Economic Activity

Gross domestic product (GDP) grew at a paltry 1.4% annual rate in 2000:IVQ. Despite this weak showing, the year still finished with a healthy fourth-quarter to fourth-quarter growth rate of 3.5%. Major contributors to the deceleration were business fixed investment and personal consumption, which fell to -1.4% and 2.9% from their respective third-quarter growth rates of 7.7% and 4.5%. The trade balance also contributed to slower growth, as exports contracted 4.3%. These declines were partly offset by an upturn in government spending, which grew 2.9% after having fallen 1.4% in the third quarter. Blue Chip forecasters expect the downturn to be short lived; GDP growth should nearly equal its 30-year average by 2001:IIIQ.

While growth in most sectors of the economy slowed last year, none was hit harder than manufacturing. Year-over-year manufacturing sales growth dropped from 8.4% in January 2000 to 2.4% during November. Retail sales were close behind, dropping from 10% to 5% over the same period. Of the December series available, retail sales have weakened further to 3.4% as year-over-year growth of auto sales decelerated from 14% in January 2000 to less than 1% in December.

The Conference Board’s Index of Leading Economic Indicators has dropped during five of the last six months, yielding a 0.76% decline over the past year. Historically, when the index’s year-over-year growth has dipped below zero, a recession has followed in every case except 1995.

The drop in the Leading Economic Indicator series prior to recessions is typi-
Economic Activity (cont.)

a. Percent change in December imputed using percentage-point contribution and index weight.
b. Correlation coefficient computed using quarterly growth rates over a moving 10-year period.

NOTE: All data are seasonally adjusted and annualized.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and the Conference Board.

c. Averaging 4.4% prior to every recession before 1990. The most recent 0.76% decline is in line with the 1995 experience and small compared to past recessions. Recently, however, the index has fallen more sharply, declining 0.64% in December alone. The leading contributors to the drop were average weekly hours of manufacturing firms, consumer expectations, and interest rate spreads. Changes in real M2 helped to offset some of these declines.

Even if this drop continues, it is difficult to gauge whether a recession is imminent. There is some indication that the correlation between changes in the Leading Economic Indicators and future GDP growth has not remained stable over the last three decades. During the 1970s and 1980s, the moving 40-quarter correlation between quarterly growth rates of the index and GDP growth averaged 0.76. After 1990, however, the correlation dropped precipitously and has averaged only 0.33 since 1994.

The correlation between GDP growth and the largest contributors to the index (in terms of weight) has also fallen significantly during this period. One hypothesis is that the 1990s relatively stable GDP growth makes it appear that the Leading Economic Indicator series is now a poor predictor of oncoming recessions. However, when the large changes in GDP prior to 1990 are eliminated from the samples to mimic volatility since 1990, the correlation is still 0.6—significantly higher than the recent correlation of 0.33. The index’s reliability appears to have declined substantially in the 1990s.