Forecasting Future Recessions

Shift to Real-Time Tracking and Automatic Stabilizers

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Why good forecasting recessions matters?

- Allows policymakers to react more quickly and blunt the depth of the downturn.

- Advance warning is especially important for monetary policy, since lowering interest rates takes time to boost demand.

- Recessions harm families, businesses, and communities. Better stabilization policies limits the economic scarring.

Key Takeaway: It’s Time for New Tools

- Historical, statistical relationships, such as the yield curve inversion, are not robust and don’t tell us what’s wrong.

- Real-time tracking of wide range of economic and financial indicators is a better way to identify and diagnose a recession.

- Better preparation: automatic stabilizers to ‘trigger on’ when recession starts and ‘trigger off’ when economy recovers.

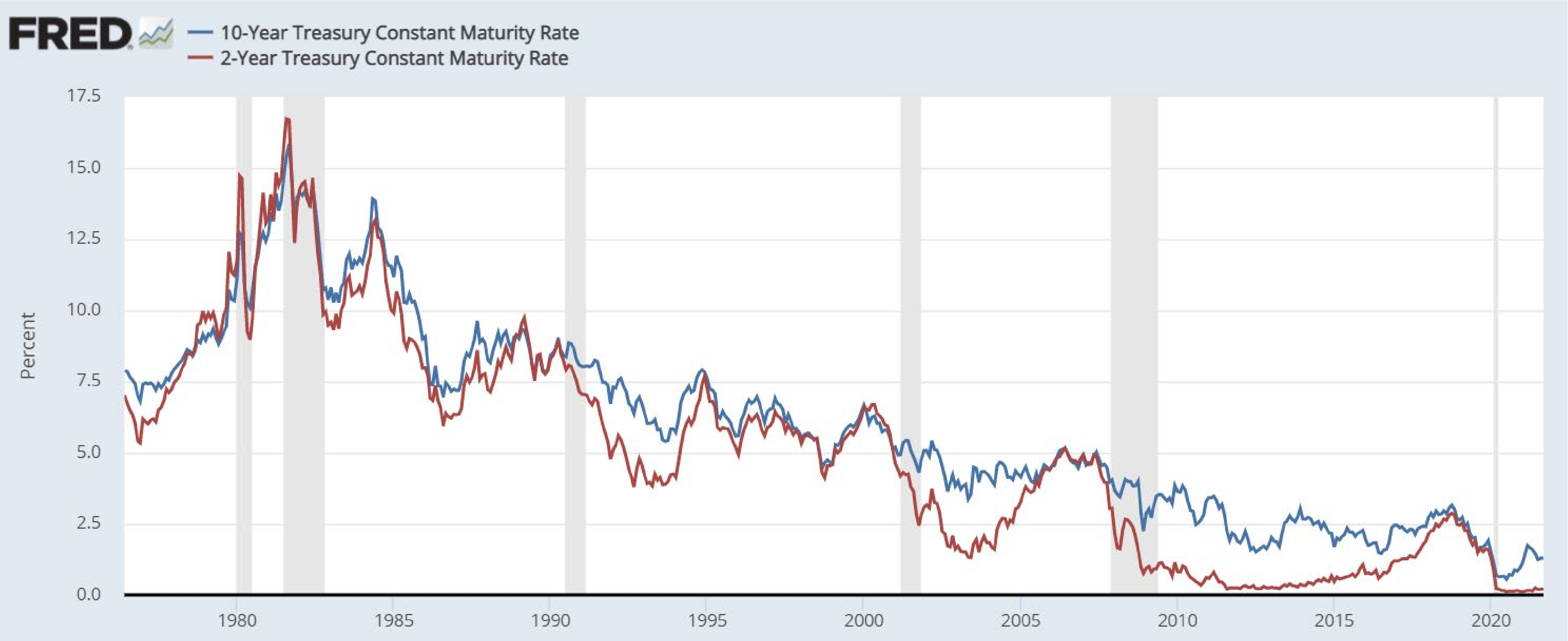
OLD TOOLS NOT ENOUGH:

Not robust and too opaque.

