A Forecasting Personality Test

Contrary to most forecasts, including my own, the economy finished 2023 strong. Inflation, as measured by the personal consumption expenditures price index, came down all the way to 2.6 percent. At the same time, despite higher interest rates, global conflicts, and banking turmoil, economic growth was healthy and unemployment was near historic lows.

But early 2024 data has been a little less easy to read, with inflation elevated and consumer spending coming in softer, while the labor market has remained quite strong. So it's easy to see why people might differ on the path forward for the economy — each forecaster sees the future through his or her own lens. You likely do the same.

You might be an optimist, expecting inflation to return to our 2 percent target while the economy stays healthy. That could well happen: The extraordinary levels of post-pandemic spending have been normalizing. The painful post-COVID-19 supply chain shortages have been largely resolved. Immigration and the rebound in prime-age labor force participation have helped alleviate labor market pressures, as have productivity increases. Most measures of inflation expectations suggest that businesses and consumers have found the Fed's inflation target credible.

There are also more pessimistic cases to be made, generally falling into three camps.

You might be a demand pessimist. You might be concerned about the recent increase in consumer delinquencies and the challenges in commercial real estate. You might worry about weakness in other interest-sensitive sectors as well, like banking, residential real estate, manufacturing, and home improvement. You might note that nearly three-quarters of last year's job gains came from just three sectors — health care and social assistance, leisure and hospitality, and government — and worry that the labor market might be nearing a turning point. Or perhaps the risk of geopolitical shocks keeps you up at night.

Alternatively, you might be an inflation pessimist. You might point to continued strong wage growth in a tight labor market. You might note consumers' continued willingness to spend; the saving rate is down to 3.6 percent versus 7.7 percent pre-pandemic, and that spending is potentially supporting higher prices. Or maybe you notice other forces that arguably have turned inflationary, from deglobalization to limited housing supply to demographics to energy transition.

Lastly, you might be a Fed pessimist. You might fear the Fed will keep rates too high for too long or normalize too quickly and allow inflation to linger. Our job isn't easy, and history teaches that most tightening cycles end poorly, though often heavily influenced by an outside event like the pandemic or the 1990 Gulf War.

What do I see?

On demand, I have to believe all of this tightening will eventually slow the economy further. After all, corporate interest payments as a percent of corporate revenues and personal interest payments as a percent of disposable personal income have only now finally gotten back in the range of 2019 levels — suggesting the full impact of higher rates is yet to come.

If the economy does cool, it doesn't need to be as painful as the Great Recession. Employers who have fought hard to recover from labor shortages tell me they are hesitant to lay people off and run the risk of being short again. And a slowdown shouldn't catch businesses by surprise; they've already slowed hiring and streamlined costs. Banks have cut back on marginal credit. In short, the economy should be less vulnerable.

On inflation, while I do hear price-setters increasingly convinced that the pandemic era of significant pricing power is behind them, the inflationary experience of the last two years has surely given them more courage to use price as a lever. (See "How the Pandemic Era Changed Price-Setting," *Econ Focus*, Fourth Quarter 2023.) So I'm still looking for the slowing in reported inflation to sustain and broaden.

Despite my concerns about demand and inflation, perhaps it is no surprise that I'm a Fed optimist, which is different than believing we are infallible. I am optimistic that keeping rates somewhat restrictive can bring inflation back to our target. While I don't see the economy overheating, the Fed knows how to respond if it does. And if the economy slows, the Fed has enough firepower to support it as necessary.

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