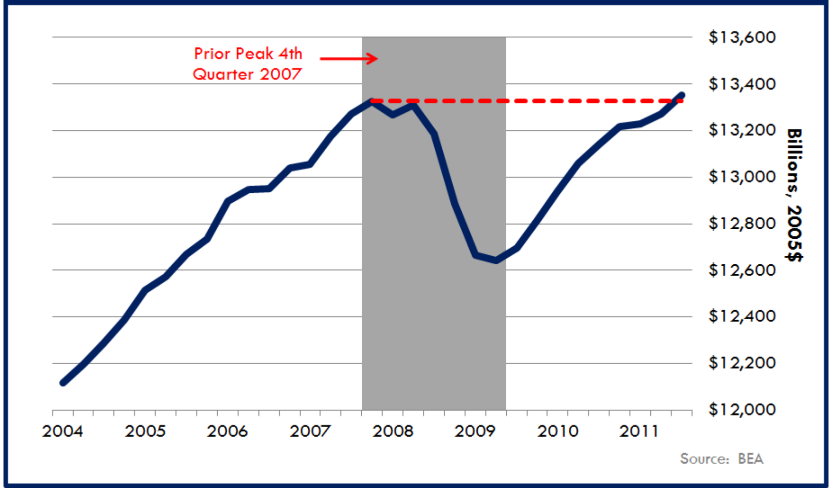


Fig. 4

Consumer Spending has Surpassed Pre-recession Levels

(Real Personal Consumption Expenditures 2005\$, Billions)

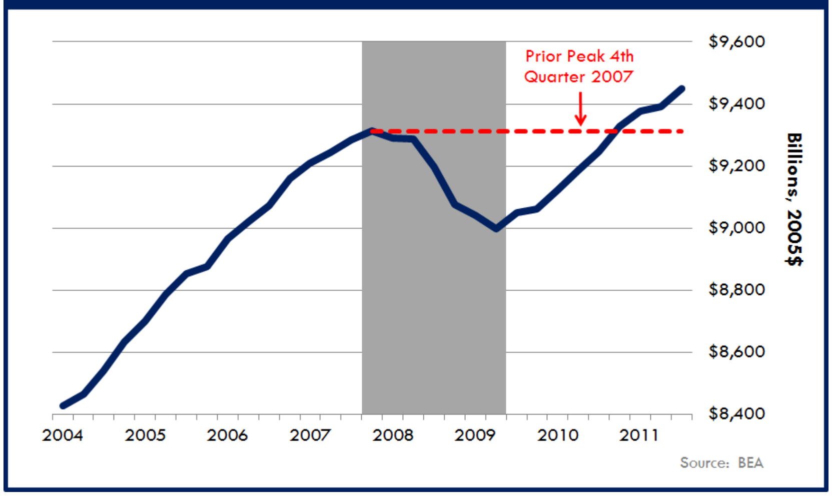
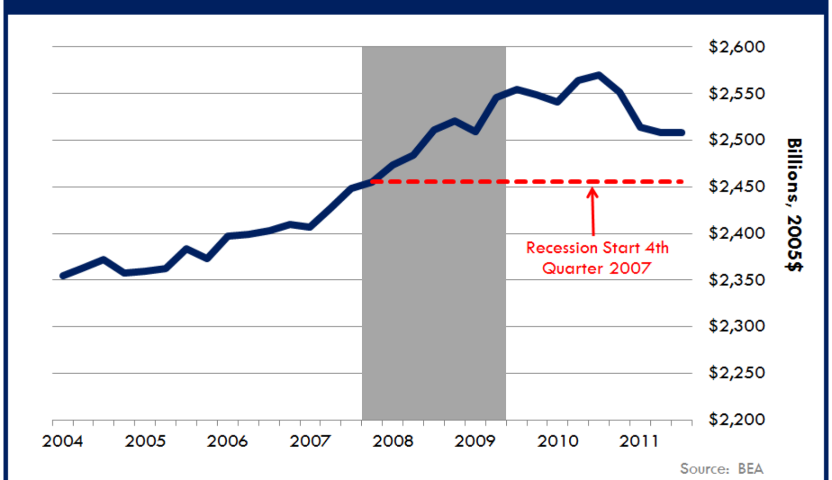


