

The Economy in Perspective

Caveat emptor...Economic activity surged at the end of last year, expanding at an annualized rate of 7.3% in real terms. That performance helped propel 1999's growth rate to 4.6%, on a par with the 1998 rate. Most economists, inside and outside government, had predicted that the pace of economic activity would recede toward 3% last year, but then warnings of an impending slowdown have been a recurrent theme for several years running.

The most recent slowdown prediction stemmed from several considerations. The surprising upturn in productivity growth was expected to abate. Another explanation relied on dollar depreciation, which would make exports more attractive to foreigners and imports less attractive domestically. (The depreciation itself was thought to result from stronger foreign economic conditions and a rebalancing of international portfolios away from dollar-denominated claims.) A third factor often cited was the stock market, whose projected weaker performance would slow the rise in household spending. And U.S. interest rates, which had declined during 1998's Russian and Asian financial-market crises, were expected to return to—or surpass—their prior levels.

Whatever the specifics, one cannot overlook a fundamental assumption embedded in many of these forecasts, namely, the concept of potential output: At every point in time, according to this concept, there exists a level of output that the economy can attain without increasing inflation. If one takes the position that actual and potential output are not always in synch, then one may be led to consider several interesting scenarios for both economic activity and macroeconomic policy.

The first possibility, of course, is that gravity-like forces will pull the economy toward its potential. One can imagine interest rates, exchange rates, and prices adjusting in ways that guide firms and households to make individual decisions that collectively restore the economy's potential output equilibrium. A second possibility is that these gravitational forces are either nonexistent or so weak that macroeconomic policies will serve to close the gap. In either case, if one takes the further position that potential output itself predictably follows a smooth growth path, then presumably one could predict with confidence the actual course of economic activity because

output growth will always converge on the potential, known path.

Generally speaking, this logic has inspired many of the forecasts constructed in the past few years and, generally speaking, has also produced large forecast errors. If the very idea of potential makes sense—a question that will not be examined here today—its has certainly not followed a predictably smooth path. When the current expansion began, economists who work with this concept thought potential output would expand at roughly a 2.5% rate, and that it would be achieved with an unemployment rate of 5.5%–6%. Six years later, the relevant numbers were, in fact, 3% and 5%–5.5%. Today, it is not unusual to hear the growth rate of potential output solemnly estimated at 3.5% or more, and the corresponding “full employment” rate of unemployment set below 5%.

What could be in store this year? To take one representative example, a panel of forecasters surveyed by *Blue Chip Economic Indicators* expects real GDP growth to slow from last year's rate back toward 3%. Economists are recycling last year's reasons: productivity slowdown, dollar depreciation, a faltering stock market, and rising interest rates. One day the consensus forecast will prove accurate, but it will be impossible to say which deserves the credit—good science or the law of probabilities.

Improving the accuracy of macroeconomic forecasts is an admirable goal, and economists have been striving toward it earnestly for almost half a century. We have become so proficient at explaining past events that we are usually able to offer at least two competing stories. And our ability to predict current-quarter GDP based on data that have already been released has become quite admirable. There is scant evidence, however, to support claims that we now have much better vision into the mid-range future than we formerly had.

Policymakers who use macroeconomic forecasts to inform their decisions have learned not to accept such guidance uncritically. And those who previously relied on the potential-output construct have learned to be doubly careful. Not only have these policymakers seen projections of actual economic activity go far wide of the mark; they have also seen the need to question the mark itself.