August 21, 2014

Seeking the Source

As the early data on the third quarter begin to roll in, the (very tentative) conclusion is that nothing we know yet contradicts the consensus gross domestic product (GDP) forecast (from the Blue Chip panel, for example) of seasonally adjusted annualized Q3 growth in the neighborhood of 3 percent. The latest from our GDPNow model:

> The GDPNow model forecast for real GDP growth (seasonally adjusted annual rate) in the third quarter of 2014 was 3.0 percent on August 19, up from 2.8 percent on August 13. The nowcast for inventory investment ticked up following the Federal Reserve's industrial production release on August 15 while the nowcast for residential investment growth increased following this morning's new residential construction release from the U.S. Census Bureau.

The contribution of residential investment is obviously welcome, but the inventory contribution in the industrial production release tilts in the direction of one of our concerns about growth performance in the second quarter. Specifically, too much inventory spending, too little "core" spending.

On the plus side, our projections for current-quarter investment spending have been increasing, outside of nonresidential structures. On the much less positive side, the nowcast for consumer spending has been falling off and currently looks to expand at a pace barely above 2 percent.

Weakness over the course of this recovery in the key GDP expenditure components of consumer spending and investment has been the subject of a lot of commentary, recent entries being provided by Jonathon McCarthy (on the former, at Liberty Street Economics) and Jim Hamilton (on the latter, at Econbrowser). McCarthy in particular points to less-than-robust consumption expenditure as a source of growth since the end of the recession that has been slower than hoped for:

> One contributor to the subdued pace of economic growth in this expansion has been consumer spending. Even though consumption growth has been somewhat stronger in the past couple of quarters, it has still been weak in this expansion relative to previous expansions.

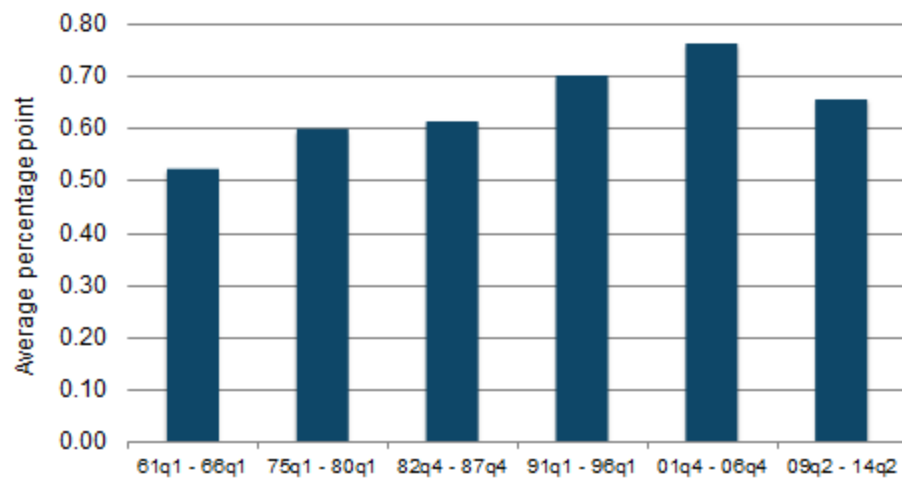
An earlier version of the McCarthy theme appeared in this post on Atif Mian and Amir Sufi's House of Debt blog:

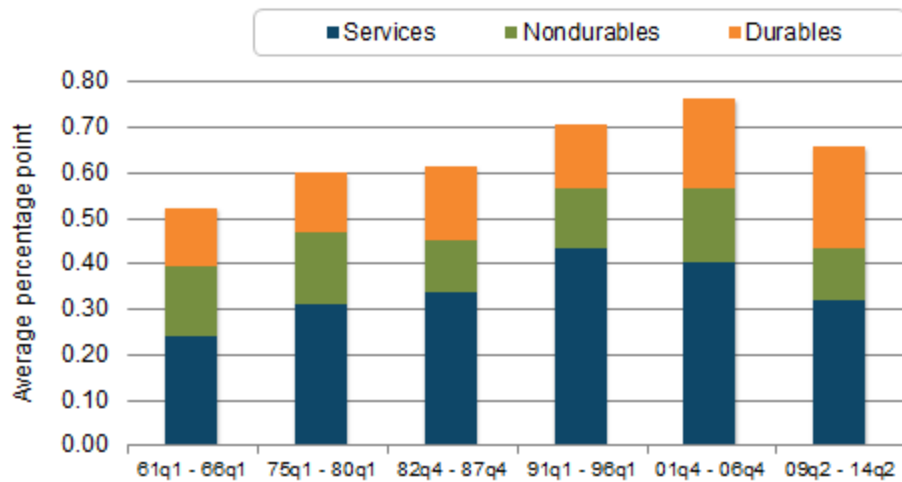
> ...the primary culprit: consumption of services and non-durable goods. They are shockingly weak relative to other recoveries.

