

**Terre Haute Tribune-Star, Progress Monthly
August 2007
“The Recession of 2008”**

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One year ago this month, columnist John Authers declared in the *Financial Times* that “there is now an almost universal expectation of some kind of an economic recession.” Also in August of 2006, *The Economist* magazine ran an article analyzing the causes of an upcoming recession that was assumed to be just around the corner. Surely it is an odd and pessimistic bunch that analyzes bad events before they even occur, but that’s economists for you.

In the year since those predictions, the Dow Jones Industrial Index has risen by 16%, Real GDP has increased 1.8%, average hourly wages are up by about 4%, and the unemployment rate actually has fallen slightly. So the predicted recession of 2007 has yet to materialize. All of which begs the question “why aren’t economists better at forecasting?”

One simple answer is that unlike weather forecasting, the systems that economists attempt to forecast are populated by people and organizations that are continuously responding to published reports, forming their own forecasts, and revising their plans accordingly. Thus when business firms start hearing that a recession is inevitable they might well start altering their plans in ways that makes a recession more *unlikely*. Likewise, if consumers begin sensing that an economic downturn is becoming more likely, they might revise their plans, thereby making yesterday’s forecasts obsolete.

John Kay, another *Financial Times* commentator, calls this process “reflexivity.” He explains it by saying “what happens is influenced by what we perceive will happen.” Thus it is impossible to discover rules for predicting stock prices because the very discovery of such rules and the actions of investors using them would affect stock prices right now.

These thoughts came back to mind in early August as a new NBC/Wall Street Journal poll reported that more than two thirds of Americans believed the U.S. economy was either in a recession already or would be soon. Coupled with the late July sell off in the stock market, some people thought all the pieces fit. And yet, a year

ago at this time many economists were already conducting post-mortems on the looming recession of 2007, which as of now hasn’t materialized. Can we be any surer of current prognostications about the recession of 2008?

Most economic forecasters avoid all or nothing claims and use data-driven models to estimate probabilities of different outcomes. Hence, instead of saying “we’re going to have a recession next year,” a good economic forecaster would present a model to support a statement such as “the probability of a recession next year is 50%.”

In macroeconomic forecasting circles, one model that has attracted my attention recently makes use of an arcane financial indicator called the yield curve, which measures the spread between long-term and short-term interest rates. Most of the time the interest rate spread is positive because long-term interest rates are higher than short-term interest rates. Every once in a while, however, long-term rates drop below short-term rates and the yield curve inverts. Researchers at the New York Federal Reserve have pointed out that this has happened before each of the previous six recessions, going back to 1970. Perhaps more impressively from a forecasting perspective, there have been no episodes of yield curve inversion that were not followed within about a year by a recession.

People have been talking about the yield curve recently because it inverted late last year and is still flat. Based on its history, that would seem to be another piece of evidence that a recession is on the way. Why would a yield curve inversion be a harbinger of bad news? One way of looking at long term interest rates is as a compounding of investor expectations about future short-term rates. Hence, if long term rates are lower than short term rates, it would seem to indicate that investors expect short-term rates to fall in the near future. One common reason for short-term rates to fall is a weakening economy. Remember, when the Federal Reserve thinks the economy is in recession, it tends to cut interest rates.

The researchers at the New York Federal Reserve developed a simple forecasting model based upon the yield curve. At the end of July, that model placed the probability of a recession within the next 12 months at about 30%. From this forecaster’s perspective, and given all of the conflicting data on the economy right now, that percentage seems about right.