Go-to tools of the past are not up to the task now

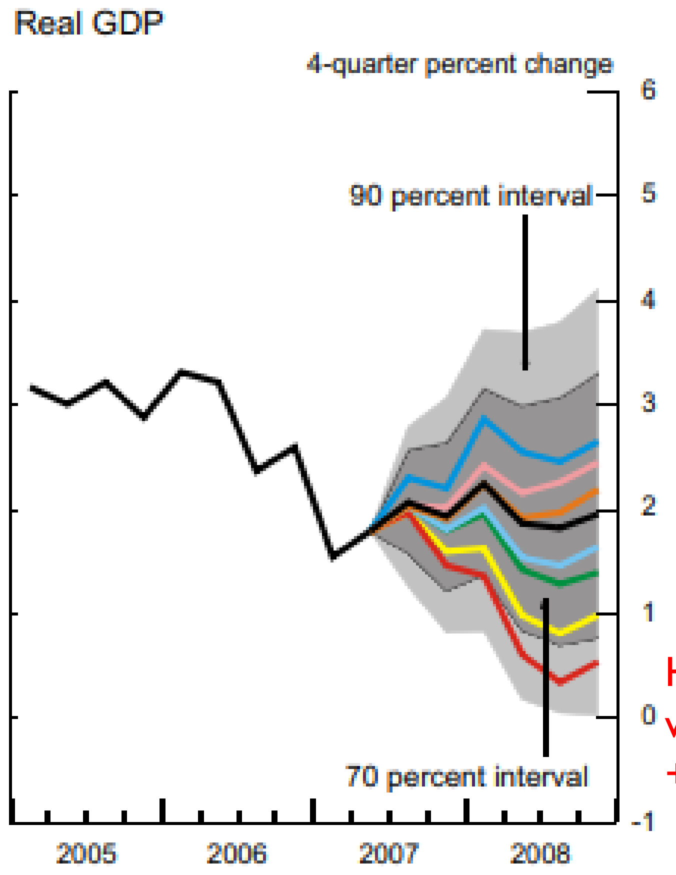
- Standard: Yield curve inversion, regime-switching factor models, leading indicators, macro modeling (FRBUS/DGSE).
- Historical relationships may change, so they aren't robust to structural changes in the economy or economic policy.
- Causes of recent recessions are more varied and not all economic. 'One-size-fits-all' forecasting tools are less useful.

Structural changes could alter historical regularities



- For example, with yield curve: decades-long decrease in rates and estimates of a [downward trend] in term premia could weaken or change the relationship.
- Plus, with many possible causes for decline, such as unconventional monetary policy, demand for safe assets, lower market risk, it makes inversions harder to interpret.

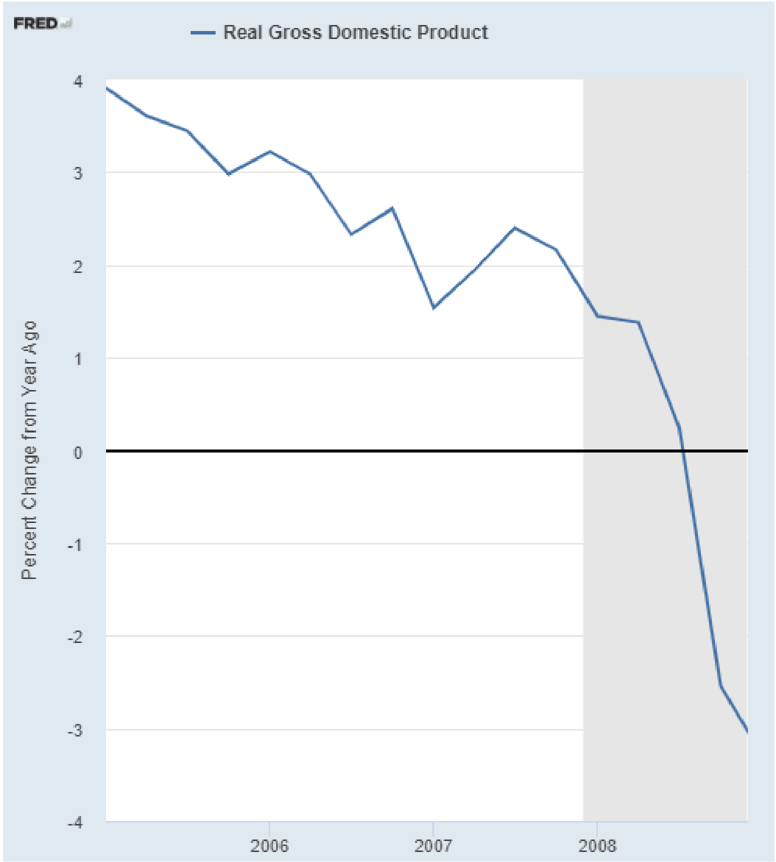
Even worst-case forecast scenarios often too sanguine



