

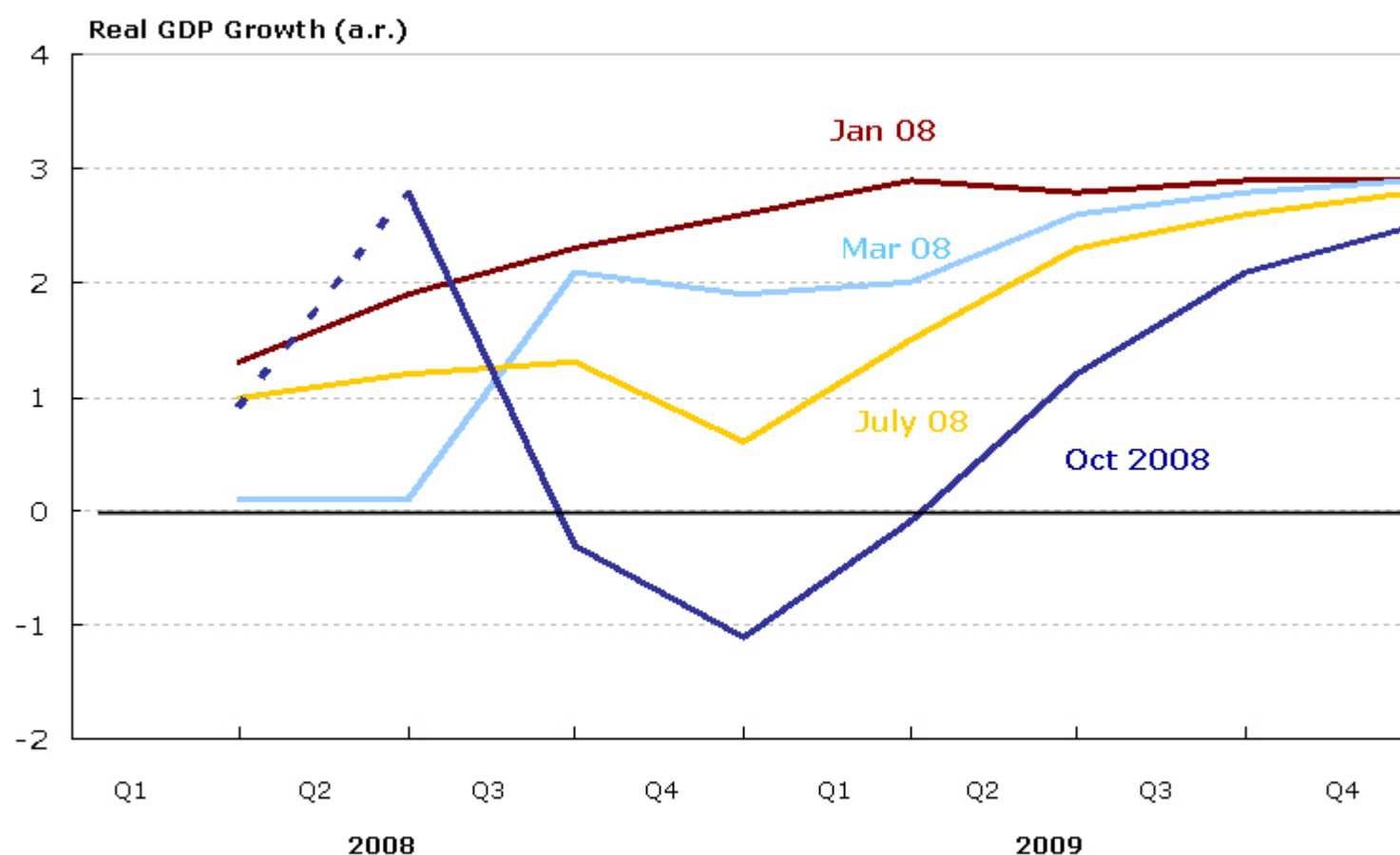
October 22, 2008

## The evolving economic outlook

I understand that economic forecasts are notoriously inaccurate. The last time I looked, [the root mean square error of economists' year-ahead growth forecasts](#) was 1.4 percentage points. In other words, you'd expect the consensus forecast to be within about 1½ percentage points of the actual outcome only about two-thirds of the time (and individual forecasts tend to be even worse than the consensus).

Accurate or not, predictions of the future are an essential input into decisions made throughout the economy, and the negative tone in the incoming data has led most forecasters to sharply cut their growth expectations through 2009. The first chart below shows how the Blue Chip consensus growth forecast for 2008–2009 has evolved.

