

PRIVATE DOMESTIC INVESTMENT IN THE CURRENT BUSINESS CYCLE

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Few business statistics are as important as those that measure private investment. Private investment decisions are often crucial in determining whether a recovery will speed up or falter. Furthermore, over the long run current private investment determines the future productivity of the economy. Analysts have been concerned about the weak behavior of investment in the current recovery. This weakness may just be a reflection of the general sluggishness of the economy. However, if this weakness cannot be explained by cyclical factors alone, then there must be other special factors inhibiting investment. In order to determine the amount of weakness to be attributed to cyclical causes, this article compares the relative behavior of investment and consumption in the current cycle with that of past cycles.¹ It then discusses some possible explanations for any weakness found in the investment sector that cannot be attributed solely to cyclical factors.

Cyclical Comparison Method In order to compare the behavior of the consumption and investment series in the current cycle with their behavior in past cycles, charts similar to the Cyclical Comparison Charts used in the Commerce Department's *Business Conditions Digest* are constructed.² Business cycles are defined using the reference peak and trough dates designated by the National Bureau of Economic Research.³ For each series percentage deviations from the reference peak level are calculated for the past five postwar cycles. For each cycle, these deviations are then superimposed on a chart in order to facilitate comparison among cycles. This is done by dating

¹ The Department of Commerce's Personal Consumption Expenditures and Gross Private Domestic Investment series are used to measure the performance of consumption and investment in the different cycles. Gross private domestic investment is composed of residential fixed investment, nonresidential fixed investment, and the change in business inventories.

² See U. S. Department of Commerce, *Business Conditions Digest*, October 1976, p. 117.

³ The peaks and troughs for the past 5 postwar cycles are: peaks: 1948 IV, 1953 II, 1957 III, 1960 II, 1969 IV; troughs: 1949 IV, 1954 II, 1958 II, 1961 I, 1970 IV. The peak and trough dates for the current cycle are 1973 IV and 1975 I, respectively.

each quarter of a given cycle according to how many quarters it is before (—) or after (+) the trough date. An average of the percentage deviations from the reference peak level for each quarter (dated as above) of all the cycles is then calculated to obtain a profile of average postwar cyclical behavior. The maximum and minimum deviations for each quarter are plotted along with this average composite deviation from the reference peak level to indicate the range of variability in past cyclical behavior. The percentage deviations from the reference peak level for the current cycle are plotted along with the average composite deviation series in order that recent cyclical behavior can be compared with past cyclical behavior.

Examination of the Data Chart 1 compares the cyclical behavior of constant dollar GNP in the current cycle with its behavior in past cycles. It shows

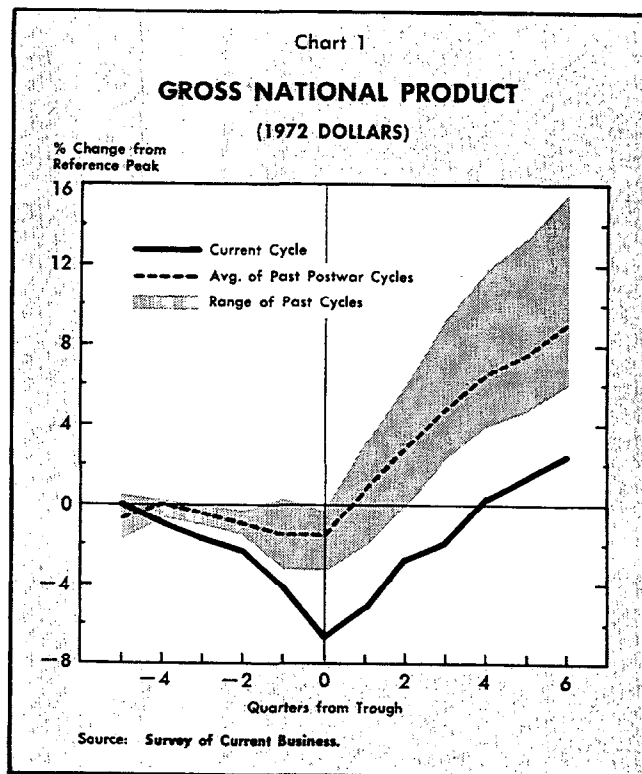
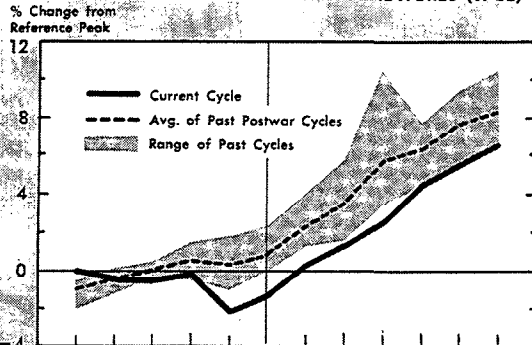
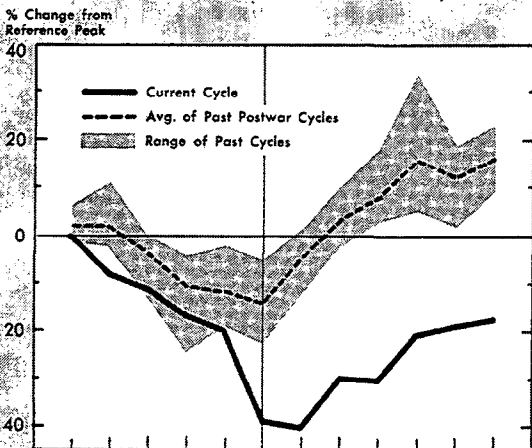