Alt Scenarios
August 2007 FOMC

Staff Forecast:
+2%

Housing Correction
with Spillovers:
+0.5%



Reality:
-2.5%

- Mistakes about which model features are important; lack of granularity such as demographics or geography; and behavioral assumptions often at odds with reality, especially during turning points.
- Standard tools, even after adding financial market channels, have not addressed concerns, such as in Stiglitz (2018). After-the-fact model changes are akin to 'fighting the last' war and do not prepare for new shocks.

New kinds of recessions could undermine on old tools

- Recessions due to rapidly changing non-economic factors like Covid-19 are near impossible to forecast.
- With better monetary policy and financial stability oversight, non-economic drivers like pandemics, climate change disasters, and political instability may become more common cause.
- Yield-curve inversion does not tell us what kind of recession is coming or how severe it will be which would inform policies.

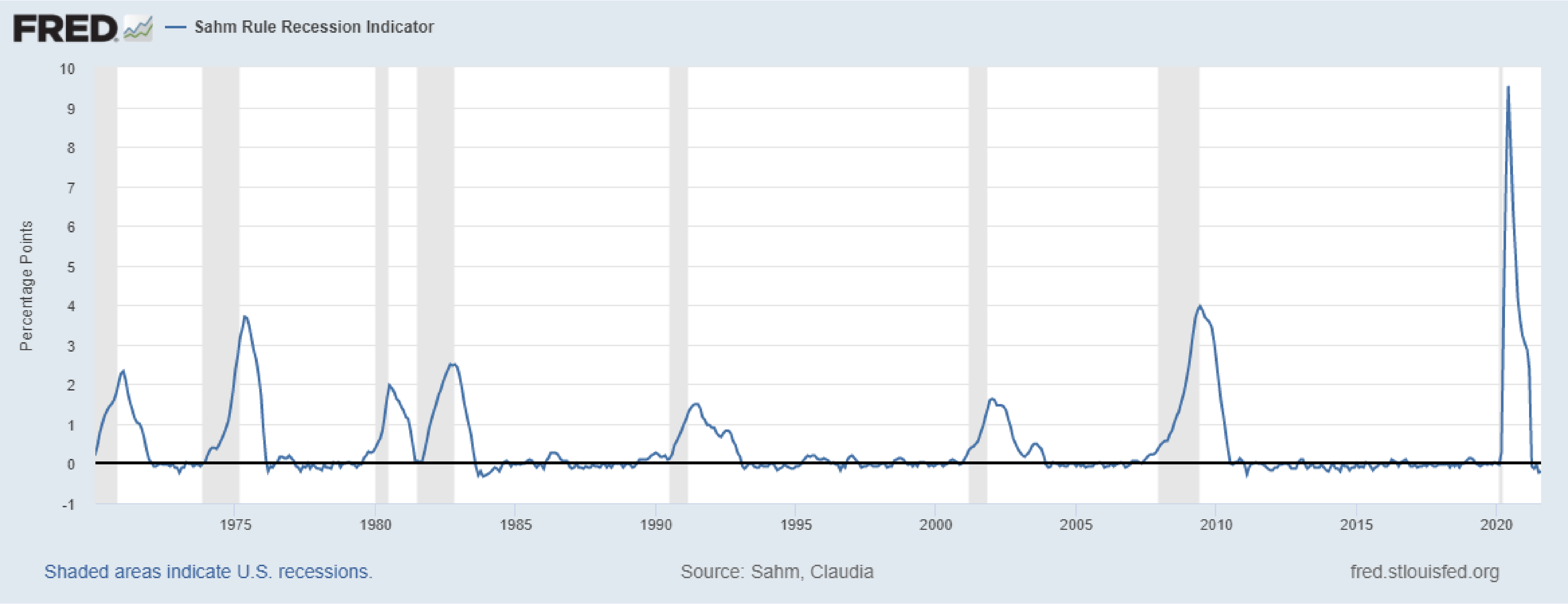
REAL-TIME TRACKING:

More precise and more informative.