### Evolution of the 2008–2009 Blue Chip Consensus Growth Forecast



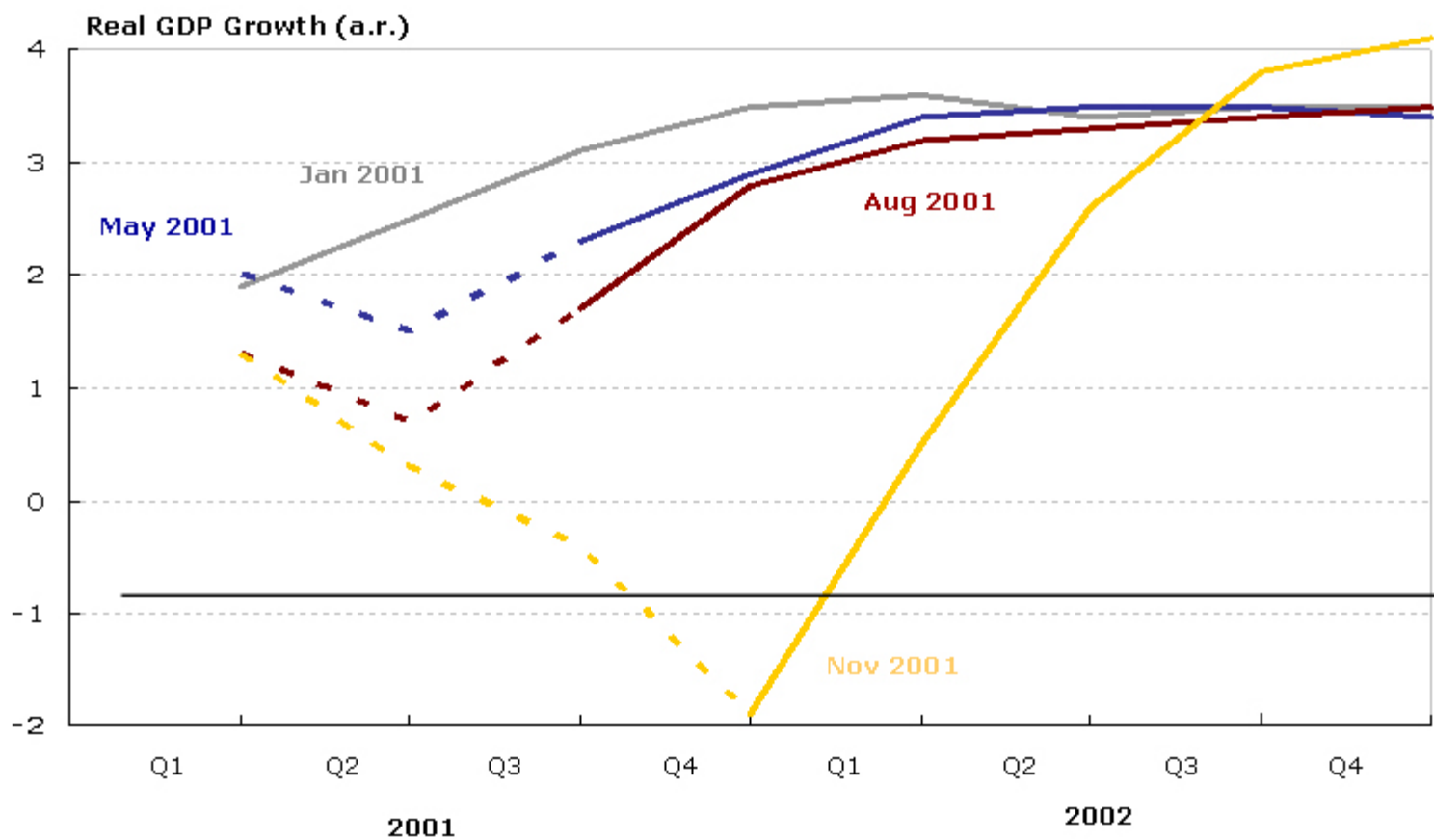
As of October 10 (before forecasters had seen most of the September data), the Blue Chip consensus forecast showed the economy entering a period of negative growth last quarter and remaining that way (or near it) until the second quarter of next year with subpar growth continuing through the end of next year.

Indeed, the current Blue Chip growth projection for the U.S. economy is a sharp deterioration from what economists had been anticipating when the year began. In January, the consensus outlook called for the year to start off a little sluggishly before gradually resuming a more typical growth path. As the year unfolded, however, and the deep problems affecting the housing market became more evident, growth prospects waned.

Want some good news? Economic forecasts are notoriously inaccurate. And they are especially inaccurate at turning points, which, according to the Blue Chip consensus, we've recently passed. Why do forecasts perform worst just when needed most? The shocks that hit the U.S. economy from time to time are complex and not very well behaved. The likelihood of extreme outcomes—so-called “tail risks”—vary from shock to shock. Moreover, there may be “nonlinearities” in response to these shocks, meaning economic relationships that operate one way when the economy is in an expansionary state may operate differently when the economy is in a recessionary state. So a model that may have worked well during the good times may not work so well during the bad.

Perhaps the evolution of the economic outlook during the previous business cycle is a useful example. Consider the next chart, which shows the evolution of the consensus forecast for 2001–2002, beginning with January 2002. As the data revealed the economy was in some distress, the economic outlook deteriorated—severely so when it became clear the U.S. economy was in recession (and in November 2002, the NBER officially declared that a recession had actually begun the previous March).

