Looking Ahead to 2009

Economic forecasting is at best an imperfect art, whether using econometric models, informed judgment, or a combination of both. There are almost as many different forecasts out there as there are economists. Witness the wide dispersion of views in any of the collection of surveys conducted by the National Association of Business Economics, the Wall Street Journal, or USA Today, just to name a few.

My own research with former colleagues at the Federal Reserve Bank of Atlanta developed methodologies to evaluate the accuracy of economic forecasts, and these are now employed by both the Wall Street Journal and USA Today in constructing their rankings. A few important conclusions follow from that work. First, predicting turning points is extremely difficult, and the dispersion of forecasts tends to increase during turning points. Second, some forecasters tend to do well consistently while others are consistently less accurate. However, the research also demonstrates that even the best forecasters tend to make big errors at times – sometimes because of weaknesses in their models or methodologies, or simply because unforeseen events do happen. Third, even when looking at the consistently best forecasters, consensus forecasts tend to be better with smaller average error rates than those of the best performers, and this includes the Federal Reserve staff forecasts.

With that preamble, what are the consensus forecasts saying about 2009? And what factors may be critical in determining the realization of those forecasts?

Both the WSJ and NABE surveys were completed in November of 2008. Survey panelists saw negative real growth in Q4 of 2008 and a continuation of that path into Q1 of 2009. The NABE panel predicted -2.5 negative real GDP growth in Q4 of 2008 and continuing into Q1 of 2009 with -1.1%. Thereafter, the panel saw growth slowly picking up in the second half of the year. Inflation was not seen to be a problem through 2009, but unemployment was. By the end of 2009, the unemployment rate was seen as being nearly 1 percentage point higher than it currently is, at about 7.4%. The drag on growth and employment was viewed as being driven by sharp declines in consumer spending and business investment. The downward pressure was predicted to continue well into 2009, but the negative impact from housing was seen as subsiding by the middle of next year. Despite the housing problems, the view was that the recession, which started in Dec. 2007, would be relatively mild, with the peak-to-trough decline in real GDP predicated to be about 1.5%. Finally, the panelists were lukewarm on the likely impacts on GDP growth of most of the emergency Fed and Treasury programs that have been put in place.

The WSJ forecasters had similar views to those of the NABE forecast panel, but less detail was provided. GDP growth was expected to be zero for the years 2008 and 2009, with the recession toping out by mid-2009. The WSJ panel was more pessimistic than the NABE panel when it came to the unemployment picture. They saw the unemployment rate at 8.1% by December 2009.

Given the choice right now of locking in those consensus forecasts, as compared with the prospect that economy would perform even better, my guess is that virtually all of us would willingly lock in the sure thing. The reason is that the majority of risks to the forecasts appear to be to the downside – that is, worse outcomes are more likely than better outcomes. What are those risks and other considerations? The following is my list, in no particular order of importance, of key factors that may affect both the timing and pace of the recovery.

The Consumer – The consumer was the driving force behind the last expansion, with spending increasing at an even faster rate for most of the period than GDP growth. Consumer spending fell off drastically in Q3 of 2008 and most likely has not recovered in Q4. I believe that spending has shut down because of uncertainty about the financial crisis, concern about the worsening employment situation, and the failure of housing prices to stabilize. It would be extremely unlikely for the economy to be able to recover significantly without a pickup in consumer spending.

Housing – There remains an excess supply of housing, and that inventory needs to be worked off. Housing prices are still falling, but the expectation is that this will moderate in the first half of this year as mortgage interest rates decline. However, just because housing prices have stabilized doesn't mean that spending on either new construction or related durables will return to anywhere near their past boom levels. Home ownership rates are only slightly off their all-time highs, so any increase in demand will have to come from either population growth or new family formation. Most likely, we will first see a pickup in multifamily housing as low-income individuals and families move into rental properties until their job and income prospects improve.

Business Investment – Another critical driver of sustainable economic growth is business investment. It is the main source of improvements in productivity growth and per capita income, and the associated accelerator effects can drive increases in employment as well. Investment by business has been in a near-steady decline, both in terms of equipment and software and commercial real estate, for nearly every quarter since the start of the recession. These two components will likely continue to be a major drag in 2009 and will respond more to increases in demand and corporate profits, when they materialize, than to declines in interest rates or increased availability of credit. It is unlikely that we will experience a significant recovery until those components turn around and businesses begin to invest again.