Tradeoffs of forecasting vs tracking

- Forecasting, if reliable, helps policymakers, but timing is important. 'It's coming sometime soon' is not good enough.
- Good tracking offers reliability signal that recession has started.
- Tracking various economic and financial indentifies sources of the recession and path of recovery.

Labor market gives reliable signal of recession start

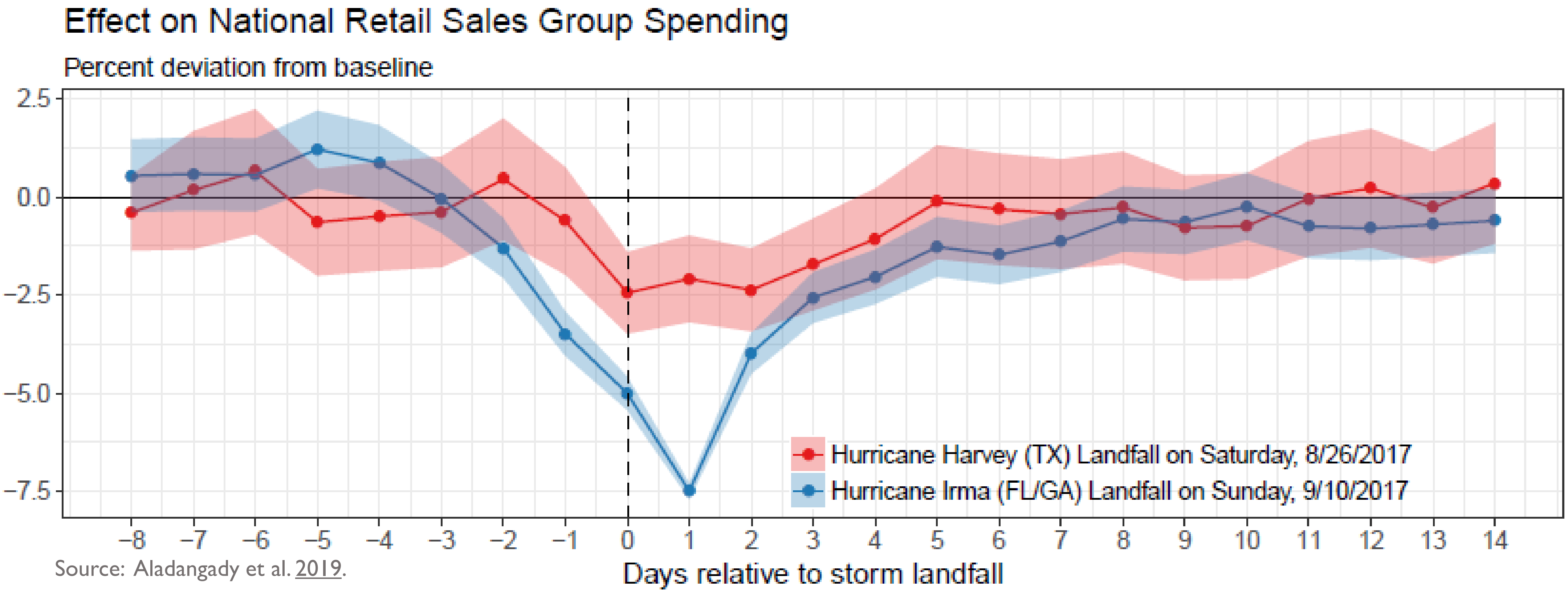


- 3-month moving average of unemployment rate up only ½ percentage point relative to prior 12 months, in a recessions. Highly reliable and from quickly available data.
- So-called Sahm Rule signaled start of Great Recession over a year before NBER recession dating and two quarters of GDP declines.

Dashboard approach to monitoring business cycles

- Huge increase of high-frequency, granular data. Track economic activity across geographies, industries, groups of people.
- Monitor spillovers from localized or new economic effects.
- Combine with official statistics and various methods, such model fore-/nowcasting and macro current analysis.
- Go beyond predicting a recession. Recovery dynamics are very important to stabilization policy decisions.

