National Economic Trends

May 2003

THE FEDERAL RESERVE BANK of ST. LOUIS

Waiting for the Investment Boom? It Might Be a While

Some economists believe that the 2001 recession ended in the fourth quarter of 2001 (see the inside cover of this publication). Since then, real business fixed investment (BFI)—expenditures on structures and equipment and software—has declined at a 2.2 percent annual rate. By contrast, in the first four quarters of the typical recovery, real BFI *increases* a little more than 8 percent.

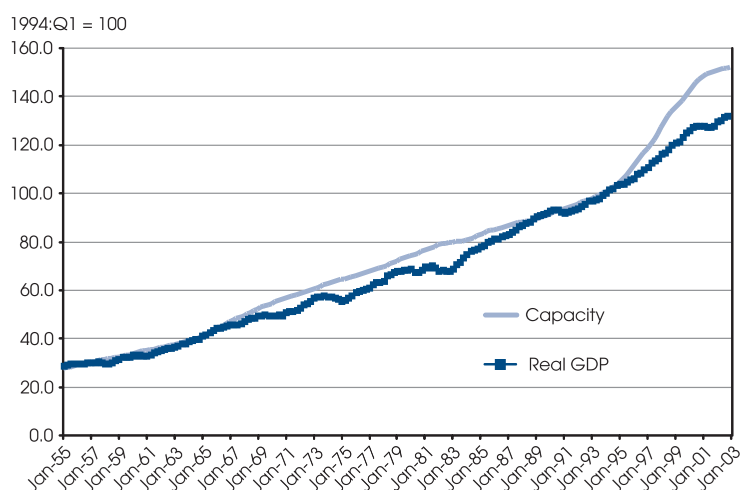
One reason why growth of real BFI has remained weak is that real GDP growth during the recovery has been weaker than normal, which is probably related to the mildness of the 2001 recession. Geopolitical uncertainties arising from the conflict with Iraq and tensions with North Korea may be another reason why business investment spending has been unusually weak. According to this argument, firms have been postponing plans for new capital projects until the risks become clearer. Indeed, in the policy statement issued after the March 18 Federal Open Market Committee meeting, Fed policymakers said that, until these uncertainties abate, they will not be able to “usefully characterize” the risks to the outlook.

Another explanation is that a recovery in business investment is being hampered by a capital “overhang.” According to this view, the economy’s actual capital stock currently exceeds its desired capital stock because of the investment boom of the late 1990s, which was perhaps exacerbated by the euphoria in the stock market. Some data support this argument: During the record-long 1991-2001 expansion, real BFI increased 113 percent and real GDP increased by about 39 percent. In contrast, during the 1961-69 expansion (the second-longest) real BFI increased 95 percent and real GDP increased by about 51 percent; and in the 1982-90 expansion (the third-longest), real BFI increased 42 percent and real GDP increased by about 37 percent.

The strongest rates of business capital spending during the 1991-2001 expansion occurred toward its end. The accompanying chart shows this by plotting the Federal Reserve’s measure of manufacturing capacity and real GDP since 1955. Economic theory says that growth of output (real GDP) will be commensurate with the growth of capital inputs and, by extension, capacity. From the first quarter of 1955 to the first quarter of 1994, growth of manufacturing capacity (3.4 percent per year) was nearly identical to the growth of real GDP (3.3 percent per year). Since 1994, however, growth of manufacturing capacity (4.7 percent) has far outstripped growth of real GDP (3.1 percent).

It is possible that the sharp declines in the prices of capital goods (particularly high-tech goods) in recent years have become more or less permanent, inducing firms to permanently alter the mix of their capital-labor inputs. If so, there might not be much of an overhang. But if an overhang does exist, we would expect to see relatively slow growth of real BFI until growth in output can create demand for capital beyond the stock already in place.

—Kevin L. Kliesen



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