Real GDP growth over the past four quarters was a paltry 1.2%, but even this was better than the 0.3% increase registered for 2001:IIQ. If the latest expansion is considered investment-led, then second-quarter data suggest that the current slowdown may be described the same way. The weak growth of GDP in 2001:IIQ resulted largely from investment, which was responsible for a whopping –2 percentage points. One reason why the expansion and the slowdown may both be investment-led is the huge run-up—and subsequent decline—in stock prices. Why stock prices tend to predict future real GDP growth is a matter of debate. Stock prices move first, but this in itself does not indicate that a drop in stock prices causes real GDP growth to decline. It is possible that investors expect low GDP growth and that this causes stock prices to fall. However, there are two reasons why lower stock prices may cause a decline in real GDP growth rather than just predicting it.

One frequently stated reason is that lower stock prices reduce households’
wealth and so lead to lower consumption. The other theory argues that firms’ balance-sheet effects are important. Lower stock prices effectively decrease the collateral backing firms’ loans; this creates higher risk premiums, hence lower investment. The risk premium is the difference between firms’ borrowing costs and the risk-free rate.

The difference between these two stories is of more than academic interest: Balance-sheet effects cause real GDP to fall both now and in the future because lower investment causes tomorrow’s capital stock to be lower than it otherwise would have been. The idea that balance-sheet effects are important is supported by the strong positive correlation between the risk premium and the investment-market capitalization ratio. Strong investment generally means higher demand for firm borrowing, which, for a given value for equity prices, increases the risk premium. A decline in equity values, however, also raises the risk premium. Such an increase would tend to decrease investment and thus output.

The correlation between the risk premium and output is ambiguous, however. Although a fall in stock prices may raise the risk premium and dampen output and investment, a weak economy may cause investment—and thus firms’ borrowing—to fall by more than the decline in stock prices, thus decreasing the risk premium. The data support both possibilities: A high risk premium tends to precede lower economic growth, while low economic growth tends to precede a lower risk premium.