What’s Ahead for 2012: The Facts about Forecasting

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2012 Economic Outlook
Atlanta, Ga.

Nov. 29, 2011

Key points

- Federal Reserve Bank of Atlanta President Dennis Lockhart expects the economy to see continued moderate growth, decently behaved inflation, continuing net job creation, but slow progress on unemployment in 2012.
- The most prominent risk to the U.S. economy now, Lockhart says, is the ongoing sovereign debt crisis in Europe.
- Lockhart views current monetary policy as appropriate and wants to keep all options open for the future.
- Private and Federal Reserve forecasters have the same economic data on which to base their projections, but they approach the task from different directions.

As a central banker, I am both a consumer and producer of economic forecasts. My experience with forecasts over the last almost five years inclines me to skepticism and humility, depending on which role I’m in. Today I want to speak from both perspectives.

First, I will provide what you came for—a view on what’s ahead in 2012. True to the conference’s billing, I’ll give you my views on the national outlook.

I’d also like to share some thoughts on my perspective as a consumer of forecasts and make the case for their value even when, as so often happens, they are wrong.

And to go further, I’d like to draw a contrast between the forecasts of private, independent analysts and the forecasts I compute and submit quarterly as a participant in the official forecasting exercise conducted by the Federal Open Market Committee, the FOMC. It’s the difference between a detached observer making assumptions about policy over a forecast horizon versus a policy maker responsible for outcomes of policy objectives over that time horizon. More on this distinction a little later.

I must emphasize, as I always do, that I will be sharing my personal views and opinions. My colleagues on the FOMC or in the Federal Reserve System may not agree with me.

Current economic situation

I’ll start with a summary of the current economic situation. Growth has picked up from earlier in the year. Inflation appears to be settling into a range that I consider consistent with the FOMC’s price stability mandate. The economy is producing jobs on a net basis, just not at a pace and volume sufficient to materially reduce the unacceptably high rate of unemployment.

Third quarter real gross domestic product (GDP) growth was initially measured at 2.5 percent and recently revised down to 2 percent. The composition of the third quarter number revealed a significant and widely unexpected drop in inventory accumulation, offset in part by a larger-than-anticipated rise in exports.

This composition of third quarter GDP may bode well for the fourth quarter. It suggests we entered the fourth quarter with leaner inventories and that demand from our trading partners has held firm.

Analysts, including my staff at the Atlanta Fed, predict fourth quarter growth slightly above the third quarter. I think growth of 2.5 to 3 percent (annualized) is a reasonable expectation for the last quarter of the year, given the data currently in hand.

The factors contributing to the current growth picture can be categorized as drivers, more or less neutral factors, and drags on growth.

Current drivers—that is, components growing faster than overall GDP—include capital goods spending, consumer purchases of autos, and exports. Retail spending in general as well as construction activity are mostly neutral factors, growing about even with the pace of GDP growth. The most significant drag on current GDP growth is government spending at all levels.

Inflation moderated in the third quarter, in large part as the influence of gasoline and other commodity costs retreated from earlier in the year. Other cost pressures, including labor compensation, remain subdued, and inflation expectations are holding steady. In other words, the underlying sources that drive inflation appear to be in check.

2012 outlook

My baseline forecast for 2012 builds on the picture I've just painted of the second half of 2011. I'm expecting continued moderate growth, decently behaved inflation, continuing net job creation, but slow progress on unemployment.

You will note I used the word "baseline." I need to emphasize that at this juncture I perceive considerable downside risk to this baseline forecast. The most prominent source of risk is Europe.

I think it can be argued that in recent weeks the European sovereign debt crisis has entered a new phase, and as a result the financial markets are jittery.

Our own fiscal challenges at the federal level constitute a significant risk as well. In my view, the disappointing failure of the so-called supercommittee to chart a credible path to fiscal balance adds to the pall of uncertainty and weak confidence that holds back more robust recovery.

Other drags on growth and headwinds deserve mention. These factors include the weakness of the housing sector with its effect on consumer spending, related household sector deleveraging, a commercial real estate sector that is still restructuring, and weak credit expansion in a financial system still under repair.

In my view none of these individually rivals the potential for spillover from adverse developments in Europe. We often speak of the *channels* through which shocks propagate and affect outcomes. Let me comment on the channels through which the real economy in the United States could be hurt by developments in Europe.

A recession in Europe would hit U.S. exports. Broadly speaking, the region is our third largest trading partner. But, in my view, the financial channel carries the greater potential of significant disruption to the already slowly recovering U.S. economy. I'm concerned about risk associated with the financial sector not so much because of direct exposure of U.S. financial institutions to sovereigns or even the most exposed European banks, but rather the more nebulous prospect of market turbulence and contagion.

So let me summarize my outlook as follows: the U.S. economy will continue to grow at a moderate pace in 2012. Unemployment will come down slowly. Inflation will stay in acceptable bounds. But this storyline involves considerable vulnerability to disruptions from European developments as well as deteriorating confidence born of our own fiscal challenges.

The value of forecasts, even if wrong

Now that I'm out on a personal outlook limb, let me turn to the perspective of consumer of forecasts. There are numerous well-traveled jokes about economic forecasters, typically involving unfavorable comparisons to astrologers, weathermen, and promoters of superstition.

