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Forecasts without a future

It is still uncertain how long the current economic crises will continue and what consequences are still to come. However one thing is definite: no research institute in Germany anticipated to what extent the worldwide economic crisis would strike. The early warning signals failed, yet the warning of a financial crisis was there. Although the German expert advisory board for economics already signalled the housing bubble in the USA in their annual report in 2006/2007, the alarm signals were not taken seriously by economists.

Pretty much everyone turned a blind eye to the crisis and now the prognosis is in freefall. This is nothing new. In 1975 local research institutes didn't anticipate the oil crisis in the same way that they didn't predict the breakdown of the Eastern Block in the 1980s. Even German reunification was a political factor whilst economic researchers were still discussing the ifs and the buts.

The herding behaviour of forecasters

If you follow the fortune tellers over the past few years, it will become clear that economic researchers did not only fail to see the indicators for the economic crisis but they also did not correctly recognise the upturn after 2005. GDP growth for a particular year was not known until the end of the prognosis horizon. This can be clearly seen in the following chart. Earlier investigations regarding the accuracy of economic forecasts are repeating themselves: the correlation of different prognoses is visibly higher than the correlation of the actual development [1]. When it comes to uncertainties about the future, research institutes and public institutes take their orientation from the evaluation of others. The actual developments elude the forecasts.

If everyone is wrong with their prognoses on a regular basis then this is a clear alarm signal that the forecasting methodologies are not delivering what they should. This is also true for econometric based models as well as analytical jigsaw puzzles concerning statistics, history and theory which are applied by both the German expert advisory board for economics and the German association for economic institutes. We need to ask ourselves what the reasons for these inaccurate forecasts are.

The tunnel view of macro-economics

Generally all forecasters use the same datasets delivered by national account statistics in form of output, foreign trade, employment, prices, etc. This is all up-to-date data which describes the volume of demand aggregates and input factors or deliver the average values. They are suitable for quantitative descriptions but not for economic analysis. The reason for this is that they do not mention anything about the reasons of change. There is nothing about the strategies of individual actors, their behavioural patterns or their goals. These gaps are usually covered up with theoretical assumptions. Macro-economists make their life easy with just one principal agent who, as a rule, makes rational decisions.

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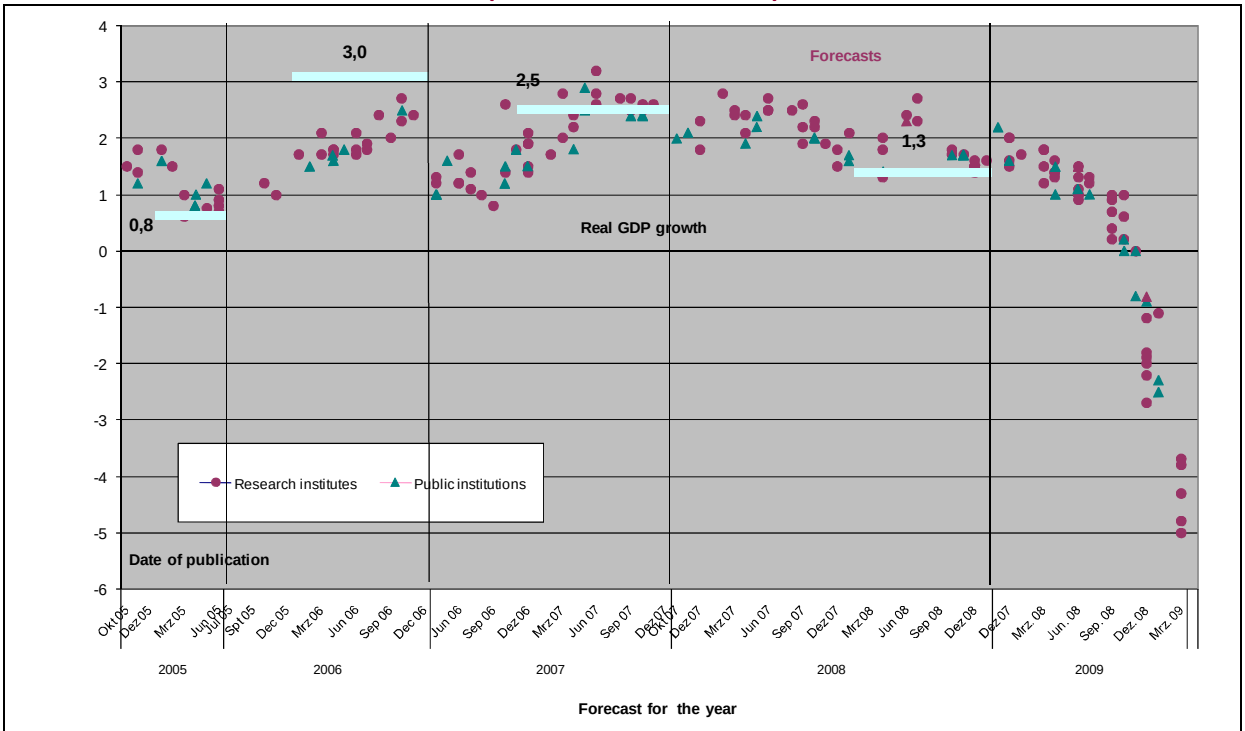
1 z.B. Charles C. Roberts, *Konjunkturprognosen und Wirtschaftspolitik: Eine kritische Betrachtung,* Köln: Bund-Verlag, 1981.

