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U.S. Economy Needs Stimulus, Not Soothsayers

By Betsey Stevenson and Justin Wolfers - Apr 2, 2012

Here's something you don't often hear an economist admit: We have very little idea where the economy will be next year.

Truth be told, our best guesses just aren't very good. Government forecasts regularly go awry. Private-sector economists and cutting-edge macroeconomic models do even worse.

For a spectacular example, let's go back to August 2008. The economy had been in recession for nine months, the investment bank Bear Stearns Cos. had already collapsed, and Lehman Brothers Holdings Inc. was well on its way to bankruptcy.

Yet leading economists responding to the Survey of Professional Forecasters predicted that unemployment would average 6 percent in 2009. Just a few months later, the White House projected that with the passage of the stimulus bill, unemployment would be less than 8 percent -- far short of the 9.3 percent it ultimately reached.

This was a big miss. It's also not unusual. The dismal science is more dismal and less science than most people recognize. Careful studies by both Federal Reserve economists and the Congressional Budget Office have found that forecasts of the next year's economic-growth rate typically miss by about one percentage point, and often more. Unemployment forecasts aren't much better.

Why? Data are imperfect. Theories are coarse. Models oversimplify. The economy is constantly evolving and can't be subjected to controlled experiments. Economic cycles are infrequent, so our understanding of them necessarily proceeds very slowly.

False Confidence

None of these drawbacks, though, is fatal to the enterprise. Rather, they tell us that policy makers, the media and the public should beware of economists who argue their forecasts with certainty. All too often we fall for false confidence, bravado and swagger, which crowd out legitimate discussion about our uncertain future.

Serious forecasters embrace uncertainty, giving rise to the much-derided stereotype of the two-handed economist. But this is exactly what we need. Like a meteorologist who warns you to pack an umbrella because there's some chance of rain, economists can assess the risks that lie ahead in a way that helps policy makers prepare for the future. To do so, they must examine both the rain and the shine scenarios, and weigh the cost of action - - or inaction -- in both cases.

Consider the current economic-policy debate. Most forecasters suggest that as the recovery slowly grinds on, unemployment will fall to about 7.5 percent by the end of 2013, from the current 8.3 percent. While this isn't great progress, it is fast enough that some have argued against further stimulus.

We know, though, that the consensus forecast is highly likely to be wrong. Unemployment could fall to 6.5 percent, or rise to 8.5 percent. Each of these possibilities needs to be considered, and weighed according to its potential benefit or harm.

If unemployment falls to 6.5 percent, there's no overwhelming reason for concern. Historical experience suggests that inflationary pressures are unlikely to build unless the jobless rate drops to 5 percent or 6 percent. Even if inflation does accelerate, the Fed has ample power to reverse course by raising interest rates to slow growth.

By contrast, the longer-run consequences could be dreadful, if we find ourselves with 8.5 percent unemployment fully six years after the recession began. Europe's experience in the 1970s and 1980s demonstrated that persistently high unemployment can become entrenched, leading to further unemployment in the future -- a process economists call hysteresis. Skills atrophy, hope fades and people lose contact with the networks that can help them find work. If this occurs with the millions of U.S. workers who have been without jobs for more than a year, it will be costly and very difficult to undo.

In other words, the cost of too little growth far outweighs the cost of too much. If we readily bear the burden of carrying an umbrella when there's a reasonable chance of getting wet, we should certainly be willing to stimulate the economy when there's a reasonable risk that doing nothing could yield a jobless generation.

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