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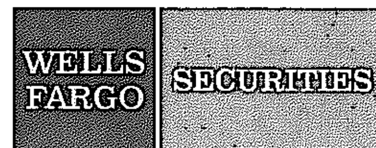

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Reflections on 25 Years Following The U.S. Economy[1]

Lessons Learned from 25 Years of Forecasting the Economy

The summer of 2009 marked my 25th year of analyzing the economy on a professional basis. Through this period I have had a front row seat to the Reagan Revolution and economic boom that followed it, the 1987 stock market crash, the collapse of the savings and loan industry, the fall of the Soviet Union, a couple of huge real estate cycles and credit crunches, a stunning stock market boom and spectacular crash, the rise, fall and re-emergence of newly industrialized economies, a handful of oil shocks, the 9/11 attacks, a couple of wars and the rewriting of the rules governing the financial markets.

Through this period three significant mentors have shown me the ropes. The first was John Godfrey, who hired me straight out of the University of Georgia. John was a veteran of the Federal Reserve Bank of Atlanta and taught me how to sift through the various economic indicators, pull out what was important, and then explain why. He also offered up great advice on how to analyze the Fed. It was much more difficult back then because the Fed made few public statements, even when it changed policy. Early years on the job were interspersed with tidbits of economic history lessons, including "Operation Twist,"[2] the infamous "Saturday Night Massacre,"[3] and the ongoing struggles the Federal Reserve faced in meeting the dual mandates of the Humphrey-Hawkins act of 1978.

GDP was not simply a number we tried to understand and predict.

The second major influence was David Orr, Chief Economist at First Union National Bank. David taught me how to view the economy through the eyes of a business decision maker. GDP was not simply a number we tried to understand and predict but also represented the volume of goods and services being produced, in real terms, and the revenues businesses, sole proprietorships and governments earned, in nominal terms. David's humble, no-nonsense approach to analyzing the economy is something that I think about every day when I review the latest economic numbers or read the daily headlines.

The third mentor is John Silvia, who explained how to view monetary and fiscal policy through the eyes of policymakers. John's background on Capital Hill as the Senior Economist at the Senate Joint Economic Committee and Chief Economist for the U.S. Senate Banking, Housing and Urban Affairs Committee provided some keen insights into the motivations behind key policy choices and how intractable certain choices are. One of the key lessons John taught is that once policy has made a major turn in a different direction, as it has recently, the impacts are slow to build but are typically very long lasting.

The three broad philosophies have been invaluable to me over the past 25 years. The period has seen an incredible amount of change but much of what was true long ago still holds true today. I

[1] This article was originally published in the January 2010 issue of *Business Economics*.

[2] "Operation Twist" was a policy pursued by the Federal Reserve in the early 1960s to flatten the yield curve by buying long-term Treasuries and selling short-term bills.

[3] The financial "Saturday Night Massacre" was an announcement on October 6, 1979 by Federal Reserve Chairman Paul Volcker that the Federal Reserve would no longer target interest rates but instead target the level of bank reserves. The Federal Reserve also immediately hiked the discount rate a full percentage point and adjusted reserve requirements.

Together we'll go far

have compiled a list of my favorite 25 rules for analyzing the economy. There are probably many more than this and many that have yet to be discovered, but this list has served me well over the past quarter century and hopefully will be of use to others.

Twenty-Five Fundamental Rules for Analyzing the Economy

Economics is just common sense made difficult.

On of my favorites is ***"economics is just common sense made difficult."*** Too often economists make things more difficult than they need to be. The most important concept to grasp when analyzing the economy is what motivates individuals and businesses to buy goods and services and what motivates them to produce and provide them. Forecasting the economy then simply devolves into determining if new policies or events would cause individuals to buy more goods and services, invest in more plant and equipment, hire more workers, or work more.

Of all the things John Godfrey taught, the one I always find most useful is that ***"it is important to distinguish between what you think the Fed will do and what you think they should do."*** As economists, we tend to follow the Federal Reserve very closely and while we may have a good understanding of how monetary policy works, our views on what the Federal Reserve should do are irrelevant. It is far more important to have an understanding of what you believe the Federal Reserve, under its current leadership, will actually do.