Economic forecasts for 2005 to 2009 (Growth of actual GDP)



Explanation: The graph shows the economic forecast for the actual German gross domestic product and how it has changed in comparison to the previous year. The values are ordered according to the time of the forecasts and the year that the forecasts refers to. Among the research institutes are the expert advisory board for economics, the association of economic institutes and the partly public research institute. The forecasts for banks are not listed. Public institutes constitute the German government, the European Commission, the OECD, IMF and others.

Source: Institute for the Employment, Economix.

However micro-economic funding would be necessary for the macro-economy. As knowledge shows that the market is heterogeneous, the questions that need to be asked are how the actors and their individual groups act overall, how they influence each other, and how the overall results come about in this process of action and counteraction.

With a limited spectrum of truth in the macro-economy it is almost impossible to get early signals of change. Forecasters failed to see the restructuring of companies, which considerably improved the competitive advantage after 2005, as well as the behavioural changes among employees. The long lasting unemployment in turn led to employees taking on unfavourable employment and being forced to accept a reduced wage even before the Hartz reforms were put into place. If the forecasters had heard the quiet sounds coming from the other side of the macro-noise then they would have made some interesting discoveries!

On the other hand, tautological productivity numbers still do not reveal anything about the causes of increased efficiency or capital stock, about how production is organised, the employment figures or the quality of work. On top of everything, these endless attempts to show detect the “real” structures behind the monetary flows are actually covering up economic correlations rather than revealing them.

Turning your back on the future – econometrics

Economic forecasts often back themselves up with econometric models, mathematical portrayals of economic occurrences. Essentially their records are the national account statistics. Additionally, they need the support of long time series in order to produce safe estimations, time

series which describe the past, not the future. Even worse is that they describe a past which possibly attracts less and less of our interests. Each phase has a specific historical characteristic which can barely be disposed of with econometric tricks.

The parameters of the econometric model can only be used for the future on the assumption that the model structure will not change. However, who wants to know that? Thus the chances of using econometrics as a way of forecasting future crises remain relatively small. Econometrics should limit itself to what it is good at – making consistent estimates of complex correlations and providing statistical backup from theories.

Rationality of economic theory – half the truth

Economic theory is a based on rational decision. Everything comes from a few logical assumptions on the behaviour of economic actors – it is abstract and generalised. The meaningfulness is thus far removed from real life.

