An A-Theoretical Approach to Speculating About Economic Growth in the Near-Term

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Whether the business cycle is a self-sustaining process, as in the "classical" theory, or merely a pattern imposed by adjustments to unforeseeable exogenous shocks, as in the "real" business cycle theory, leading economic indicators have predictive value. According to the "classical" theory, this is true especially at turning points, but also at other junctures. According to the "real" business cycle theory, this is not true at cycle peaks, because they are caused by random shocks. Assuming that there will be no such disruptions this year, however, both views allow for the leading properties of some aspects of economic activity at this point in the current cycle.

In practice, these leading characteristics can be exploited to produce a specific forecast of economic growth for the year. Based on the historical relationship between the composite leading economic index (LEI) and real gross domestic product (GDP), the recent pattern of the LEI is consistent with a 2-1/2 percent increase in economic activity this year. Given the first quarter level, this translates into an annual growth rate of 3-3/4 percent from the first to the fourth quarters.

Unfortunately, a precise forecast is not the same thing as an accurate one. The LEI points to a specific rate as the most likely over the balance of the year, but is consistent with many other rates of growth, as well. As it turns out, the dispersion of possible growth paths is wide enough that none is reliable.

But when the question is changed from "How fast will the economy grow?" to "How likely is it that growth will exceed a certain threshold?", the analysis does provide some guidance. An examination of the many different potential futures implied by the uncertainty inherent in the historical LEI-GDP relationship puts the odds that growth will top its long run trend rate of 3 percent at approximately 2:1. That is still far from a sure thing, but at the racetrack a horse with odds like that is a heavy favorite.

How might such a scenario unfold? Even with unspectacular gains in auto sales, real consumer spending can easily grow by 2-1/2 to 3 percent from the first to the fourth quarter. That is not much of an acceleration from the 2-1/4 percent pace of the past year, and there are many signs of a step-up in growth. Consumer confidence is climbing once again, consumers have managed a substantial restructuring of their balance sheets, and labor markets are finally firming. The household employment survey shows net job creation of 1.2 million since last November. The lengthening of the workweek in manufacturing, increases in over-time hours, and several surveys of hiring plans suggest the trend will intensify this summer.

With respect to inventories, the surge in final demand in the first quarter, coupled with the sharp inventory liquidation and recent increases in commodity prices, is consistent with net additions to real inventories of $20 billion per quarter at an annual rate. The tentative strengthening of short term business credit also points to growth in inventories.

A modest widening in the trade deficit will offset some of the boost from inventory rebuilding, as demand in the U.S. outstrips demand overseas. Residential building is likely to cool off in the third quarter, as demographics begin to overshadow cyclical factors. Nonresidential construction may continue to contract under the weight of high vacancy rates, though perhaps less rapidly. But the prospects are bright for investment in equipment, judging by the surge in first quarter profits and the relatively high level of capacity use for this stage of the business cycle. The May survey of capital spending plans is consistent with growth of 10 percent or more at an annual rate from the first to the fourth quarter.

As is always the case, the evidence is not one-sided. A chief objection to the solid-growth scenario is that M2 continues to grow too slowly to support a 4-percent recovery. Recent research at the Cleveland and Dallas Federal Reserve Banks shows that the closing of failed thrifts by the Resolution Trust Corporation (RTC) understates M2 by accelerating the move out of small time deposits at thrifts. When M2 is adjusted for RTC activity, the relationship between M2 and its opportunity cost is restored, suggesting a measurement problem, not a policy problem. Finally, other gauges of monetary thrust, such as commodity prices, the foreign exchange value of the dollar, the slope of the yield curve, and growth of the narrower monetary aggregates, are not inconsistent with sufficient liquidity to sustain economic growth of 4 percent.