Austan Goolsbee on the Fed's Broken Forecasting Model

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by Justin Kermond

Austan Goolsbee is optimistic that the long-run prospects for the U.S. economy are outstanding due to the unbounded strength of our human capital, innovation and entrepreneurialism. However, Goolsbee warned that the next 12-18 months will be bumpy and the illusive V-shaped recovery will not happen because the U.S. Federal Reserve "forecasting model is broken, [and] if you are waiting for the 2006 normal bus to come back and pick you up and take you back to prosperity, you are actually hitch-hiking because the bus is not going to come back".

Goolsbee is the Robert P. Gwinn professor of Economics at the University of Chicago's Booth School of Business and serves as a strategic partner at 32 Advisors, a global consulting and advisory firm. He previously served as a member of the Obama cabinet and as chairman of the Council of Economic Advisers, as well as the chief economist for the President's Economic Recovery Advisory Board. He spoke to an audience of advisors as a keynote speaker at the Morningstar Investment Conference in Chicago on June 14th.

The Fed's broken forecasting model

Goolsbee asserted that the Fed's broken forecasting model has resulted in 30 quarters in a row of "serially correlated errors" resulting from the Fed's unrealistic expectations that the U.S. economy can return to the go-go days of 2006. The Fed repeatedly predicted a 3% growth rate, and the actual results were a 2% growth rate with a different follow-up excuse each quarter. Those excuses ranged from the winter being too cold to an earthquake in Japan to the British threatening to exit the European Union. Goolsbee said the Fed has "established a totally credible ridiculousity of non-credibility." Goolsbee said that none of these excuses are valid and that the next 12-18 months "are not going to be that great," but he does not think the economy is at risk of overheating or hyperinflation. Goolsbee said the economy will continue at a modest 2% growth rate.

The root of the problem is the broken model that unrealistically assumes that the return of the housing market, an increase in consumer spending, the drop in the price of oil, the political system and the Fed can lead the U.S. economy to the next V-shaped recovery, according to Goolsbee.

What it takes to have a V-shaped recovery

Goolsbee said that the economy has grown at a modest rate for an extended period of time, but the growth rate has consistently disproven what the Fed has been predicting. Goolsbee explained that the Fed's predicted V- and then U-shaped recoveries never emerged because the Fed was waiting for a savior to lead us to recovery and "the savior never showed up." The Fed defines normal as 2006, but 2006 is not going to happen again because it was an unsustainable bubble period. Goolsbee explained that V-shaped recoveries in the U.S. have only occurred when the economy could return to the same economic growth engines that were generating economic growth prior to a recession. In the case of our most recent recession, the U.S. could not return to an economy based on housing investment and consumer spending. Instead, we have had to steer our economy toward a more export-, capital investment- and innovation-oriented growth, which cannot happen as a V-shaped recovery. This is a much slower process of adjustment, as it requires industries to retrain its workers and relocate them from areas without to areas with jobs.

Why the U.S. housing market is not the short-term savior

Goolsbee explained that when looking at the last 109 years of U.S. housing price data, the first 90 years showed housing prices appreciating at a modest 30 to 40 basis points per year. But an 8-year period starting in 1998 followed where housing prices grew at 13.5% annually. The Fed and other economists have repeatedly predicted a much higher rebound growth rate in the housing market than has actually happened. The Fed predicted higher rates of people buying houses, new housing starts and associated construction booms than actually materialized. Goolsbee said this is because the Fed model is broken just "like our brains as the model is implicitly waiting for things to go back to normal" and the Fed's model defines normal as 2006 data. Goolsbee said this is an incorrect assumption because the 2006 data was in an unsustainable bubble period, and housing will not grow at that rate again but will resume being a positive contribution to GDP with a more modest growth rate.

Why the U.S. consumer is not the short-term savior

Consumers in the 2000s were spending at a faster rate than their incomes were growing, and Goolsbee pointed out that at two times during this period, the national savings rate was negative. He said that this was not a sustainable savings rate and that consumers are not going to go from their current 5% savings rate to the -0.5% rate of 2005. As a result, Goolsbee does not expect the U.S. consumer to lead the V-shaped recovery, but he does expect consumer spending to provide a small positive contribution to GDP.

