**Discussion**

**ARE EXPERT ECONOMIC FORECASTERS SOCIALLY USELESS?**

Philip Booth[[1]](#footnote-1)

**Introduction**

In recent times, economic experts have come under fire. This discussion article examines some of the reasons why, and considers the fundamental problems in economic forecasting that might have led to expert economic forecasters making a less-than-positive contribution to the analysis of important recent economic events such as Brexit and the financial crisis.

**Experts’ forecasting record**

Economic experts did not come off well in the financial crash. This was one of the most cataclysmic economic events in the developed world since World War II. The effects are still being felt now, nearly ten years on. The fact that most mainstream economists missed the warning signs of the crash is well known.

Indeed, in November 2008 HM Queen Elizabeth II visited the London School of Economics and asked about the crash: ‘Why did nobody notice it?’[[2]](#endnote-1) This was a good question. The first sentence of the last Bank of England Financial Stability Report issued before the financial crisis started in the UK read: ‘The UK financial system remains highly resilient’ (Bank of England 2007, p. 5). Although, in the overview that followed, some concerns were raised, the tone was rather sanguine. The report continued (2007, p. 6):

The trading of credit risk in financial markets enables risk to be better diversified across the system as a whole. But recent events in US sub-prime mortgage markets have illustrated that weaknesses can also emerge. Similar problems in a more significant market, such as corporate credit, could have more serious consequences if credit quality were to deteriorate.

Even though the potential for risks was spotted, the Bank of England even got their likely source wrong. It is hard to pin the blame for the financial crisis on a failure in corporate credit markets. This rather relaxed view amongst the experts was also reflected by Paul Tucker’s remarks as late as April 2007. Tucker was head of the Bank’s Market Operations and said: ‘So it would seem that there is a good deal to welcome in the greater dispersion of risk made possible by modern instruments, markets and institutions’ (Tucker 2007, p. 314). They were the very instruments which were at the seat of the crisis (though they did not, as such, cause the crisis) and which were encouraged by regulatory and other interventions by ‘experts’ in the US government.

  Of course, just as public sector ‘experts’ did not see the crash coming, private sector ‘experts’ did not either –if they had done so, it probably would not have happened. However, it is worth mentioning the apparent lack of foresight of public sector actors in particular because many people believe that it has been a correct response to the financial crisis to vest more power in their hands.

Just as the crash was not predicted, forecasters hardly covered themselves in glory in the period afterwards either. In 2009, the Bank of England believed that there was a negligible probability of inflation rising over 4 per cent within two years (itself 2 per cent above its target). In fact, inflation rose to 5 per cent (Bank of England 2009, espec. pp. 40, 46). The overestimate of economic growth by the Office for Budget Responsibility after its inception in 2010 was substantial, in a way which had important implications for government finances. This was not a case of equal and opposite errors in every year, suggesting that the timing of growth was different from forecast, but errors in the same direction year after year. In other words, it would appear that something was missing from the model.

Further errors were made in the run-up to, and following, the Brexit (EU referendum) vote. Just before the vote, the Bank of England expected the economy to grow by 2.3 per cent in 2017. After the vote, this was adjusted to 0.8 per cent before the forecast was upgraded to 1.4 per cent in November 2016 and 2 per cent in February 2017:[[3]](#endnote-2) in other words, almost to where it was before the referendum. Nothing much had changed in the interim. Clearly, the Bank was unable to understand that the private sector of the economy tends to be pretty robust in the face of shocks that arise from the real (as opposed to the monetary) sector. Or, perhaps, it simply was not possible to make sensible forecasts.