Another key concept deals with the business cycle. **"Recessions are caused by the build up of imbalances and some sort of event or policy change that causes investors, consumers, businesses and regulators to become more risk averse."** Once you understand where recessions come from, you can begin to assess the risk of falling into one. The significant event leading up to the most recent recession was the housing boom, which resulted in an enormous oversupply of housing and a sharp run-up in housing prices. The event that put us on a path to recession was the unprecedented drop in home prices that began back in 2006. Falling home prices led to growing financial problems and bankruptcies at mortgage lenders and government sponsored enterprises that eventually brought down huge investment banks and financial institutions.

Imbalances can build up far longer than seems logical.

"Imbalances can build up far longer than seems logical."[4] During a boom, all sorts of justifications for the elevated level of economic activity will seem logical. We saw this at the height of the tech bubble and height of the housing bubble, which is one reason we ended up with such a tremendous oversupply of fiber optic cable and single-family homes.

"Persistent inflation is always a monetary phenomenon."[5] Measured price increases can sometimes pop up because of supply disruptions, spikes in key commodity prices, or bad weather. A persistent rise in inflation, however, will only take hold if the money supply has increased dramatically for a sustained period of time.

"Rising food and energy prices by themselves are deflationary if they are not accommodated by a loose monetary policy." If consumers are spending more of their income for necessities, they have less to spend on everything else.

"Conditions do not have to be perfect in order for the economy to grow," and that is a good thing because conditions seldom are perfect. The economy almost always faces a seemingly endless string of challenges: the budget deficit is too big, taxes are too high, regulation is too burdensome, and consumers have too much debt. Yet, while this was true for most of the prior 25 years, the economy grew solidly throughout most of this period.

"There is a tendency for forecasters to focus more attention on what is wrong with the economy than what is right." Bad news almost always gets more attention than good news, and this is no different with economics. A danger, however, is that focusing too much attention on the negatives might cause you to miss out on valuable opportunities.

[4] This rule is loosely based on the often-cited quote attributed to John Maynard Keynes, to the effect that "markets can stay irrational longer than you can stay solvent." However, there appears to be no real evidence of Keynes actually saying it.

[5] This quote is based on the famous quote from Milton Friedman and Anna Schwartz [1963], which says that "inflation is always and everywhere a monetary phenomenon."

"The natural tendency for the U.S. economy is to grow."[6] Each year the United States adds close to three million new residents, which means we add the equivalent of France to our population every 20 years. In addition, trend productivity growth is somewhere around 2 percent. When you add in Americans' strong desire to live better than each preceding generation, there is an enormous natural tendency for the U.S. economy to grow.

The natural tendency for the U.S. economy is to grow.

Over the past 25 years ***"the greatest forecasting mistake economists have made is to underestimate economic growth."*** Paying too much attention to all the negatives in the economy tends to make economic forecast too pessimistic. Forecasters tended to overestimate the drag from federal budgets deficits during the late 1980s, the banking crisis in the early 1990s, and most of the subsequent crises that we faced during the past two decades. Many forecasters were also slow in recognizing that the potential growth rate of the economy had increased in the late 1990s with the advent of new information technologies.

"A trend will continue until is stops."[7] This famous line attributed to Herb Stein [1998] really cuts through the clutter on a number of fronts. Anything that grows faster than the underlying fundamentals can support will ultimately stop. If homebuilders build houses at a faster rate than the growth in the number of households that can afford to buy them, then ultimately building activity will stop. Likewise, if the federal government spending rises faster than the Treasury's ability to raise taxes or borrow money then spending growth will eventually stop.

"You can learn an awful lot by simply observing."[8] Some of the best economic indicators I have seen in recent years have been things that I have observed with my own eyes and then verified with the data. If the airports seem more crowded take a hard look at the airline revenue passenger miles, whose growth tends to coincide with real GDP growth. A pickup or deceleration in airline revenue passenger miles may tip you off to a shift in the economy's underlying momentum. While it may seem trivial, the same holds true with retail sales and business at your favorite restaurant.