There is something of a chicken-and-egg conundrum in all of this discussion. Has GDP growth disappointed because consumer and business spending has been lackluster? Or has consumer and business spending been weaker than we expected because GDP growth has lagged the pace of past recoveries?

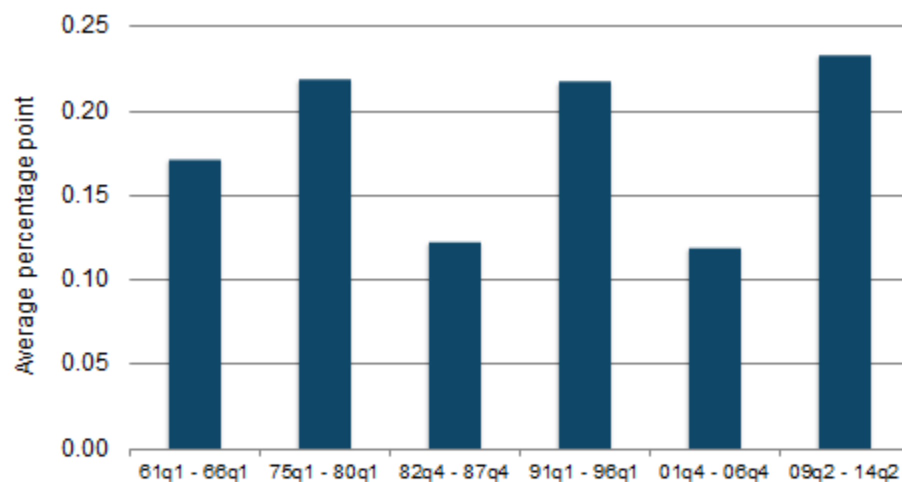
In fact, the growth rates of consumption expenditure and business fixed investment—which excludes the residential housing piece—have not been particularly unusual over the course of this recovery once you account for the pace of GDP growth.

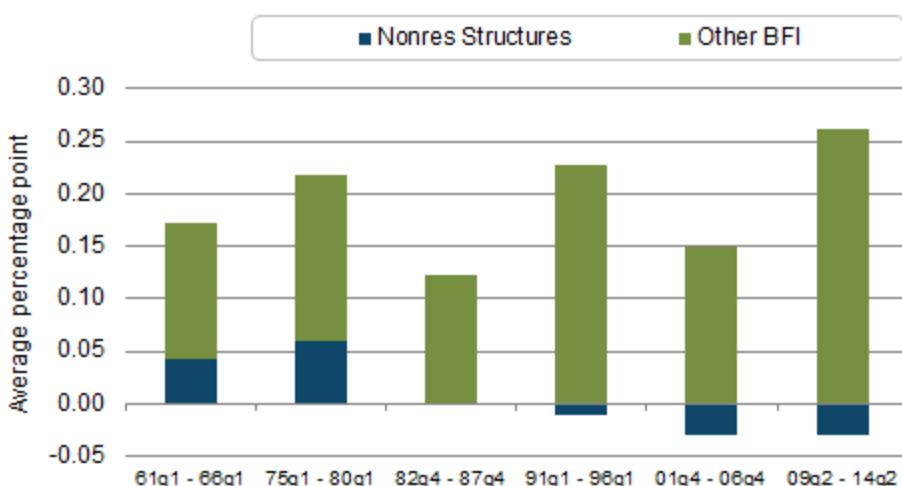
The following charts illustrate the average contributions of consumption and investment spending as a percent of average GDP growth for the 20 quarters following six of the last seven U.S. recessions. (I have excluded the period following the 1969–70 recession because 20 quarters after that downturn include the entirety of the 1973–75 recession.)





It is worth noting that these observations also apply to the components of consumption (across services, durables, and nondurables) and business fixed investment (across equipment and intellectual property and structures), as the following two charts show:





The conclusion is that if growth in consumption and investment has been particularly tepid over the course of the recovery, it merely reflects the historically tepid growth in GDP.

Or the other way around. These charts represent nothing more than arithmetic exercises, a mechanical decomposition of GDP growth into couple of the spending components that make up to the whole. They tell us nothing about causation.

What we have is the same too-full bag of possible explanations for why GDP has not yet returned to levels that—before the financial crisis—we would have associated with "potential": too much regulation, too little lending, excessive uncertainty, not enough government-driven demand, and so on. Maybe more investment spending would cause more growth. Maybe not.

In the language of the hot topic of the moment, this ultimately takes us to the debate over secular stagnation—what does it mean, does it exist, what is its cause if it does exist? Steve Williamson provides a useful summary of the debate, which is not yet at the point of providing actual answers. And unfortunately, the answers really matter.

By Dave Altig, executive vice president and research director of the Atlanta Fed

August 21, 2014 in Economic Growth and Development, GDP | Permalink