Expectations and the Economy

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Key points:
- Atlanta Fed President Dennis Lockhart said that economic data in the first part of the year generally were weaker than forecasters anticipated but that more recent data had exceeded most forecasters' expectations.
- Lockhart interprets recent data and anecdotal reports as signaling a gradually improving economy. Though risks remain, Lockhart does not anticipate a double-dip recession in the absence of a significant negative shock to the economy.
- Lockhart believes that it would go a long way toward "clearing the air" of economic uncertainty if the European debt situation is stabilized and put on a believable resolution path and if the supercommittee delivers a credible fiscal plan accepted by Congress.
- Lockhart cautioned against perceptions that enduring weakness or recession is inevitable.

I want to thank the East Tennessee chapter of the CFA Society for inviting me to speak this evening. I always start with a disclaimer, so let me get that out of the way up front. These are my personal views and not necessarily those of my colleagues at the Federal Reserve or on the Federal Open Market Committee (FOMC).

Each Reserve Bank has quite a lot of resources devoted to preparation for a regional president's participation on the FOMC, where monetary policy is made. Our work at the Atlanta Fed in support of monetary policy involves a number of tasks. These include tracking data, running econometric models, reading the analysis of others, and talking to economic actors like you. From all this information, we construct and continuously adjust a narrative that tries to explain where the economy is and where it's going.

I'm not going to say much on policy this evening. Rather, I want to spend some time reviewing the economic story of 2011, as the year built to today's situation, in an effort to provide perspective on what you're hearing about the economy. Everyone in the world of economics is pretty much privy to the same data. Yet, in interpreting signals from the data, serious observers can arrive at quite divergent views on the state and direction of the economy. Today, serious predictions for the next 15 months range from forecasts of impending recession to an outlook for slow but improving growth. Among those holding the no-recession view, there are a variety of opinions on how vulnerable the economy is to negative shocks. Notably absent are predictions of growth rates consistent with, for example, a rapid pickup in job creation.

I won't test your attention span by reciting the ups and downs of every important data element measured in the economy over the last nine months. But I do want to provide enough of a timeline to convey the movements and swings we've seen over the year by looking at three cuts of the information. They are, first, the objective economic conditions on the ground; second, the direction—better or worse—of the data; and, third, the degree of surprise versus expectations as economic indicators came in.

Why consider how the numbers came in relative to expectations? Because expectations, particularly at this juncture, can influence how our economic fortunes actually play out. A week ago, in an interview following his winning the Nobel Prize in economics, Thomas Sargent, who is an adviser for the Atlanta Fed's Center for Quantitative Economic Research, is quoted as saying, "What's going to happen is going to depend partly on what you think is going to happen." Hold that thought.

First quarter: Very little growth

The basic story of the first half of this year was one of disappointment versus expectations. At the beginning of the year, the consensus forecast had gross domestic product (GDP) growth for 2011 in the range of 3 to 4 percent. Though the Atlanta Fed's forecast was at the lower end of that range, we generally shared the view that the recovery was firmly established.

But as first quarter data came in, they did not live up to expectations. The forecast was revised down, and we now know the economy is estimated to have grown at a meager 0.4 percent in the first quarter.

The oil and commodity price shocks early in the year, along with severe weather events, seemed to provide an explanation for the negative surprises to first quarter growth. You can add some impact from the March 11 tsunami tragedy in Japan, but most of that impact was felt later.

A pretty clear picture of just how bad the first quarter was became apparent toward the end of the second quarter, when the FOMC met in late June. At that point, notwithstanding weakness in the early months of the year, the widely held outlook was that growth would rebound in the second half. Many anticipated that the effects of the price and disaster shocks would quickly dissipate.

Second quarter: Rethinking our position

Now let's move on to the second quarter. As data on the second quarter came in, many forecasters, including us, were surprised that the data were on the downside of what were already modest expectations for the quarter.

Let me mention parenthetically that, given the complexity and dynamism of the economy, forecasting is fraught with errors and misses. One of my colleagues says the only thing he can forecast with certainty is that his forecast will be wrong. It's when forecasts are persistently wrong in the same direction, and by a substantial measure, that you worry you've missed the real story.

As the summer progressed, the data surprises were unrelenting and on the negative side of expectations.

By the time of the early August FOMC meeting it was clear to my Atlanta Fed colleagues and me that we had to rethink our position. The momentum of the economy looked a lot weaker than was our assessment earlier in the summer.

A lot of worrisome stuff was piling up. For one thing, revised data revealed that the weak first quarter was one of a succession of progressively slowing quarters and not merely the result of one-time events.