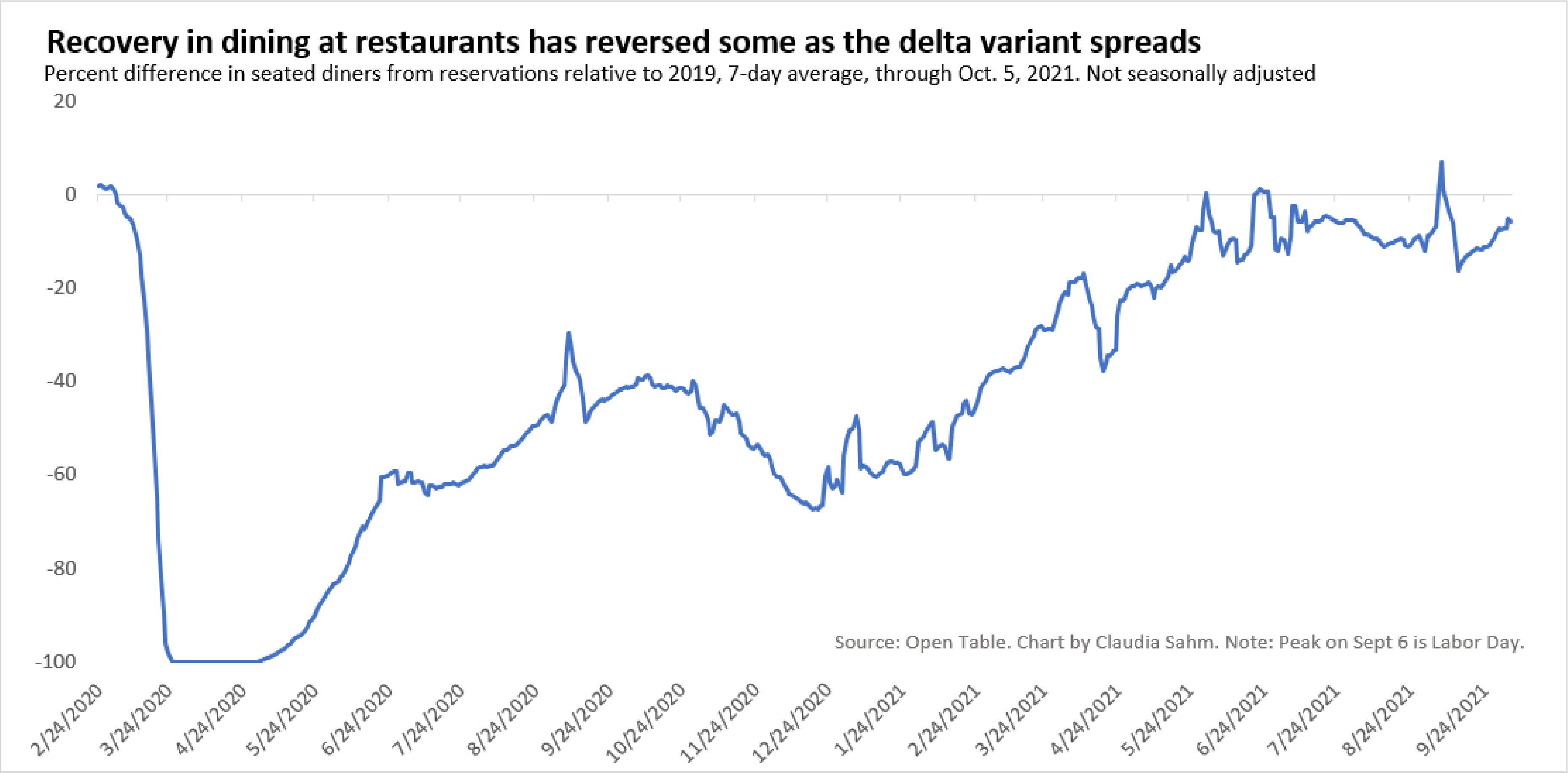
Track, not forecast: Hurricanes Irma and Harvey



Source: Aladangady et al. 2019.

- Daily, geographic, retail sales series created by the Fed can study local shocks, such as hurricanes. Unlike forecasts, tracking incorporates specific features of the event.
- Available within a few days and detailed geographies allows tracking rapidly changing conditions and spillovers such as housing market bust or large decline in oil prices.

