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WHY ARE ECONOMIC FORECASTS UNRELIABLE?

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Q: Why are economic forecasts so unreliable?

A: Because economic and social phenomena are very complex.

Q: More complex than physical sciences; chemistry or meteorology, for example?

A: Very much so. It is much easier to forecast the impact of heat on iron, or the reaction of salt with iron, or the likelihood of rain in the next twenty-four hours than it is to forecast next year's prices. In general, physical sciences deal with simple phenomena.

Q: So what distinguishes simple from complex phenomena?

A: The distinction is based upon the number of variables scientific formulae must possess in order to reproduce the characteristic patterns of relevant theoretical structures.

Q: That needs to be unravelled! Can you give an example?

A: For the relationship between two chemical molecules (say, salt and water) the relevant variables are few, easy to understand and simple to explain. Economics is concerned with relationships between men and men (and between men and things).

Q: Much more complicated.

A: Yes. The relevant variables are vast and generally too numerous, too diverse and too transient to enable formulae to reproduce characteristic patterns within relevant theoretical structures.

Q: Chemical reactions are simple and easy to forecast. Human behaviour is complex and difficult to forecast.

A: How concise and clear is that statement.

Q: But surely some economic forecasts are accurate?

A: If so, it is a consequence only of their number and diversity. Consider John Kenneth Galbraith's two-way classification of forecasters: those who don't know and those who don't know they don't know. Equally appropriate is the aphorism 'Give them the rates or give them the dates but don't give them both'.

Q: That's all very glib. Surely there is some science in economics upon which forecasts can be based. Are there no scientific laws in economics?

A: The concept of a scientific law that is valid for simple phenomena - a definite rule which links two events as cause and effect - is rarely applicable to complex phenomena.

Q: Aren't statistical methods relevant here?

A: No. Only simple phenomena permit any meaningful analysis of categories of data obtained under identical circumstances. Such conditions rarely apply to economics. Although it may be possible to indicate general patterns of behaviour, detailed forecasts remain elusive.

Q: But if you *had* to make an economic forecast, how would you attempt to do so?

A: All scientific forecasts are based upon theory. If the theory is relevant, actual (past) states of the economy would be expected to accord with expectations derived from scientific theory.

Q: But that is history.

A: Most certainly it is; but scientific forecasts rely upon the extrapolation of those relationships into the future with the hope that there would be no unexpected surprises.

Q: Please ... in a nut shell: how would *you* attempt to make an economic forecast?

A: Using theory, I would attempt to identify some meaningful trend which has been relevant in the recent past and then extrapolate its path into the near future.

Q: What did you mean by 'hope that there would be no unexpected surprises'?

A: Theoretical models focus upon relationships between variables which are systematic. Theoretical models make no attempt to incorporate singular surprises, mistakes and readjustments. So, in order to compare actual events with their theoretical counterparts, it is necessary to suppress all the surprises, mistakes and readjustments. In respect of complex economic phenomena, these features are always relevant. So, important details will always be neglected.

Q: Give me a good example of a notable forecasting failure.

A: It would be hard to find one to beat that from the American economist Irving Fisher. On the 15th October 1929, Fisher said that he expected 'to see the stock market a good deal higher than it is to-day within a few months'. Nine days later, share prices tumbled on Wall Street and the Great Depression ensued.

Q: That's the worst?

A: To be fair to Fisher, it is probably matched by the British economist, Lord Keynes. On the 25th October of that same year he commented 'There will be no serious direct consequences in London resulting from the Wall Street slump'

Q: But it was, in fact, the onset of the Great Depression.

A: Indeed it was.

Q: Why do economists bother to make forecasts?

A: Few economists become rich through acting upon the basis of their forecasts, but many earn high salaries from their selling them.

Q: Why should anyone buy them?

A: Why indeed. Comments by former Chancellors of the Exchequer suggest that this is not money not well spent.

Q: What have they said?

A: Denis Healy cited inaccurate borrowing and international payments forecasts which sent him cap in hand to the IMF in 1976. He expressed the view 'that most of the theories on which economics is based are bunkum.'

Q: Who else?

A: Nigel Lawson complained that his economic advisers failed to anticipate the 'change in behaviour by both borrowers and lenders' after the abolition of foreign exchange controls in 1979 and, again, after the collapse of the building society cartel in 1983. Competition among lenders resulted in an unexpected increase in personal debt from around 50% to over 100% of annual income. This unexpected change in behaviour flummoxed all the forecasters.

Q: Have government forecasts always been poor?

A: Since their inception in 1968, Treasury growth forecasts have been wrong by 1% on average against a base figure of 2.5%.

Q: Do Chancellors really need accurate economic forecasts of the economy?

A: A Chancellor of the Exchequer must ensure a sustainable relationship between state revenues and state expenditures, large proportions of which are determined by the performance the economy.

Q: Examples please.

A: Tax revenue rises and falls with economic activity, while social expenditure (on unemployment benefits, *etc.*) tends to rise and falls counter-cyclically. So some attempt must be made to estimate trends for the year ahead, in order that government departments can have some basis upon which to formulate their policies.

Q: Is there nothing which can be done to improve government forecasts?

A: In respect of attempts to anticipate economic trends, 'scientific' models based upon macroeconomic theory perform no better than purely statistical extrapolations of time-series data. The latter make no pretence at providing any insight into economic relationships.

Q: Economics and economists are simply irrelevant?

A: That is the implication.

Q: And the statisticians have taken over?

A: They are taking over.

Q: And the forecasts will improve?

A: Most unlikely.

Q: So where does this leave economic forecasts?

A: In the realm of fantasy. Our knowledge changes with each moment of time. Our knowledge shapes our action and our action determines the outcome of events. It is, therefore, hazardous in the extreme to attempt to predict any future state of this world.

Q: Can we stop there?

A: Perhaps we should.