Fig. 5

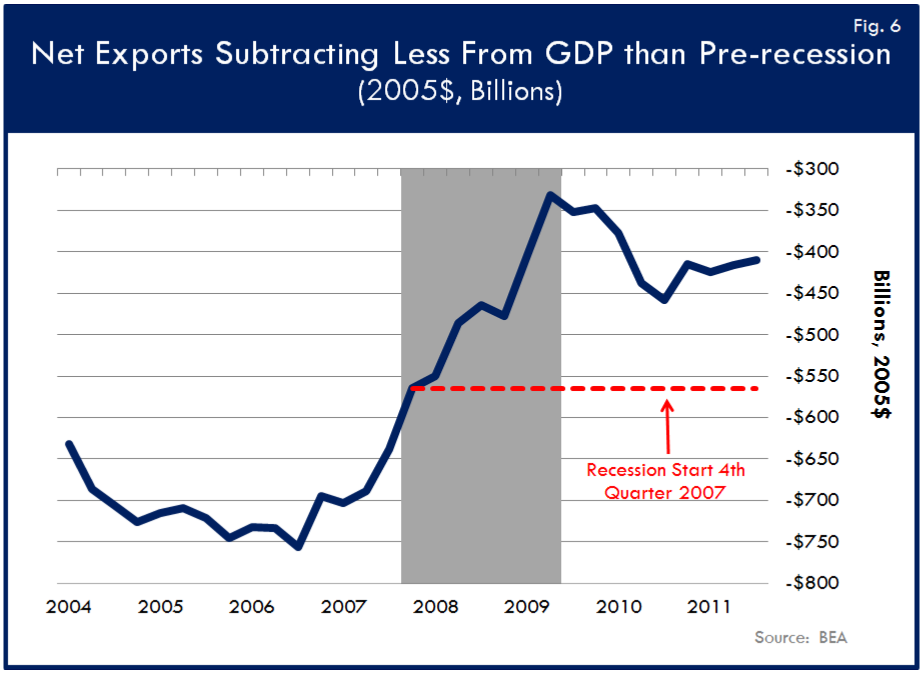
Government Consumption and Investment Above Pre-recession Levels

(2005\$, Billions)



Imports and Exports

The trade component of GDP, net exports, is also greater than pre-recession levels. Real net exports increased from -$564.6 billion (2005 dollars) in 4th-quarter 2007 to -$409.4 billion in the most recent quarter. Net exports are calculated by subtracting imports of goods and services from exports of goods and services (See Fig. 6).

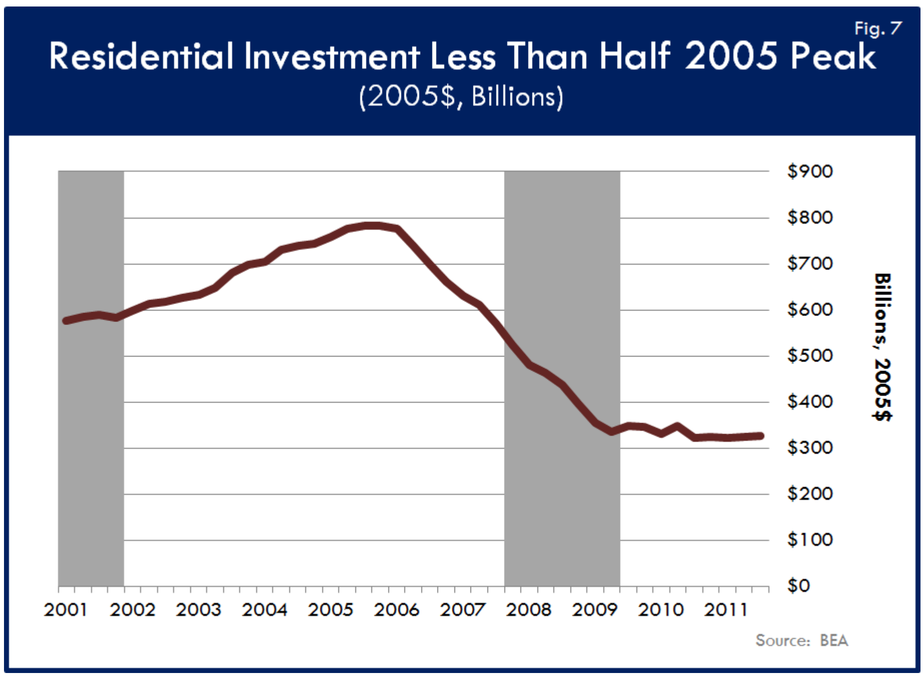


Real imports are only 0.2% greater in real terms than they were in 4th-quarter 2007. Real exports on the other hand are 9.9% higher in real terms than they were in 4th-quarter 2007.

Exports are an increasingly important contributor to GDP. In the most recent quarter, exports were equal to 13.3% of GDP – an all-time high.

