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Grave new world

Economist Insights

Do economists have a natural propensity towards optimism? If we look at the weight of forecasts published by the economists of the IMF, one might think so, given their unwaveringly optimistic, but erroneous, view of growth prospects in the years since the financial crisis. A view which, it must be said, the market has shared. But what does this misplaced optimism actually point to?

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A famous song by the comedy group Monty Python advocates that one should "always look on the bright side of life". You might think that nobody could be more different from Monty Python than the serious-minded economists at the International Monetary Fund (IMF). Yet over the years those economists have proven that they do have a tendency to look on the bright side of life, at least when it comes to their forecasts.

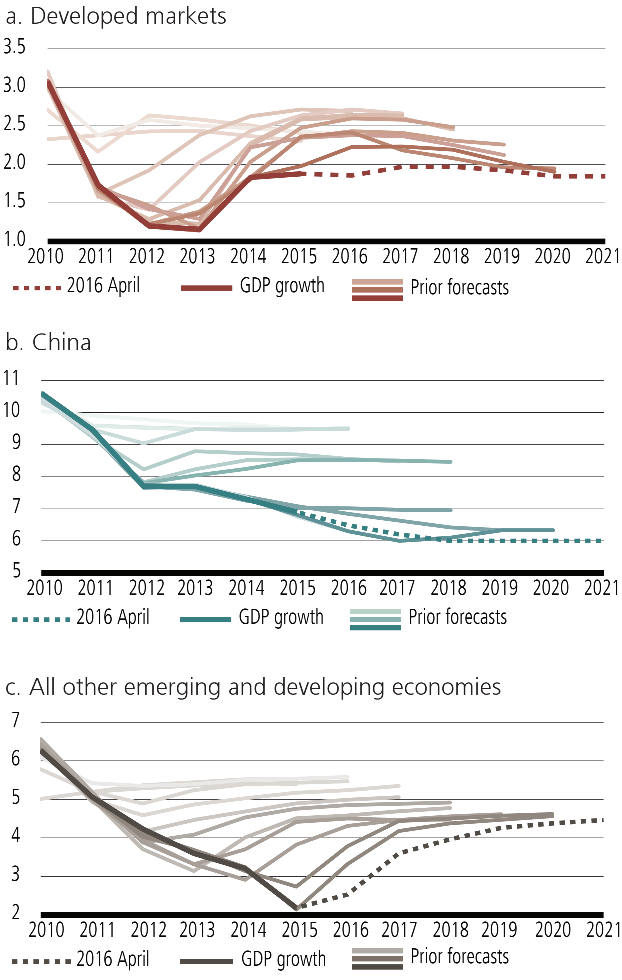
The IMF publishes two main forecasts each year, one in spring (April) and one in autumn (September). This is one of the most exhaustive forecasting exercises anywhere – no surprise given that there are 189 member countries that must be forecast and the IMF employs over two thousand economists. But one thing is consistent: ever since the financial crisis, the IMF has been too optimistic about growth prospects in these forecasts.

Following the recession there was an expectation that growth would move back to something like the pre-crisis trend in developed markets (chart 1a). After a couple of years, and the onset of the Eurozone crisis, there was a realisation that growth would slow down. Nonetheless, the IMF anticipated that eventually growth would bounce back to something at least close to the pre-financial crisis trend. The expectation of a recovery in 2014 was correct, but expectation of the trend fell.

The problem was not confined to developed markets. The IMF always expected that China would continue at the most recent rate of growth. But that rate of growth has continued to slow, and now the IMF is actually out right pessimistic, forecasting a further slowing from here. And it is not just China, other emerging and developing markets saw a slowing each year since the financial crisis, but every forecast from the IMF included a reacceleration within a year or two (chart 2b-c). Yet still we are waiting for that rebound to happen.

Chart 1: Slow learner

Vintages of forecasts by the IMF for real GDP growth, YoY %



Source: IMF. Note: IMF forecasts are made in April and September of each year.

The IMF is not alone in their optimism bias. The market consensus moved very similarly (it is usually quite close to the IMF view in aggregate). Part of this similarity lies in the nature of economic models used by economists: economic forecasts tend to converge on a long-run trend. Sometimes convergence happens quickly, sometimes it happens slowly, but widely followed economic forecasts always converge. If they did not, the economic models can get sent off onto exploding tangents (either up or down). Convergence itself is not the problem; the problem may be the level growth converges to or the speed at which growth converges.

The difference between these two explanations really represents two of the competing views on how the world has changed since the financial crisis. On one hand you have those who believe in secular stagnation, who argue that trend growth is now going to be much lower in perpetuity. For them the models are failing because the trend growth estimates are too high.

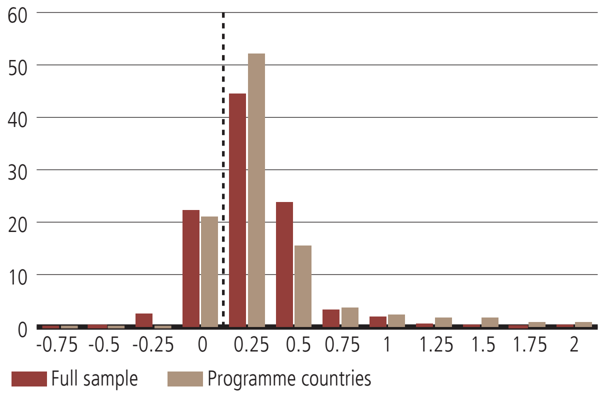
Then there are those who focus on this being a financial crisis-driven recession and hence it is taking longer for the economy to revert to trend (a balance sheet recession, or a debt super-cycle). Alternatively, the view could also be expressed that trend growth will be lower for a number of years because of the financial crisis, although this makes little difference for how growth would look (what it would suggest is that inflation should come back sooner).

Could there be another reason that the IMF is more optimistic? A cynical observer might argue that the IMF will be more optimistic about countries which they are lending money to. The IMF is not allowed to lend money to countries that are not forecast to be able to regain market access (i.e., they can fund themselves by borrowing from the market). The stronger a country's growth is, the more likely that it would be able to achieve market access. So there might arguably be some political pressure to provide a more optimistic forecast. And in particular, when the IMF is already involved in a country, they may not want to be forced out by a pessimistic forecast.

So is there any evidence of bias in the IMF's forecasts for countries that are in a lending programme? Well, they are biased towards optimism, but pretty much only to the same extent that all their forecasts are biased this way (chart 2). In our full sample, the IMF was overly optimistic in 75% of years for countries on a 2-5 year horizon since 2006. For programme countries, the result was 78%. This is too small to be statistically meaningful.

Chart 2: Unbiased in their bias

Distribution of GDP growth forecasting errors 2-5 years out, by IMF since September 2006, standard deviations of each underlying country's GDP growth (equally weighted)



Source: IMF, UBS Asset Management

Given that other economists have made the same mistakes, and given the IMF treats programme countries the same as other countries, the statistical bias in IMF forecasts appears to be more of an honest mistake. However, it does not bode well for the economics profession, given how persistent the optimism bias has been. It simply looks like economists have been backward looking and only slowly adapting to their new reality. But if this is simply an unusually slow recovery because we had a financial crisis, then this backward-looking approach will make economists wrong again in the future. If, on the other hand, we are entering a secular stagnation, then the forecasts will eventually prove right as growth converges on a new low level. Forget the bright side then; welcome to a grave new world.