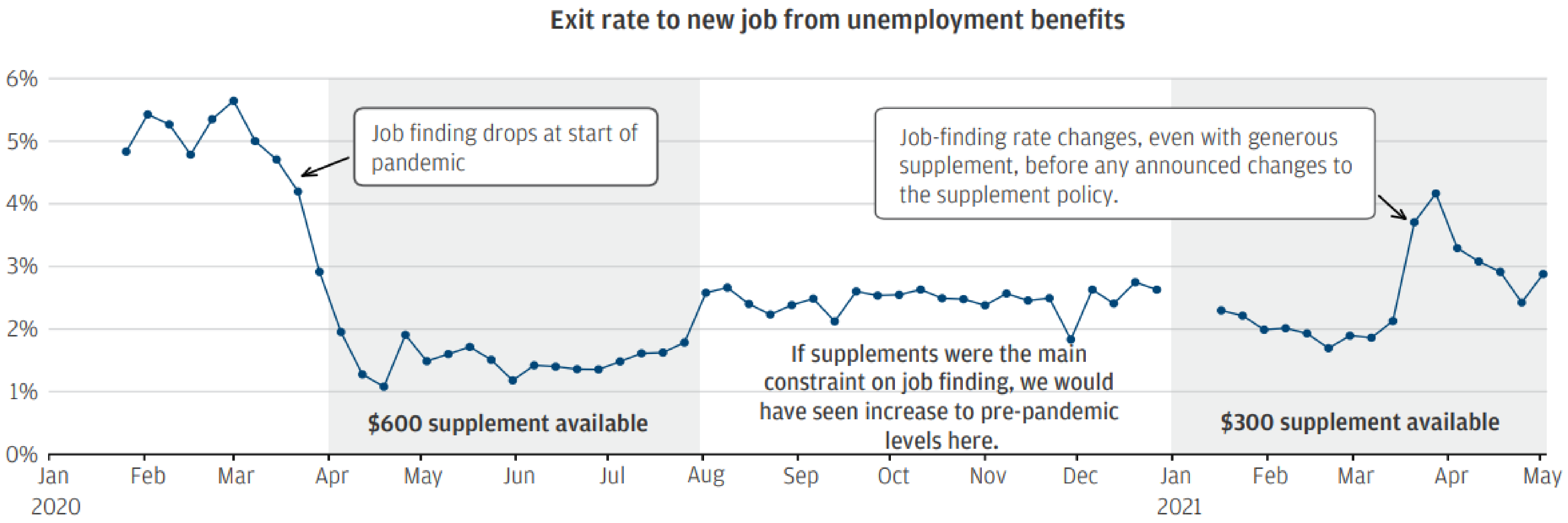
Monitor shocks: Open Table and delta variant



- Safety of face-to-face services like restaurant dining more at risk during Covid-19 than other types of spending. Tracking data like Open Table particularly useful now.
- Offers real-time monitoring but less statistical rigor of official statistics. Combine many types of data.

Real-time research: JP Morgan Chase Institute

Figure 1: The job finding rate changes modestly when UI supplements change.



- JP Morgan Chase Institute partnered with researchers to study effects on unemployment insurance (Ganong et al. 2021). Rigorous analysis to policymakers when they face decisions.
- Best practices for 'real-time research' are use validated, tested data sources and peer-reviewed research methods; set findings within prior research, and be transparent about data and assumptions.