Further, the weakness in growth seemed to be more broad-based than earlier price and disaster shocks could account for.

Add to this information that in late summer there were, in rapid order, a number of blows to confidence. In addition to the GDP revisions, there was the debt-ceiling battle, the S&P downgrade of the U.S. credit rating, Hurricane Irene and the storm damage on the East Coast, stock market volatility, and an initial report of zero job growth in August. And very prominently, the European debt crisis seemed to worsen, which again raised the possibility of spillover into the U.S. financial system and economy. All this worked to change views about the underlying fundamentals of the U.S. and global economies. As a consequence, growth estimates for the second half of the year and into 2012 were marked down substantially by most forecasters.

Third quarter: Gradually improving economy

The somewhat overlooked story of the period since the end of August is that much of the incoming data have exceeded most forecasters' low expectations. For the third quarter at least, it appears that downgrades of growth forecasts have been too pessimistic.

Admittedly, the economic environment today is characterized by heightened uncertainty. That uncertainty itself can act like a negative shock to the economy if investment and consumption decisions come to be driven by worst-case scenarios of extremely sluggish growth, at best, with a very good chance of sliding back into recession.

My view is that this worst-case scenario is less likely than it appeared to be a couple of months ago. I don't expect a double-dip recession, at least in the absence of a significant negative shock. I think recent positive surprises in the data should give pause. I think it's too early to draw fatalistic conclusions about the course of the economy. As I see it, recent data and anecdotal reports are signaling a gradually improving economy, and I think this point needs to be recognized. In support of this view, I'll paint a picture from our working with the data. We at the Atlanta Fed regularly monitor the data series that directly enter into the GDP calculation, along with important other series, including employment. We compare these data elements to Bloomberg's published consensus expectations for each. In the months leading up to July, the downside surprises in the data dominated. In August and September, upside and downside surprises were roughly equal. But in October, the surprises have generally been to the upside. Importantly, these surprises to the upside exceeded expectations by a significant measure. I've concluded an unqualified narrative of a downward trend is unjustified.

Risks and growth

There is certainly downside risk to this picture. While there are a number of risk factors, in my view, the two most prominent at the moment are financial instability from developments in Europe and further loss of confidence if the so-called congressional "supercommittee" here in the United States fails to reach agreement—that is, if the supercommittee is unable to arrive at a credible and sufficient fiscal rebalancing plan, leaving the fallback to mandatory cuts as the only resort.

These risks aside, most private sector forecasters envision growth in 2012 approaching 2.5 percent. In the opinion of many economists, that 2.5 percent approximates the steady-state growth rate of the economy's potential. This rate would certainly be an improvement over 2011 as a whole. The problem is without growth measurably better than 2.5 percent, little progress will be made in absorbing slack in the economy—above all, labor market slack.

Can the economy do much better than 2.5 percent in the coming quarters? There are a number of reasons to be cautious about predicting anything stronger than about 2.5 percent. For one, there is the Reinhart-Rogoff thesis that economies recover very slowly following severe financial crises. There is the prospect of fiscal drag continuing at the state and local level along with the anticipation of sizeable federal government spending cuts. There is the ongoing trend of household deleveraging. And there is the weight of lower house values on consumers' spending. All this gives the economy a fragile feel.

Let me now return to the theme of uncertainty. Many have observed that we are living in a world of "Knightian uncertainty." That's a term named after University of Chicago economist Frank Knight, who examined and distinguished between risk and uncertainty. The world he described is one where the environment is not just risky, but one in which risk is difficult to quantify. In such an environment, circumstances feel unfamiliar and historical precedent provides little guidance. There is, in such circumstances, acute uncertainty about the fundamentals of the economy. This uncertainty compounds the difficulty of estimating the likelihood of outcomes, a task that is challenging in the best of times. I think this idea captures the feel of current circumstances, and may well be a large part of the explanation for the disappointing performance of the current recovery.

Glass half full?

So, in closing, I would offer the following thought with all appropriate tentativeness and caveats. If the European situation is stabilized and put on a believable resolution path, and if the supercommittee delivers a believable fiscal plan accepted by Congress, these two developments would go a long way toward clearing the air and energizing economic activity.

In the meantime, I would simply point out that recent economic data are mostly directionally positive and have mostly exceeded expectations. Tom Sargent's quote bears repeating for emphasis: "What's going to happen is going to depend partly on what you think is going to happen." A cautious mindset in the current environment is certainly warranted. But as the numbers over the last couple of months demonstrate, outcomes better than consensus expectations can happen. Let's not talk ourselves into believing that enduring weakness or recession is inevitable.

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