



Mussa and the Art of Economic Forecasting

Michael Mussa, whose economic projection last year turned out to be more correct than many others, discusses the art and science of economic forecasting.

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Steve Weisman: For nearly three decades, Michael Mussa, senior fellow at the Peterson Institute for International Economics, has been doing economic forecasts—first at the University of Chicago and later at the IMF, now here at the Institute. He’s been wrong, he’s been right. Right now, his forecast looks pretty good. This is Steve Weisman at the Peterson Institute, here to talk with Mike about his current forecast but more generally about the art of forecasting and how one goes about it. So, Mike, thanks for joining me.

Michael Mussa: My pleasure.

Steve Weisman: Let’s talk about what an economic forecast is and is it an art or a science?

Michael Mussa: In any economic forecast, you’re seeking to project how the economy will perform over the relatively near-term future, usually out a year or two. And we generally refer to longer-term forecast as projections and there, it’s mainly assessing what the likely long-term trends of the economy are, which is a somewhat different game than near-term forecasting.

Steve Weisman: Sort of like weather versus climate?

Michael Mussa: Yes, in many respects indeed.

Steve Weisman: Last year at the depth of the recession, you predicted that the recovery would be more brisk than many others did. And it looks like your predictions turned out to be more correct. Isn’t that right?

Michael Mussa: Yes. Generally over the years, my forecasts have not been very different from the consensus, the average view of most other forecasters. Last year, I took a decidedly different view, being at or even a little above the upper end of forecasts by say, the blue-chip panel of 50 forecasters for the United States or the Economist panel or others, because I sensed a little more than a year ago that probably the government had done enough to bring an end to the financial crisis and that we should anticipate an economic recovery beginning around the middle of 2009. The rule in recoveries is they surprise you on the upside.

Steve Weisman: But if something continuously surprises you, why is that surprising?

Michael Mussa: It’s an oddity about forecasting that in the upturn, forecasts turn out to be too low. Partly that may be that you don’t know exactly when an upturn is going to start and whether it

will be sustained or may poop out after a quarter or so. But I think another element of it is, for private forecasters, that you've almost always missed forecasting a recession and you don't want to make another mistake in the same direction. So the tendency is to be quite cautious about forecasting the upside recovery. I take a different view. I said, well, I missed the recession, I'm not going to miss the recovery.

Steve Weisman: Why are forecasts so different? Do some people look at some things as opposed to others? And if so, what's your particular approach?

Michael Mussa: It's just part of the art and the science of the exercise. The fact of the matter is that the future course of the economy is uncertain and there's no way that one can predict with a high degree of accuracy how things are going to transpire. And especially in circumstances such as you've had over the past year where there's a question about whether we were going to get a recovery and then how strong it might be. The degree of uncertainty is large and naturally the range of forecasts, which tend to be centers of distributions of what people think the most likely outcomes will be, also are more dispersed than normal.

Steve Weisman: Last year, I know a lot of people said that this is going to be a slower recovery because of the weakness of financial institutions. And that was a fundamental premise that you didn't quite accept. So it wasn't just like choosing this indicator versus that, it seemed to be almost more of a kind of basic analytical difference of view that you had.

Michael Mussa: There was some difference of analysis. My reading of the historical record is that it is the recovery of the economy that ultimately rescues the financial system. It's not the restructuring of the financial system that produces the economic recovery. And I think we're seeing again a repeat of that now. Bank profits are going up, their valuations in the stock market are going up, and that's primarily because the economy is stronger, loan losses are [declining] or [are] expected to decline. And I anticipate that in a recovery we would see that, as we have in most past recoveries. And there was too much emphasis in other people's forecasts about how dire this situation would be in financial institutions, especially if we got what they were predicting, which was virtually no recovery.

Steve Weisman: So what do you see now given that these institutions are strengthening?

Michael Mussa: I continue to expect what I regard as a moderate-paced recovery. So I'm projecting in the first six quarters of recovery, which ends at the end of this year, that we'll get between 6 percent and 7 percent cumulative growth. So it'll be growing at about a 4-percent rate annually, and at that pace of advance we'll continue through next year. Now, that's well below the average pace of recovery following deep recessions earlier in the post-war period. So a lot of the arguments that we should expect a slower recovery this time, I assign credit to. I just don't want to give too much credit to them.

Steve Weisman: What about the next two years?

Michael Mussa: There, we're really into projection land, since even under my top of the charts forecast, we would still have 8 percent unemployment at the end of 2011. We're going to have a lot of slack left in the economy by the end of next year and I think we will continue to grow in recovery mode and bring the unemployment rate down gradually over a period

of four years or so, back down to the neighborhood of 5 percent. So that would say then the economy should be growing perhaps 3.5 percent, a percentage point above its normal potential growth rate of about 2.5 percent.

But there are a variety of things that could either accelerate or interrupt that process. As one moves forward in time and gets a little bit better idea of whether we might get some of those things in 2012—if we have big tax increases or something of that kind that would slow the recovery or other developments that might accelerate it. It's too soon to try and say growth in 2012 will be above 3.5 or below 3.5.

Steve Weisman: I'm curious to know, Mike, it's sort of like an elite club, the forecasters at the major financial institutions. Do you all know each other? What's it like to talk to your colleagues doing this?

Michael Mussa: I certainly don't know all of the 50 inside the blue chip but I probably know 20 of them reasonably well. I interact with them at various meetings of economists around the country at various times. And I read what many of them are saying, in addition to the summaries that are produced by various agencies. I think it's important in forecasting to know and understand what other forecasters are saying and why. Often, as I said, I don't diverge very far from the average. The past year or so has been a relatively rare instance in which I am sharply different from the average.

Steve Weisman: Let me ask you about the political context of economic forecasting. What's the history of administrations distorting forecasts in order to further their political goals? You've been in the US government; you served on the Council of Economic Advisers. How credible is any administration on this?

Michael Mussa: Doubts are always expressed, are often expressed that the forecast has some political element in it. I think that there's some element of truth in that. But the other side, I think we've seen recently that when it came in, the new administration had an initial forecast for the economy that was very similar to the average of private forecasts at that time. But it turned out that the unemployment rate did not peak at around 8 percent or a little higher. It went on up to 10 percent. So they persistently got slammed in terms not only of the forecast but in saying that their stimulus package was a failure and all the rest of it because the outcome turned out to be worse than they were projecting. That, I think, tends, if anything, to make them a little bit gun shy about forecasting a relatively strong recovery—because if they're right, they're not going to get much credit for it and if they're wrong, then they're going to get a lot of blame. So one thing, if it's a normal bias perhaps to overstate things on the optimistic side, there's an important deterrent to doing that now.

Steve Weisman: Mike, thank you very much for walking us through a little bit of this. Let's hope you're right about the future.

Michael Mussa: You're welcome.