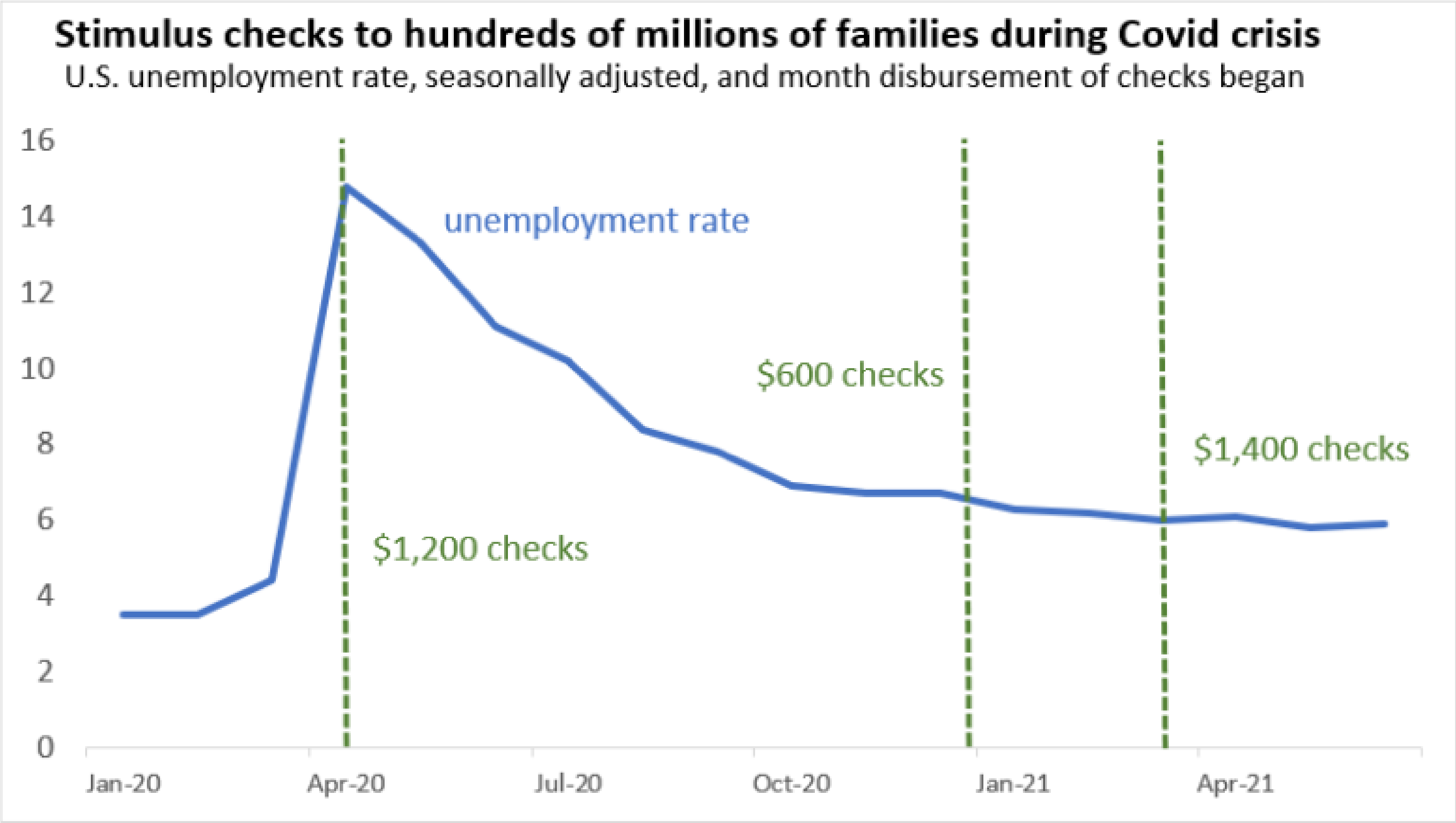
RESPECT OUR IGNORANCE:

Prepare policy for the unforecastable.

Create more automatic stabilizers

- Type and start/stop of monetary and fiscal policies to fight recession and speed recovery are mostly discretionary.
- Put policies used often in recessions like stimulus checks and extra jobless benefits on autopilot. Commit before recession.
- Tying basic relief to economic conditions would take the guess work out of durations and reduce the politics.

Preparation would lead to better policies



- Stimulus checks during the first year of the Covid crisis were effective at providing relief to families and bolstering demand (Sahm, 2021) *but* could've been more effectively timed, scaled and delivered.
- Time spent on debates over minor technical details of checks like what should the income phase out for the checks be was a distraction from pandemic efforts. Delivery systems should be built ahead.

Bonus: Good Macro Tips

See my Stay-At-Home Macro Substack.

- "Good Macro Tip #1: Learn from your mistakes"

- "What's wrong with being confident?"

- Several posts on inflation, supply chains, consumer spending, Fed and fiscal policy.

- Free paid subscriptions for students/RAs/pre-docs. Email me: stayathomemacro@gmail.com.