Chart 2
**COMPARISON OF
 CONSUMPTION AND INVESTMENT**
 (1972 DOLLARS)

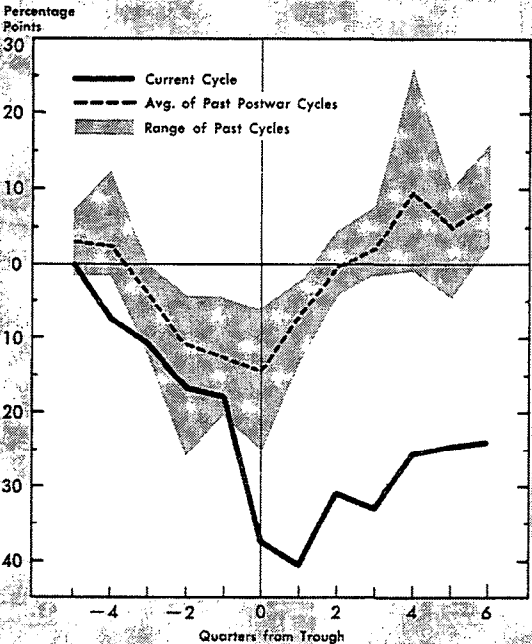
a. **TOTAL PERSONAL CONSUMPTION EXPENDITURES (TPCE)**



b. **GROSS PRIVATE DOMESTIC INVESTMENT (GPDI)**



c. **% CHANGE IN GPDI MINUS % CHANGE IN TPCE**



Source: Survey of Current Business.

that the decline in real GNP is much sharper in the current cycle than in past cycles and that the rate of recovery has been slower. For example, six quarters after the trough date, real GNP is only 2.3 percent higher than the reference peak level for the current cycle, while for the average of past cycles it is 8.96 percent higher. This suggests that both consumption and investment may be recovering more slowly than usual.

