Search

A A A

Federal Reserve Bank *of* Atlanta

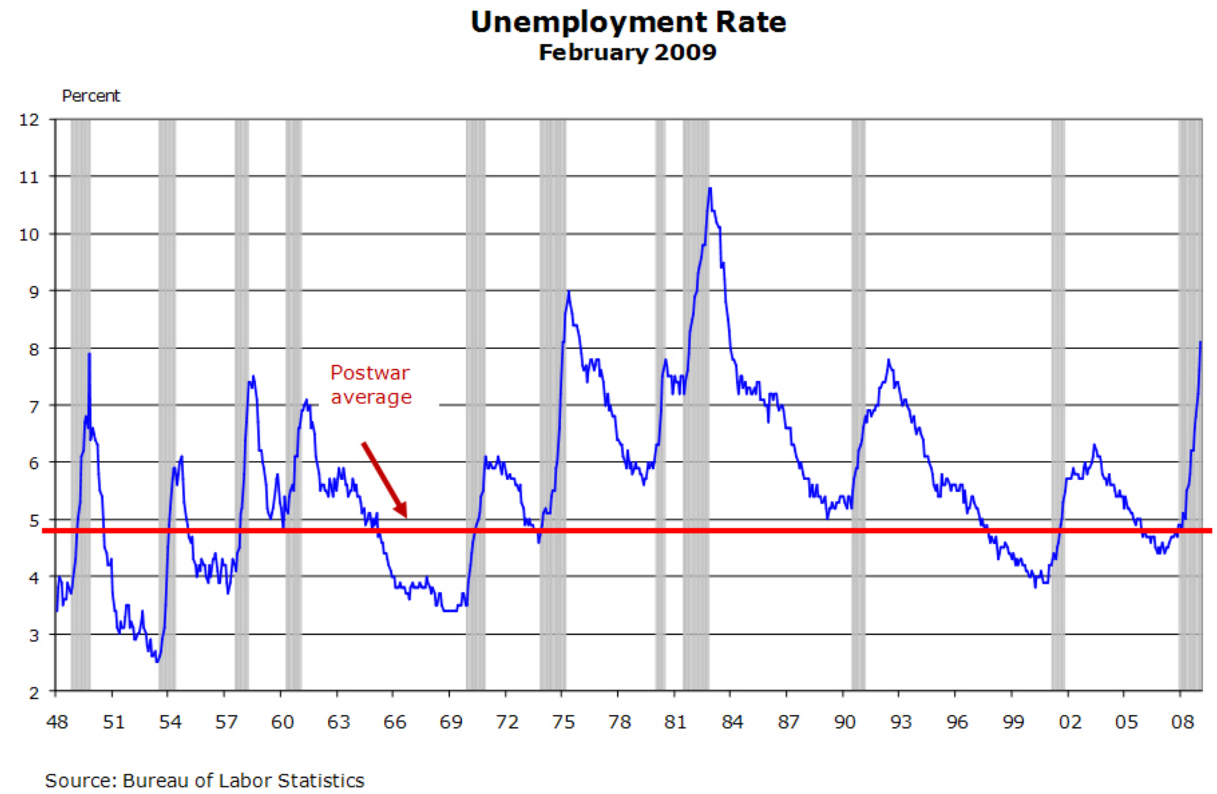
March 6, 2009

Dueling forecasts

When smart people debate, something interesting is bound to come of it, so I have been reading an interchange over the past couple of days in the blogs of Greg Mankiw and Paul Krugman. Krugman's blog provides the necessary background on the source of the debate:

> "Greg Mankiw challenges the administration's prediction of relatively fast growth a few years from now on the basis that real GDP (gross domestic product) may have a unit root—that is, there's no tendency for bad years to be offset by good years later.
>
> "I always thought the unit root thing involved a bit of deliberate obtuseness—it involved pretending that you didn't know the difference between, say, low GDP growth due to a productivity slowdown like the one that happened from 1973 to 1995, on one side, and low GDP growth due to a severe recession. For one thing is very clear: variables that measure the use of resources, like unemployment or capacity utilization, do NOT have unit roots: when unemployment is high, it tends to fall."