Treasury forecasts fared no better. Prior to the vote, HM Treasury published an analysis of the immediate effect of a referendum result in favour of leaving the European Union. Indeed, it was probably this and other similar analyses which led Michael Gove, the then Secretary of State for Justice, to make his comments criticising ‘experts’ (Mance 2016) which have since been the subject of much discussion. The Treasury document suggested that within two years of the referendum result, GDP would be 3.6 per cent lower than in the event of a vote to remain in the EU, using cautious assumptions. An alternative scenario suggested that GDP could be 6 per cent lower. The Treasury suggested that a state-of-the-art vector autoregressive model was used and that:

This [forecast] is based on a widely-accepted approach, and is supported by the effects of uncertainty already evident in financial markets and the real economy. A recession would be expected to follow even in the more cautious scenario with a significant risk that the outcome could be far worse. (HM Government 2016, p. 9).

This document was not only prepared by the Treasury but was reviewed by Sir Charles Bean, a former Deputy Governor and Chief Economist at the Bank of England and professor at the London School of Economics (LSE). The combination of LSE academic post, Bank of England positions and knighthood of the reviewer, together with the Treasury as publisher, surely means the document qualifies as coming directly from the heart of the ‘expert’ class.

**Experts and overreach**

There are at least two overlapping problems when it comes to forecasting by expert economists. The first is that economists focus in their thinking on what is measurable rather than on what is important. The second is that economists have come to overvalue both formal modelling and spurious precision in such modelling. These two problems are, of course, related and were important topics discussed by F. A. Hayek, not least in his Nobel laureate lecture (Hayek 1974).

  Current approaches to economic forecasting can be correct when we do not need forecasts. When everything is progressing according to the assumptions underlying the model, the forecaster might tell us whether inflation is going to be 2.4 per cent or 2.3 per cent in six months’ time, or the modeller might provide an appropriate range with probabilities attached. This might be useful in some contexts, but it is largely missing the wood for the trees.

What happens when important things are happening that the models do not or cannot take into account? Take the example of the role of monetary growth in asset price inflation and the financial crash. It is too far-fetched to argue that monetary policy mistakes were the cause of the financial crash (or, at least, that they were the only cause). There were also regulatory failures, moral hazard stoked in various ways, reckless behaviour and entrepreneurial error. However, without persistently loose monetary policy in the US, things may well have played out very differently. The same is true, though to a lesser extent, in the UK. There are also other examples of where monetary growth was important in artificially stoking economic activity and inflation with disastrous consequences, and where this was not picked up by mainstream economic modellers – such as in the late 1980s.

  Presciently, Mervyn King, the then Deputy Governor (later Governor) of the Bank of England, had noted back in 2002, though without drawing the necessary general lessons or implementing them within the Bank of England’s forecasting processes, that central bank models do not include money despite money being the main driver of inflation. King said that he believed inflation was a disease of money, that there were real dangers in central banks relegating money to a ‘behind-the-scenes’ role. Specifically, he said: ‘My own belief is that the absence of money in the standard models which economists use will cause problems in future’ (King 2003, p. 86).

How right he was. He was an expert, of course. But an expert who knew that what was not in the model was more important than the variables that were modelled. Sadly, he did not swim against the tide of the profession’s elite.

The reason that macroeconomic models do not include money is that the relationships between the supply of money and the economy are not easy to model. Typical models based on aggregate demand and supply are easier to construct and test. But, in focusing on what is measurable, such models miss what is important. Economists set far too much store by spurious statistical sophistication.

One response to this argument is that models could be improved to include the important variables. Instead of modelling the economy in the traditional ways used by central banks, focusing on output gaps and so on, perhaps – to continue this example – money should be the driving force of a model of inflation of goods, services and asset prices. However, the instability of the precise relationships between money and inflation would mean that such models would not pass the tests demanded by modern econometricians. But that does not mean that money is not important. Perhaps we are thinking the wrong way about how to model and what to expect from models.

Indeed, in many of the instances described above various factors could be cited that led model predictions to turn out to be ‘wrong’. After the financial crash, there were continual changes in government policy, such as the decrease and then increase in Value Added Tax. Forecasters could assist by not only including a better probabilistic interpretation of their predictions, but also explaining intuitively the reasoning behind the model and the kinds of events that might lead to its predictions not coming to pass.