The point is that there is not only one single rationality but rather several different value systems where economic behaviour is deemed 'rational'. In reality there are many 'rational' actors who find themselves in a social and political environment which influences their decisions. Moreover, the actors are not homogeneous. They build up interest groups which strive for dominance and power so that they can then impose their 'rationality' on others.

Economic theory says nothing about the value system of a community. It can generate consumer decisions without knowing the use of a product. It talks about work and capital without being able to specify their qualities. It analyses markets without knowing the psyche of the consumers. It had no category for the greed for money which ruined the financial markets.

If economics does not want to suffocate itself then it needs to open itself to other disciplines; sociology, psychology and political sciences. The theoretical approaches need to be fundamentally reformed and new methods need to be developed – just like Akerlof and Schiller do in their most recent book 'Animal Spirits'. Only then will we be able to see a different quality of economic forecasts.

What has to be done?

Step 1: a new modesty

After everything that has happened over last few months, every forecaster should make themselves a big sign that says "I don't know the future!" and hang it above their desks. That alone is a safe and true statement. They need to make themselves aware that alongside every "if…then…" statement a "but if that doesn't happen…" statement also exists.

Instead of pointed forecasts, alternative scenarios need to be developed which think ahead in terms of how the world or the country or the region could develop if other alternative conditions were to arise. This prevents all expectations moving in one direction and enforces consciousness that the future is open to change. In this way we can create conditions for wide political debates and competitive ideas.

Step 2: Opening up economic sciences

Economic science is to do with people and societies, both of which are complex and contradictory.

If economic prophets had been informed of the political changes in Arabic countries in 1975 or had observed the breakdown of the Eastern Block in the 1980s or had even paid more attention to the historical approach of Nouriel Roubini, then they would have noticed the dangers of an economic crisis much earlier.

It is not possible to develop economics in a sterile room. Models constructed in such an environment barely survive. They need to open up to the social reality which is determined by moral concepts, power and conflict. In this environment, rational arguments which seek emotional greed are frequently justified. Therefore, economic science needs input from psychology, sociology and political sciences.

Economics concerns people and not machines.

Step 3: Micro funding of the macro economy

If you want to know how the whole economy develops then you have to know what happens at the micro level. A number of precise observation instruments are needed – more instruments than we possess today. Individual markets need to be observed and analysed with regard to imbalances and undesired developments. Reactions from the market participants need to be measured and their flexibility evaluated. Company surveys from official statistics, the Socio-economic Panel of the DIW, the IAB-Company Panel, the IAB-Job Vacancy Survey and the Ifo-Business Cycle Survey need to be used more intensively in order to be able to put together a picture of the micro world. Generally equilibrium models need to be developed so that the micro world can be combined with the macro world.

Step 4: Simulation instead of determination

Models which simulate various behavioural regimes are necessary so that we can think in alternative ways. It depends on illustrating the dependency of the behavioural parameters instead of the input and output: how does the aggregate saving ratio change with increasing unemployment, how does wage elasticity increase when the labour market cools off? These dynamic games which arise from the behavioural parameters of a whole economy are the focus of interest because alternative pictures of the future can only come about with this knowledge.

Step 5: A new start

The current worldwide crisis reveals the weakness of mainstream economics and cries for a new way of thinking about the future – a way of thinking which handles the future as an option and not simply as fate. This requires even more modesty from futurologists.

It is vital that economic forecasts are regularly evaluated. It is not only about accuracy but also about the independence and the economic proof in the arguments.

The complexity of the economy needs to find itself in thought again. Economic research needs to rework the foundations because isolated economical rationality creates phantom worlds. Belief in rationality nourishes trust in the self regulating power of the market – a misconception as the financial crisis has shown. Thus the prevailing economy remains fairly unproductive when it comes to political advice. Unless they make fundamental changes, they are paving their way for their own downfall.

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