"Never be overly eager to change your forecast." Obviously you have to change it when the facts change but always remember that economic data are revised frequently and often by substantial margins. Some of the worst mistakes I have made have been to give up on a forecast too soon.

Never be overly eager to change your forecast.

"Do not be afraid of making mistakes." You will make them. It is part of the job. I learned when I was a goalkeeper on our high school soccer team not to get so upset about the other team scoring a goal that you second guess every move. You can do the same thing in economics. The critical questions you need to ask are: is your forecast well thought out? Have you researched and tested you conclusions? What are the holes in your argument and what are the risks associated with them? Are you making conservative or aggressive assumptions? If you have done all your homework, stated your position clearly and identified the risks, then you are likely to be wrong far less than you are right. Most important of all, have you informed your clients and prepared them for contingencies?

"Rapid growth nearly always sows the seeds of its own destruction." Booms generally lead to busts because they lead to overproduction or overinvestment in the sector that is booming.

Along those lines, ***"booms generally lead to unforeseen problems."*** When activity is booming sloppy credit underwriting, inefficient operations, and outright fraud are hard to see. This is the basis behind one of Warren Buffet's [2002] favorite sayings ***"You never know who***

[6] This is another rule that has been stated in numerous ways by numerous people. The ultimate source, however, is likely Adam Smith [1776].

[7] What Herb Stein really said is that "if something cannot go on forever, it will stop." The phrase is widely known as Stein's law.

[8] This quote is loosely related to a widely cited statement attributed to Yogi Berra, where he is reported to have said, "You can see a lot just by observing."

is swimming naked until the tide goes out." Just think of the Bernie Madoff scandal, which did not become evident until the fall 2008 financial market collapse.

Capital will always flow to the highest available risk-adjusted rate of return.

"Capital will always flow to the highest available risk-adjusted rate of return." Every investment and business endeavor involves evaluating the risks involved in investing in that business and the return on that investment. The greater the risks, the higher the return has to be in order to attract any given amount of capital. Anything that heightens risks in the economy tends to restrain investment and business activity in general.

"The economy does not simply grow and contract, it is constantly evolving." This is a concept made famous by Joseph Schumpeter [1975] and has become known as creative destruction. The basic concept is that there are always new industries and growth sectors evolving in the economy and there are always industries and sectors that are declining. Unfortunately, the declining sectors are typically easier to see than those that are growing.

"Soft landings are extremely hard to pull off.

"Soft landings are extremely hard to pull off." The relatively long business cycles of the past few decades have witnessed several attempts by the Federal Reserve to bring the economy in for a soft landing. The Federal Reserve's objective is to slow the economy just enough to head off inflationary pressures without causing the unemployment rate to increase. The Federal Reserve's record is spotty to say the least. The problem with soft landings is that slower economic growth leaves the economy vulnerable to external shocks. The Federal Reserve nearly engineered a soft landing back in 1990 but then Saddam Hussein invaded Kuwait and oil prices skyrocketed, sending the economy into recession later that month. We were also headed for a soft landing back in 2001 but 9/11 put an end to that.

"Changes in political leadership matter" because the forces behind these changes have an immense amount of resources invested in their efforts.

Whenever possible try to ***"view the economy through the eyes of a business owner, consumer, and policymaker."*** Think about how each would view the current environment and what each would view as risks and opportunities.

"Always look for consistencies and inconsistencies" in the economic data and your forecast. Inconsistencies demand considerable attention and may provide a hint about possible mistakes and vulnerabilities in your forecast.

"Write your reports and give presentations as if you were explaining economic concepts to your mother." This will help ensure you respect your audience and do not talk over their heads.

"Listen to those who have opposing views." At a minimum they will provide a good stress test to your own view and they might be right. I have found that I learn much more from reading reports and books written by folks that I disagree with than those I agree with.

"Do not outrun your headlights." Know you limitations. The economy is like a giant puzzle that you will never finish piecing together. Do not try to do everything. Accept help when it is offered and concentrate on the things you know and do best.

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