Special Report

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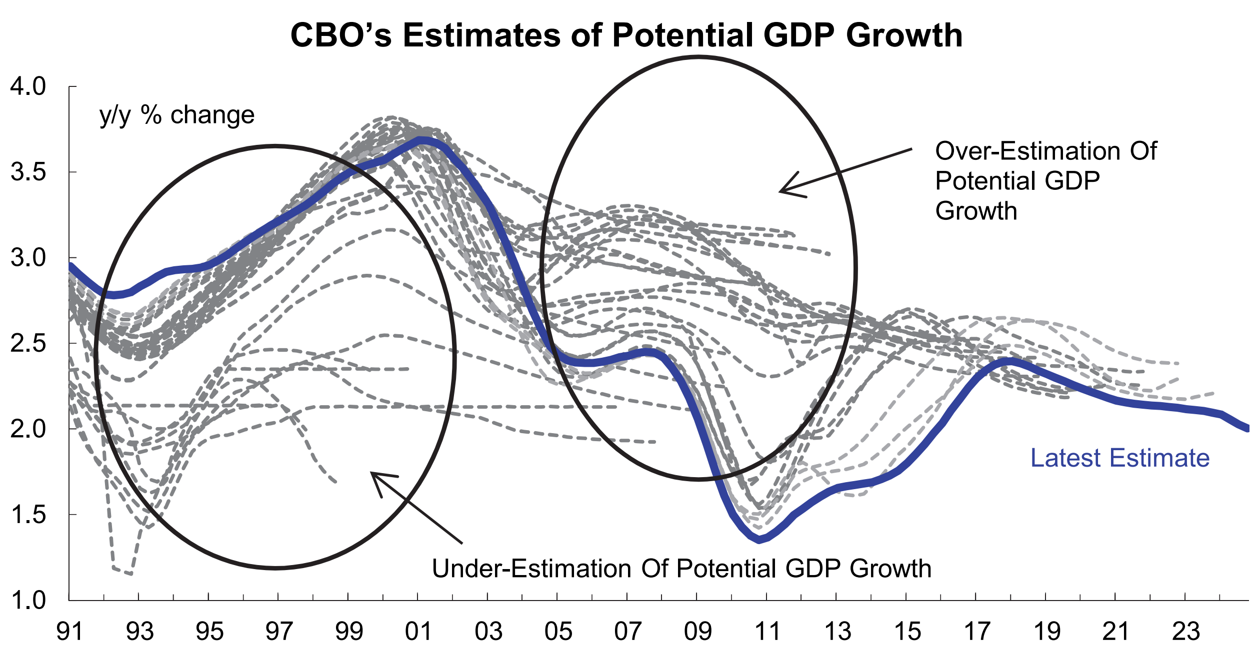
'New Normal', Or Simply The Same Old Mistake?

- **Potential GDP growth forecasts for the US economy tend to be sharply underestimated during downturns, and overestimated during boom periods. This should serve as a strong caution to fans of 'new normal', 'this time is different', 'secular stagnation', and low-for-long schools of thought.**

Many debates on the outlook for economic growth and the neutral rate of interest over the full cycle ahead hinge upon the ability to forecast potential GDP growth which represents the non-inflationary speed limit of the economy. For instance, the 'new normal' catch phrase argues that the potential speed limit of the economy is lower than it used to be and we should simply get used to this such that the long-run neutral rate of interest is biased to be lower than previously. 'This time is different' proponents would argue something similar. Fans of the secular stagnation school of thought — including views expressed by highly regarded economists like Larry Summers (here) and Paul Krugman (here) — believe that developments over recent years have "cast a substantial shadow on the economy's future potential" to quote Summers. They cite persistent downward revisions to US potential GDP growth since 2007 in likening today's US situation to estimates of potential GDP growth in Japan that were revised steadily downward from the early 1990s onward as expectations were steadily lowered. This view then motivates Keynesians to promote policy recommendations that are geared toward forcing a lower real rate of interest and/or taking tangible steps to increase demand including via fiscal policy in an effort to raise the economy's speed limit.

Such views therefore substantially rest upon the ability to forecast potential GDP growth. The broad observation in what follows is that we've heard much of this same reasoning before — and in stark contrast to the one Japan parallel, — we have forgotten the lesson on how wrong it was in the past.



Source: CBO, St. Louis Fed, Scotiabank Economics.

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To this effect, the accompanying chart might be accused of resembling something to be found hanging on a wall inside the New York Museum of Modern Art or perhaps Medusa's flowing locks, but it speaks volumes in the debate. Each individual line represents the Congressional Budget Office's (CBO) forecasts for potential real GDP growth starting when first published in 1991 (data available on request). The thick dark blue line is the latest forecast for potential GDP growth from 2014-onward spliced onto the latest historical estimates of past years' potential GDP growth and therefore captures all revisions to date. Each dashed grey line represents potential GDP growth forecasts and revised past estimates drawn up in prior years. Three powerful observations ensue.

Potential Growth Is Under-Estimated Coming Out Of Periods Of Weakness...

The first key observation is that potential GDP growth was sharply underestimated in past periods of economic weakness like the early 1990s and perhaps like it may be underestimated today. All of the grey dashed lines progressively shifted higher during each round of forecast revisions for potential GDP growth in the 1990s up to today's estimates. The recession and ensuing softness during the early 1990s was very similar to today in that the first estimates of the speed limit of the US economy started off very low and pushed down to just above 1%. As the economy improved, forecasters then progressively revised estimates higher in backcasting efforts such that today's estimate for potential GDP growth back in the early 1990s lies in the 2 ¾ - 3% range.

…Over-Estimated During Periods Of Strength...

The second observation is that **potential GDP growth is overestimated at points of cyclical strength** like much of the 2000s. All of the grey dashed lines over this period progressively shifted lower in each forecast revision. Note that the latest estimates for potential GDP growth during that decade (again, the thick dark blue line) are persistently lower than the initial estimates for that period. Whereas much of the emphasis in the literature is upon the period of 2007 onward during which potential GDP growth estimates were revised lower, this was actually the case for several years prior to 2007.

…And Thus Heavily Pro-Cyclical

Juxtaposing the first observation with the second observation makes it such that one should be very careful about putting the emphasis upon persistent downward revisions to potential GDP growth since just before the crisis, while ignoring persistent upward revisions to potential growth over prior periods. This emphasis upon selectively sampling revision periods risks resulting in flawed policy prescriptions and market perspectives, and over-reacting during such periods just when forecasters may be overreacting to contemporary circumstances themselves.

In all, the message we're left with is that long-term estimates of potential GDP growth are heavily pro-cyclical in that they are too low when devised during periods of softness and too high when devised during periods of economic strength. Forecasting potential GDP growth is a complex exercise that is fraught with enormous uncertainty and forecasters may repeatedly fall into the trap of convincing themselves that 'this time is different' only to discover that it really wasn't. **This same mentality was in place in the early 1990s and ended in disaster for bond investors in 1994.** Coming off the period of excess in the 1980s and ending it with Resolution Trust, large numbers of failed thrifts, a junk bond melt-down, and the technical insolvency of a large money center bank motivated a comparable forecast bias that US growth would never rebound and the Fed wouldn't be able to tighten monetary policy for a very long period of time. Later during the 2000s we convinced ourselves as a profession that the economy's speed limit was higher so monetary policy could be relatively loose for longer and we know how that play ended. With revision risk to potential GDP growth forecasts that can be measured in orders of magnitude, it's simply not clear that views on public policy steps or long-term borrowing costs should rest upon the ability to forecast the speed limit of the economy.

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