Investment – the Missing Link

The investment component of GDP, formally known as gross private investment, can be divided into two major categories: (1) fixed investment and (2) change in private inventories. Within the fixed investment category there are (1) nonresidential fixed investment and (2) residential investment.



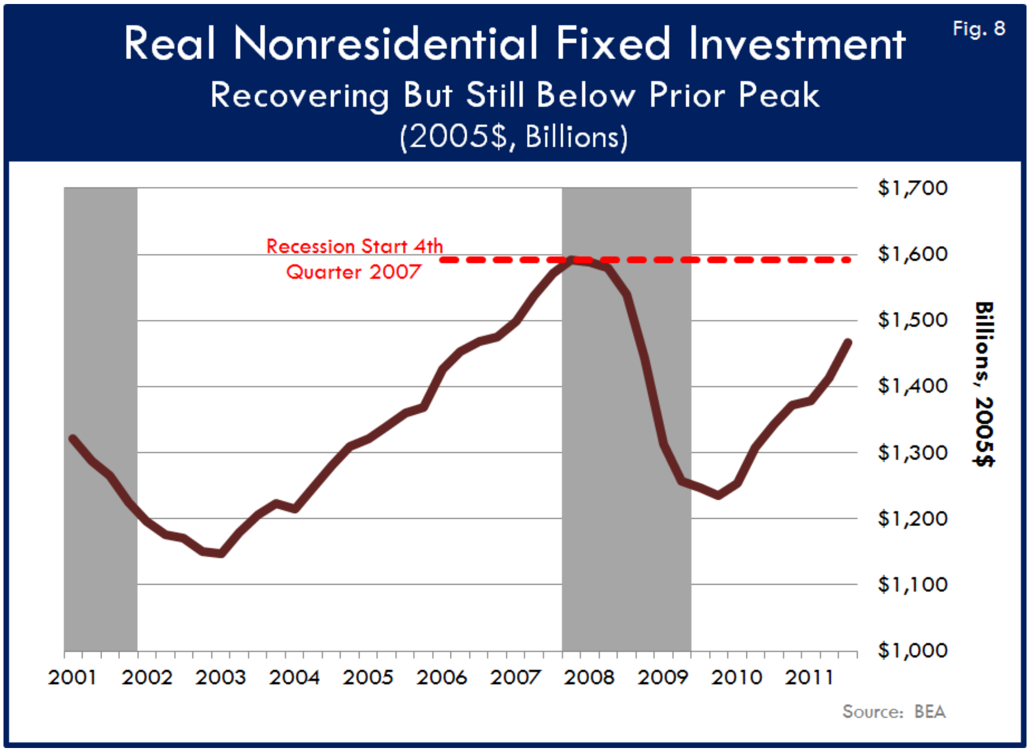
Both components of fixed investment have not recovered to pre-recession levels. The decline in residential investment has been well-documented in connection with the housing bubble that served as a catalyst, if not the proximate cause of the recent financial crisis and recession.

<u>Housing</u>

While residential investment ticked up modestly in the most recent quarter to $326.3 billion (2005 dollars), it is 38% below the 4th-quarter 2007 level and 58% below the peak reached in the 4th-quarter 2005. Residential investment accounted for just 2.4% of GDP in the most recent quarter. On average during since 1980, residential investment has represented 5.0% of GDP.

Figure 7 shows the recent path of residential investment. The evidence of the bubble is quite stark.

Private Nonresidential Fixed Investment



As noted earlier, changes in private nonresidential fixed investment has highly correlated to changes in private sector payrolls. Private nonresidential fixed investment consists of business investment in buildings, equipment, and software. Like the housing component of investment, nonresidential fixed investment remains significantly below pre-recession levels. Nonresidential fixed investment posted an all-time high of $1.6 trillion (2005 dollars) in the 4th-quarter 2007. Despite the positive increase in in today's report, nonresidential investment remains 7.8% below its peak. Nonresidential investment was slightly less than $1.5 trillion (2005 dollars) of GDP (Fig. 8).

Conclusion

The proposal to increase taxation on investment goes against the foundation of economic recovery. Without private investment, there cannot be sustainable growth and job creation. The old adage that says "if you want less of something tax it more, if you want more of something don't tax it or tax it less" rings true in the midst of our current tepid recovery.

The overhang of health care reform, excessive regulation, a worsening federal fiscal situation, and the drumbeat for higher taxes on investors, entrepreneurs and other job creators remains a significant threat to economic growth and private sector job growth.

The consumer is contributing more, government is contributing more, and exports are contributing more. Missing in action, however, is private investment. The recovery cannot reach a critical mass without increased and increasing private investment.