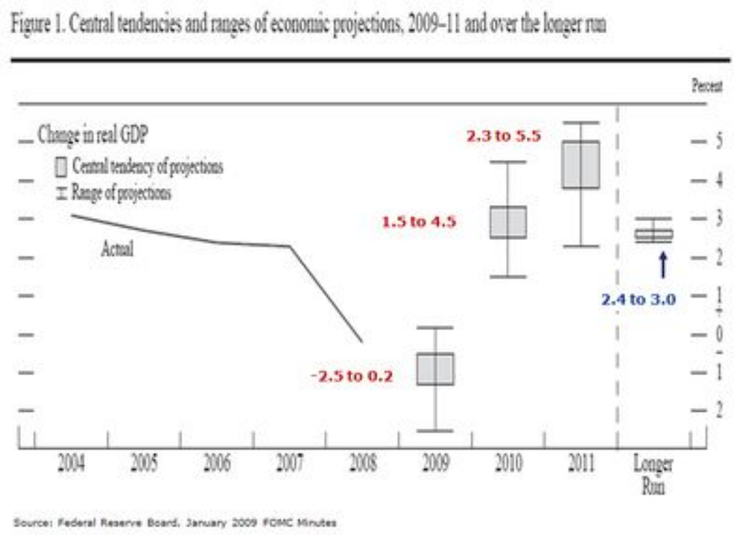
It is certainly true that when "unemployment is high, it tends to fall," but where it falls to is not always so obvious:



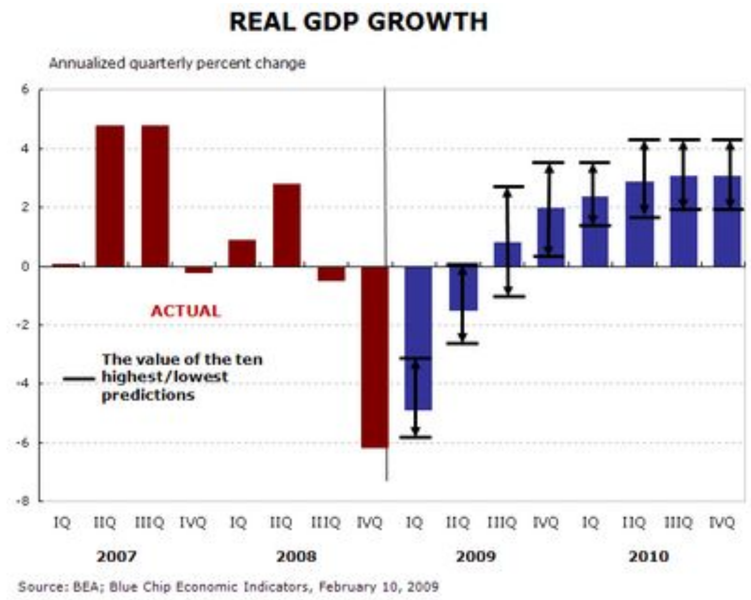
Prior to the 1973–75 recession, the average quarterly unemployment rate was 5 percent. If you had a forecast contemplating a return to "normal" following this particular recession you would have been holding your breath for a couple of decades.

Professor Krugman makes the central point, I believe, when he makes reference to the "difference between, say, low GDP growth due to a productivity slowdown… and low GDP growth due to a severe recession." That statement is, itself, recognition that the economy does periodically experience protracted episodes during which average growth and average unemployment simply do not revert to previous levels—at least not for a long time.

One of the striking things about the economic projections reported by the Reserve Bank presidents and Board's governors in the minutes from the last meeting of the Federal Open Market Committee was the rather large variation in views about GDP growth, even as far out as 2011:



That sense of uncertainty is shared by private forecasters:



What gives? There are lots of reasons for differences of opinions, and I obviously cannot (and should not) try to divine what is anyone else's deepest forecasting thoughts. But for me, "low growth due to severe recession" does not automatically imply a demand-driven downturn from which the economy will quickly spring back.

When I look ahead, I envision the U.S. economy over the next several years in terms of a simultaneous process of recovery and reformation: Recovery in the sense that the actual contraction of GDP will end, but reformation in the sense of structural transformation in financial markets, consumer behavior, and perhaps an adjustment of the global imbalances that are arguably at the root of much of the financial instability that has characterized the past decade.

If we are right, the long run is indeed rosy, but the long run will only arrive after some significant and protracted headwinds abate. And that is not a picture that suggests a rapid bounce back to "normal" growth.

By David Altig, senior vice president and research director at the Atlanta Fed

March 6, 2009 in Economic Growth and Development, Forecasts, Labor Markets | Permalink