And this takes us to the second point. We demand too much of models in terms of statistical precision – even though this is a spurious precision – and this is one reason why we construct them as we do. The view taken by most Austrian economists is that we cannot forecast the behaviour of seven billion people all with a will of their own. Instead, a good understanding of theory can help us make what Hayek called ‘pattern predictions’:[[4]](#endnote-3) we can tell the kind of thing that will happen, but not predict it with accuracy. Traditional economic modelling pretends to predict with accuracy things that do not matter yet seems unable to tell us anything about important events outside the model which really do matter. It would be better to have models, or ways of thinking about the economy, which help us to understand the kind of things that might happen, without the spurious accuracy of modern econometric techniques.

Indeed, well before the crash – in 2005 and 2006 – a group of economists, mainly members of the Shadow Monetary Policy Committee, twice wrote to the *Financial Times* warning of trouble ahead if monetary growth continued at then current rates. However, none of our group would have been confident forecasting precisely what would happen. But we were aware that important things were going on that would lead to consequences such as asset price inflation, consumer price inflation, an expansion of bank lending, and so on: and these things did happen.

As Hayek put it in his Nobel laureate lecture of 1974 (slightly amended to clarify the points):

Unlike the position that exists in the physical sciences, in economics and other disciplines that deal with essentially complex phenomena, the aspects of the events to be accounted for about which we can get quantitative data are necessarily limited and may not include the important ones … all the circumstances which will determine the outcome of a process … will hardly ever be fully known or measurable. And while in the physical sciences the investigator will be able to measure what, on the basis of a prima facie theory, he thinks important, in the social sciences often the variables treated as important are those which happen to be accessible to measurement. This is sometimes carried to the point where it is demanded that our theories must be formulated in such terms that they refer only to measurable magnitudes.

Economists can usefully shed light on issues such as ‘does openness to trade lead to growth?’, ‘in what circumstances might free trade reduce the living standards of some people and for how long?’, ‘what will happen to the market for hotels if the internet radically reduces the cost of people renting out rooms and there is no change in demand?’. But they cannot predict the precise magnitudes of these effects.

Interestingly, in an era when government sets so much store by forecasting the precise level of growth in the economy, it is worth noting that Hayek was wrong in one respect. People are no longer confident that things can be measured so precisely in the physical sciences. It is clear, for example, that the impact of man-made climate change is very difficult to measure except as a ‘pattern prediction’. Just to give one example, it now appears more likely that climate change will lead British summers to be wet rather than hot and dry – but views on this might change again. What will happen to winters is anybody’s guess. These things depend on the interaction between the Gulf Stream, the melting of the polar ice caps, the position of the jet stream and the salt content of sea water. Something is likely to happen, but quite what and to what extent we don’t know. The effect is especially unpredictable given the interaction of natural climate change with man-made impacts. If climate change modellers were clearer about this, perhaps they would not be dismissed quite as readily as they are in some quarters. As with economists, humility and honesty is important.

The distrust of experts has not entirely escaped senior staff at the Bank of England. Former Deputy Governor Minouche Shafik (who has since moved to the LSE) recently gave a speech on the subject to the Oxford Union (Shafik 2017). However, her proposals to deal with the problem related to process rather than method – better peer review, experts getting out and talking to people of different views more often. No doubt this is important. But what is really needed is a bit more humility. There should be more willingness to appreciate that the right answer to a question will relate to tendencies and not to precise magnitudes. For the poorest people in the world, good economic policy is a matter of life and death – and we can say what sort of policies and roughly examine their effect. It is not as if what we do is not important. We do not need to pretend that we can predict things that do not really matter to several decimal places in order to justify our value to the world.

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**Notes**

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2. This was widely reported in the press. See, for example, Pierce (2008). [↑](#endnote-ref-1)
3. These forecasts are available from the Bank of England’s inflation reports. [↑](#endnote-ref-2)
4. See, for example, Hayek (1974), though this was a recurrent theme in his work and in this reference he referred to his earlier works. [↑](#endnote-ref-3)