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

- 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 recession. 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

- 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.

Source: Aladangady et al. 2019.
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

- 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.

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