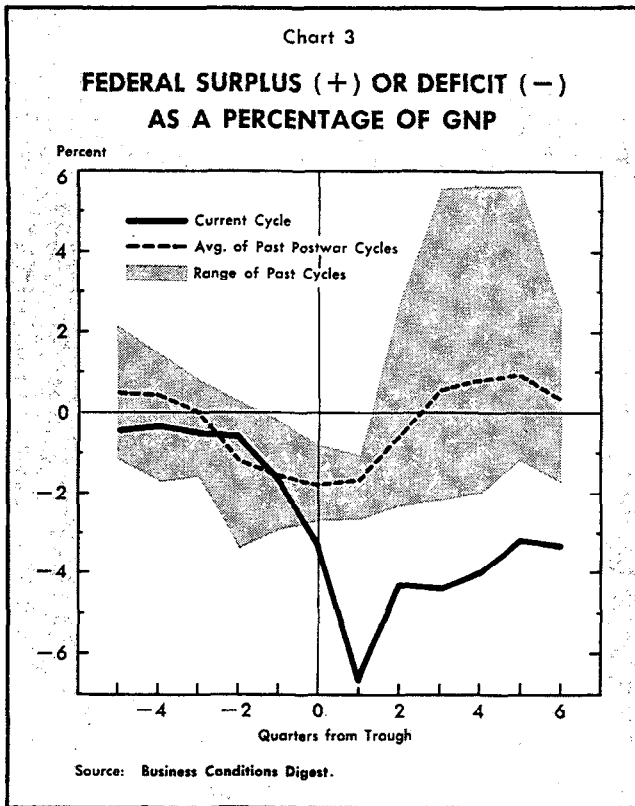
Comparison of Consumption and Investment

Chart 2a shows the cyclical behavior of constant dollar personal consumption expenditures in the present cycle and in the average of past cycles. The chart indicates that on average the recovery of real personal consumption from the initial peak to six months after the trough has been somewhat slower in the current cycle than in past cycles.

Chart 2b compares the recent cyclical behavior of real gross private domestic investment with its past cyclical behavior. Again, the chart indicates the recovery of real gross private domestic investment has been slower in the present cycle than it has been in past cycles. However, comparison of Chart 2b with Chart 2a seems to indicate that the recovery of investment relative to the recovery of consumption has been much weaker in the 1973-76 cycle than in past cycles.

Chart 2c measures the difference between the percentage change from the reference peak level of real gross private domestic investment and the corresponding percentage change for real personal consumption for both the average of past cycles and for the current cycle. This difference measures the relative performance of investment and consumption in the present cycle and in past cycles. The chart shows that the weakness in the current recovery has been much more pronounced in the investment series than in the consumption series. For the average of past postwar cycles, the percentage change from the initial peak to six quarters after the trough for real gross private domestic investment exceeds the corresponding percentage change for real personal consumption by 7.92 percentage points; for the current cycle, the percentage change from the initial peak to six quarters after the trough for real gross private domestic investment is 23.8 percentage points *less* than the corresponding percentage change for real personal consumption.

Reasons for the Weakness in Investment A number of different hypotheses have been put forward to explain this weakness in the investment sector. Three of these are presented below.



The first is that the large Federal deficit in the current cycle has been “crowding out” private investment. Proponents of this view argue that the effect of Government spending financed by borrowing from the private sector is to reduce the amount of savings available for private investment. According to this hypothesis, the total supply of bonds in the capital market increases as Government debt increases. This greater bond supply causes bond prices to fall and interest rates to rise, thereby crowding out private borrowers. Moreover, so the argument goes, since the deficit in the current cycle has mainly financed income transfer programs such as unemployment insurance, that deficit (assuming it crowded out private investment) would tend to increase consumption relative to investment in the recovery.

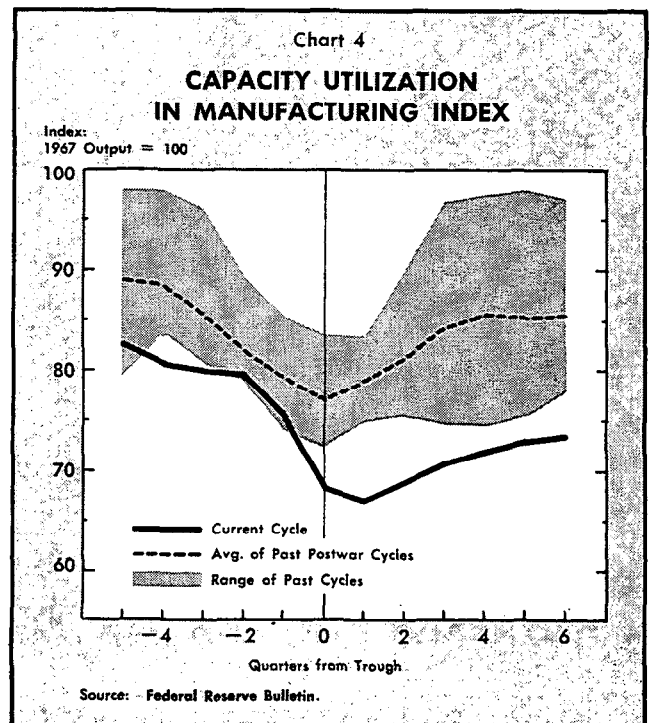
Chart 3 shows the Federal surplus (positive values) or deficit (negative values) as a percentage of GNP for both the current cycle and the average of past cycles. The chart indicates that the deficit as a share of GNP is substantially larger in the recent cycle than in past cycles. Since it has been financed chiefly by sales of bonds to the public as opposed to indirect bond sales to the Federal Reserve,⁴ pro-