## Evolution of the 2001–2002 Blue Chip Consensus Forecast: Recessionary Phase

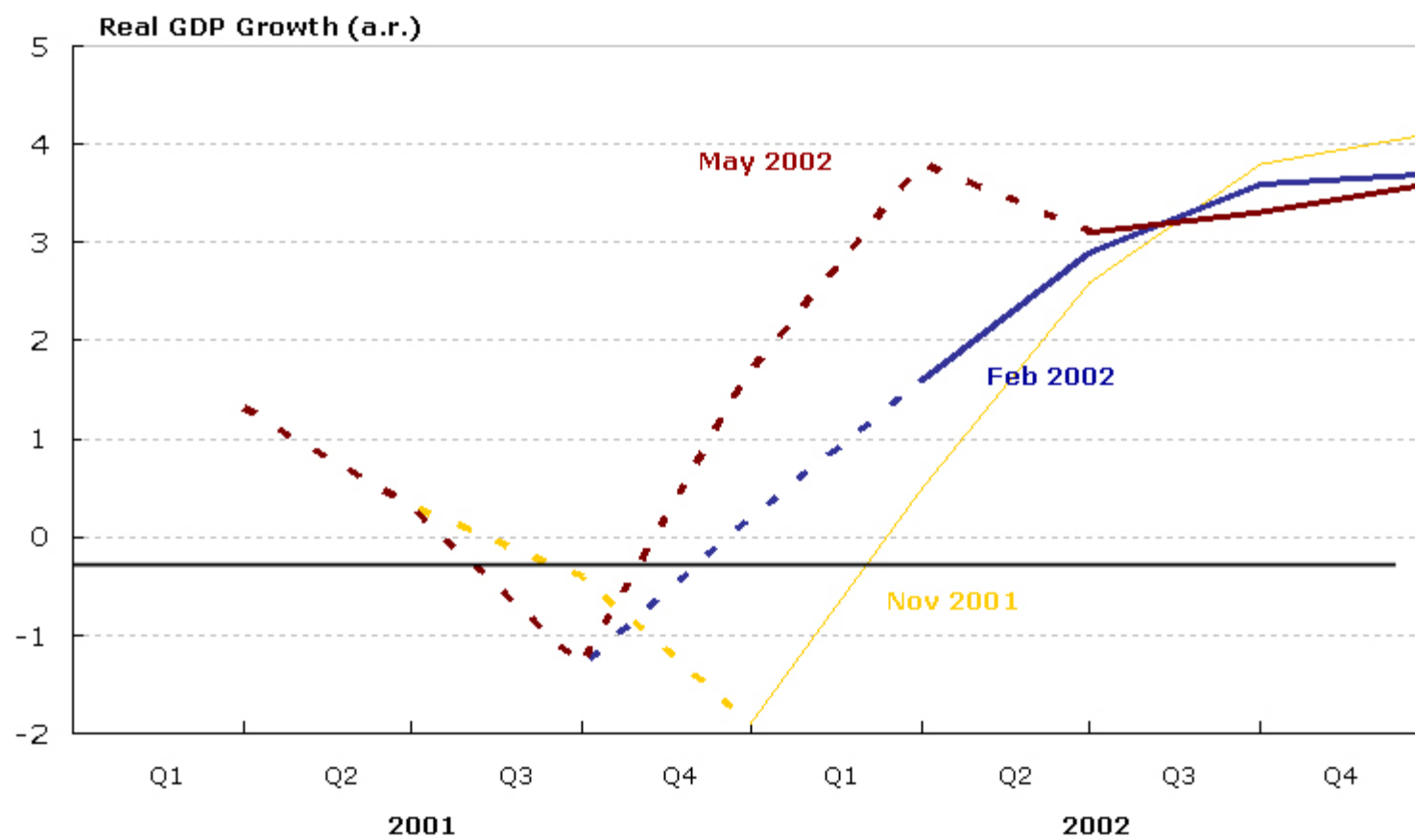


\* Dashed line represents real-time actuals.

Source: BlueChip Economic Indicators

But remember, there are (at least) two turning points in the business cycle. There's the downturn *and* a recovery. So the same problems that make spotting recessions hard also make it hard to anticipate the rebound. Again, let's look at what happened during the last business cycle. The next chart shows how the consensus forecast evolved as the economy transitioned from recession to expansion, which, coincidentally, began in November 2001.

## Evolution of the 2001–2002 Blue Chip Consensus Forecast: Expansionary Phase



\* Dashed line represents real-time actuals.

Source: BlueChip Economic Indicators

Between November and May of that time, the incoming data revealed that the consensus forecasts made during the recessionary period were overly pessimistic. The onset of expansion occurred sooner, and with more strength, than economists initially expected.

I am not aware of any individual forecast that can consistently outperform the consensus. And this is not an argument denying the economy is facing difficult times. But perhaps it's useful to keep in mind the limitations of economic forecasts in times like these.

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