Why the drop in oil prices is not the short-term savior

Goolsbee notes that there are prominent economists who think the price of oil will save our economy and lead us to higher GDP growth. One group says that half of the recessions in the U.S. since WWII were caused either directly or indirectly from high oil prices and that the fall of oil prices will produce an oil induced boom. Goolsbee had two objections to this line of thinking. First, he said that we have less manufacturing and have become dramatically more energy efficient since the 1980s when we had the last oil price induced recession. Goolsbee said that since then “the energy intensity per dollar of GDP has fallen by some 65%.” Second, Goolsbee objects to the belief that supply is the major driver of oil prices. In contrast, Goolsbee cautioned the audience that there should be a much more substantial weight on demand as a major driver of oil prices. Goolsbee said, “The fall in the price of oil is loosely correlated almost exactly with the fall of almost every other industrial commodity in the world,” and world market demand was dramatically affected by slowdowns in both China and the emerging markets.

Why the jobs market has done as well as it has

Goolsbee explained that up until the plummet in new jobs in May 2016 (+38,000), the U.S. had experienced two years of job creation with rates as high as we have ever had. Goolsbee offered the following explanation of how we have been able to have a job creation rate that is correlated with a 4-4.5% GDP growth when we have only had a 2% actual growth rate. Economists have differing views with one group, including the Fed, thinking the higher jobs rate is a leading indicator and a higher GDP growth rate will follow. Goolsbee includes himself in the other group who thinks that jobs growth rate equals output growth minus productivity growth. In the most recent two years, we have had 2% output growth with a -2% productivity growth, which combine to explain the 4% jobs growth rate. If the productivity rate goes back to a historic 2% rate, the jobs growth rate would go to 0% as the existing work force can absorb additional workloads due to productivity increases. Even if the productivity growth rate only goes back to 0%, the jobs growth rate will remain low relative to the last two years and be more consistent with the current slow 2% GDP rate.

Why the political system is not the short-term savior

Goolsbee thinks the second half of the Obama administration’s second term has been productive relative to previous administrations, but he said that you cannot expect the last two years of any administration to help the economy very much. The last two years are primarily focused on agenda setting for the next administration rather than policy setting, which is the focus of the beginning of new administrations’ terms.

Goolsbee noted that despite the Democrats losing mid-term elections and a toxic and gridlocked political environment in Washington D.C., the Obama administration has done better than all of the recent preceding administrations in its last two years, the George W. Bush was book-ended by Hurricane Katrina and the financial crisis; Bill Clinton was impeached; George H. W. Bush was voted out of office; Reagan had the Iran contra scandal; Jimmy Carter had the Iranian hostage crisis and was also voted out of office; Nixon had Watergate and Vietnam; Kennedy was assassinated; and Eisenhower had a heart attack with seven months of prescribed bed rest.

Why the Fed is not the short-term savior

Goolsbee thinks the Fed has done what it was supposed to do to stimulate the economy with the different iterations of quantitative easing, but “the best bullets were used on QE1 and the next best bullets were used on QE2 and the third best bullets on the Twist and the fourth best bullets on QE3,” with the incremental effect of each policy operation less than their predecessor. Goolsbee does not think the Fed has many bullets left to stimulate the economy.

What is the longer-term savior of the U.S. economy?

Goolsbee said that beyond the current 12-18 months of short-term bumpiness without silver bullet saviors, the economy is going to be fine. Goolsbee said it is wrong to believe in a “new normal secular stagnation” or that we should just get used to disappointment forever. Goolsbee closed by predicting that in the long run, the U.S. economy will be fine because our demographic problem is less pronounced than any other advanced country. Goolsbee said that we are starting from a position of strength and our savior will be our people, our human capital, our commitment to innovation and entrepreneurialism and the “productivity level and skill base of our workforce, which remains number one in the world of all major economies.”

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