This has not been a year that has enhanced the reputation of the economic forecasting field. In January, the consensus full-year 2011 GDP forecast of the Blue Chip panel of economists was over 3 percent. As of the beginning of this month, that number had fallen to under 2 percent. Similarly, the midpoint of the FOMC's consensus full-year 2011 GDP projections was near 3 percent as late as June but had also fallen below 2 percent by the beginning of this month.

These may sound like big misses, but they are actually well within the range of typical forecast errors. With such a record you may wonder why forecasters, the Fed included, don't do a better job. To answer this question, let me suggest three reasons why forecasts may be off.

While it's relatively trivial in my view, the first reason involves missing the timing of economic activity. An example of that was mentioned earlier when I explained that GDP for the third quarter had been revised down while the fourth quarter is expected to compensate.

A second reason that forecasts miss the mark is, in everyday language, stuff happens.

To be a little more precise, unforeseen developments are a fact of life. In my view, the energy and commodity shocks early in the year had a significant impact on growth in the first half of 2011. The tsunami-related supply disruptions, though temporary, were an exacerbating factor. In fact, a lot of shocks or disruptions are quite temporary and don't cause one to rethink the narrative about where the economy is likely going.

Changing narratives

Which brings me to the third reason why economic prognostications go off track: we, as forecasters, simply get the bigger story wrong.

What I mean by getting the bigger story wrong is failing to understand the fundamentals at work in the economy.

There is perhaps no better example of this problem of recognizing the fundamentals than the early debate over the expected shape of the recovery that began over two years ago. Some forecasters expected relatively rapid growth in the first years of post-recession expansion, citing the post-war pattern of sharp recoveries following deep recessions. Others, influenced by the now well-known research on financial crises by economists Carmen Reinhart and Kenneth Rogoff, argued that the correct historical comparison suggested a much slower pace of recovery.

It is now fairly clear that the Reinhart-Rogoff thesis is the appropriate one. But it is worth emphasizing that those in the Reinhart-Rogoff camp did not possess more or better data, or that those who had predicted a "V-shaped" recovery were ignorant of history. In the end, forecasters had to make an informed guesstimate of which fundamentals were truly in place. It has only been with the passage of time that a clearer picture has emerged.

A longer-term economic forecast essentially derives from a narrative about economic fundamentals: whether there are major imbalances that will trigger painful corrections in the future, whether there are major drags on growth and what those are, what factors are driving growth, and whether those growth dynamics are sustainable.

A persistent string of misses in the same direction *may* be a signal that the underlying fundamentals on which forecasts are based need to be rethought. Careful examination of the source of forecast errors can lead to a better understanding of those fundamentals, with an obvious payoff in terms of better decision making. This is why I said in my introduction that forecasts can have value even if they're wrong.

Now I'd like to revert back to the perspective of producer of forecasts. Specifically I'd like to comment on the economic projections published four times a year by the FOMC and how the forecasting exercise they represent differs in a fundamental way from the practice of private forecasting.

The instruction given to each FOMC participant is to submit a forecast that will be compiled into a "Summary of Economic Projections" (SEP). As a participant I am asked to embed an assumption of "appropriate monetary policy," which is defined as each policy maker's view of the future path of policy most likely to ensure the Fed achieves its dual objectives of maximum employment and stable prices. It is this appropriate monetary policy assumption that creates the distinction between private forecasts and those generated in the SEP exercise.

I would argue that a Fed monetary policy maker's forecast—mine, for instance—is not so much what he or she predicts is going to happen from the point of view of a detached observer. Rather, it's a projected path to a state of the economy approaching some set of policy objectives.

The starting point for private forecasters is normally a policy assumption on the basis of which they then make a forecast. The starting point for a policy maker is an outlook that calls for an appropriate policy posture of either staying the course or making an adjustment, sometimes even a complete reversal. You can think of the distinction in terms of "which came first, the chicken or the egg?" But in this case, substitute "which came first, the policy or the forecast?"

I'm explaining this rather arcane distinction so you understand what accompanies the outlook I just presented to you today. Implicitly accompanying my outlook was a personal view of what constitutes appropriate monetary policy aimed at achieving the policy objectives mandated by Congress. Our mandates, to repeat, are to promote the goals of price stability and maximum employment.

Appropriate monetary policy at present

Now I'll be explicit. At this time my notion of "appropriate monetary policy" is one of holding steady the current policy rate (federal funds rate) of zero to 25 basis points and the balance sheet steady at current scale. I supported efforts to put pressure on longer-term interest rates for the modest additional stimulus that might produce. That said, I am skeptical that further asset purchases will produce much gain in terms of increased economic activity. I don't believe further bond purchasing by the Fed is a potent policy option given the set of circumstances we currently face. But that is not to say that such a policy action would not be powerful and appropriate in other circumstances, and I don't think any option should be taken off the table.

I'll end with this thought: even though forecasts of private sector analysts and those done by the Fed are different exercises, ideally there should not be a wide divide between the two. If the Fed is effective with its communication with the public there should be substantial alignment. Enhancing our communication with you, the public, is therefore to my mind a worthy priority. I hope these remarks have served that purpose.

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