⁴ From December 31, 1973 to September 30, 1976, total holdings of Government securities by private investors increased by \$123.9 billion, while total holdings by the Federal Reserve went up by only \$17.9 billion.

ponents of the crowding out hypothesis believe that the deficit in the current cycle has been crowding out private investment.

A second explanation is that the severity of the recent recession has created an abnormal amount of excess capacity in the economy, which has acted as a brake on investment spending. According to this view, investment is determined by the difference between the desired capital stock and the actual capital stock. The desired capital stock decreases during recessions and increases during expansions. If, during a severe recession, the desired capital stock decreases substantially more than the actual capital stock, then during the initial part of the recovery increases in the desired capital stock will lead to increased utilization of capacity and not to increased investment. Since the recent recession has been more severe than the past postwar recessions, adherents of this “underutilization” hypothesis believe that it is a cause of the weakness in investment in the current recovery.

Chart 4 depicts the cyclical behavior of the Federal Reserve’s Capacity Utilization in Manufacturing Index, which measures the ratio of actual output to a measure of total output capacity, for the current cycle and for the average of past cycles. The chart indicates that for the current cycle the index is lower on average than past cycles throughout the entire period, and that the recovery of the index to pre-recession utilization rates has been a little slower than usual in



the current cycle. However, it is difficult to determine to what extent this low level of capacity explains the recent weakness in investment.⁵

The third explanation is that recently proposed "antibusiness" legislation, such as stricter antipollution requirements and price controls, plus the erratic behavior of recent monetary and fiscal policy, has scared businessmen away from long-term investments. According to this "scare" hypothesis, the threat of these antibusiness proposals becoming law, as well as the unpredictability of future monetary and fiscal policy, has increased the risk associated with private investment, which is similar to reducing the rate of return on investment. If the current mood of legislators is more antibusiness than it has been in previous cycles, or if current monetary and fiscal policy has been less predictable than past policy, then one would expect consumption to outperform investment in the current cycle. While this hypothesis is difficult to support empirically, adherents point to statements by both business leaders and financial analysts that support it.

⁵ Also, the degree to which this capacity utilization index actually measures the utilization rate of the economy is open to question. It is particularly difficult to measure how much of the existing capital stock is actually usable. This is especially true in recent years, since the rapid rise in energy costs has made many older plants obsolescent.

Obviously, the policy implications of each of these explanations differ. For example, an increased deficit financed by borrowing from the public will have little or no effect on total spending if the crowding out effect is strong. The underutilization hypothesis suggests that if the recovery is going along smoothly, then investment will eventually pick up as pre-recession utilization rates are reached. And if the scare hypothesis has validity, then more cautious and predictable economic policies are needed to restore confidence and induce investment.

It is possible that the weakness in the recovery of investment spending has been the result of a combination of all three of the above explanations. For example, it is possible to have some crowding out occur and at the same time have a low utilization rate inhibiting investment, with an unpredictable Government simultaneously scaring businesses with its policy threats. It is also possible that the weakness in investment has been caused by factors not mentioned.⁶ Whatever the causes, the subject of the determinants of private investment merits continued, careful study.

⁶ Some other possible causes of the weakness in investment include: the adverse effect of inflation on corporate profits; the restructuring of corporate balance sheets weakened by the recession; and the longer time it takes for investment spending to respond to changes in economic activity than for consumption spending to respond.