The Financial Sector – Most of the efforts by the Federal Reserve and Treasury have been directed at addressing what they perceived to be a liquidity problem as manifested in a significant widening of credit spreads. Only belatedly has it been recognized that financial market problems have been due to inherent questions about institutional solvency and asset quality. Consequently, early efforts to address these problems met with, at best, marginal success. Deleveraging must take place and institutions must rebuild their capital with private sector injections and not government money. Lending will not pick up until losses are recognized and purged from balance sheets and needed recapitalization takes place.

Stimulus Packages – Consistent with past fiscal stimulus efforts to jumpstart consumer spending, the 2007 stimulus package was largely ineffective. The Obama administration is considering somewhere between an $800 billion to $1 trillion stimulus package, with the goal of creating 3 million jobs through infrastructure spending. Such massive directed spending efforts will take time to put in place, perhaps even a couple of years before money begins to flow. It simply takes time to create the bureaucracy to administer the programs and to design and engineer infrastructure projects of sufficient scale and volume to have a major effect on economic activity. If history is any guide, such plans are likely to be costly and not very effective. Again, research suggests that the most effective programs are automatic stabilizer initiatives, such as the extension of unemployment benefits and tax cuts, which put money immediately into the hands of consumers.

The Value of the Dollar – The dollar had recovered against most foreign currencies before the Fed's December rate decisions. In the short term, the cut in interest rates means that the dollar is likely to continue to decline in value. The good news is that this will act to stimulate exports again and discourage imports, and help to cushion the decline in real economic growth. The US is probably further into the current recession than most of our major trading partners, and the US economy is likely to recover from this downturn before other countries and recover more quickly as well, because of its inherent flexibility. This will strengthen the dollar relative to other currencies and reverse the decline in the exchange rate. Timing here is critical for those wishing to make the trade.

Inflation – Most economists have looked at the recent declines in inflation and have suggested that the most important policy focus in the short run should be on stemming the decline in real GDP. However, the Fed and foreign central banks have injected massive amounts of funds into financial markets, and there are no announced plans for how this liquidity will be withdrawn as money velocity begins to pick up. The recent decline in inflationary pressures has everything to do with what has happened in the energy market, which will continue to be a significant source of risk in coming years, and nothing to do with current policy. If monetary authorities react preemptively and do so in error, then we could easily truncate whatever expansion might be underway. The more likely error, however, is that central banks will wait for signs of solid increases in inflation and then will act to counteract inflation pressures. They will react too late and too much, with predictable negative consequences.

Regulatory and Policy Risks – Once the new Congress starts up in January, its first priority will be finalizing a fiscal stimulus package. However, close behind that will be a series of efforts to reform the financial system and its regulatory structure. Right now the mood of the country is anger at having to bail out financial firms. People are especially upset at the large Wall Street firms, which are perceived as having paid outrageous salaries and bonuses to managers who ran their companies into the ground. Such perceptions, regardless of whether they are right or wrong, are easy to address with tightened regulations and restrictions on executive compensation. The Madoff Ponzi scheme could not have come at a worse time with regard to investor confidence in the information they are receiving about investment prospects and performance. The events will embolden legislators and prompt them to "do something." History again suggests that reforms conceived in haste and anger oftentimes have unintended consequences which take years and even decades to be corrected.

Conclusion – The list of risks seems long and potentially severe. Adverse realizations of even a few could pose a threat to the forecasts for even modest growth for the second half of 2009. Volatility will be with us until it becomes clear that policy uncertainty has been resolved, the course of the stimulus program of the new administration is set, and aggregate demand and investment have begun to pick up. It is also the case that most significant new businesses tend to be born in tough times, in part because established firms overreact and spurn or abandon investment opportunities that they might have otherwise undertaken. In addition, there are also significant anomalies and asset mispricing in the market that astute investors can take advantage of. For example, Cumberland has long been interested in the unique opportunities that the municipal securities market has offered and has been able to find safe and extremely attractive tax-free returns in that market throughout this financial crisis.