Chief economist's comment

What can we forecast about next year?

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- Economic forecasts are not meant to be precise.
- Economic models use assumptions that may not be true. Models have ranges and margins of error. These are hard to make clear in a tweet of 280 characters.
- Economics is good at making relative judgments. Economics can identify cause and effect. Economics can prove economic fake news is fake. Economists are generally good at predicting policy.
- Next year the world economy should grow around trend. The Euro area and China should slow a little relative to this year. The economic cycle may be more muted overall. The risks are that inflation is a little higher, but not a lot higher. Central banks will likely keep normalizing policy.
- Investors should not get worked up about decimal points in economic forecasts for 2018. We believe the basic economic fact that investors need to know is that the world is doing OK.

Economists should not make forecasts.

December always has a rash of economic forecasts for the year ahead. The reception areas at CNBC and Bloomberg TV are crowded with mobs of economists fighting to get their forecasts on air. But there are big problems with making precise economic forecasts.

Economic models are not precise. Models use lots of assumptions. Those assumptions may not turn out to be true. Models give a range of possibilities rather than a single, certain number. Economists know and understand these issues. However, the world of hashtag economics does not allow for all of this to be explained. It is difficult to warn about possibility ranges and underlying assumptions in 280 characters. This is why economists should not use Twitter (follow me @PDonovan_Econ). Economic views often give a false sense of precision, because the reporting of economics is simplified and shortened. That precision simply is not there, in our view.

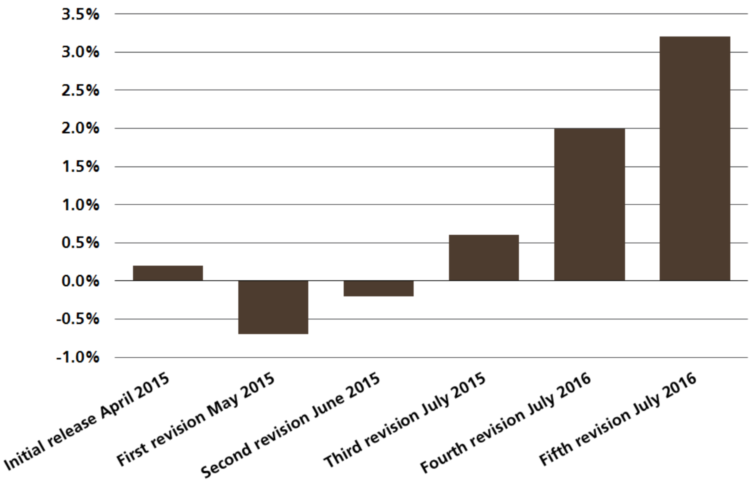
The illusion of precision is not helped by other media. A dramatic headline "Growth forecast to fall below 1%" attracts more readers or viewers. "Growth will be a bit below trend, probably" is far less dramatic. The dramatic urges of financial media appear to be part of the problem.

Economists know that the real world is messy. The relationship between policy and the economy is always changing. The ways different parts of an economy behave are always changing.

This means that past experience can never be a precise guide to the future.

A further problem is that economic data is not very precise. Economists are trying to hit a target that is moving rapidly. Economic data is being revised more often, and the revisions are larger than in the past. The following chart shows annualized US GDP growth in the first quarter of 2015.

How fast was the US growing at the start of 2015?
It depends when you ask the question – annualized growth, reported at different times



Source: United States Bureau of Economic Analysis

Growth was initially reported very weak, below consensus and barely moving. Then the data was revised to show the US economy was shrinking – and shrinking a lot (the number was –0.7% annualized). Then it was revised to show the economy was shrinking a bit. Then it was revised to show the economy was growing, but a long way below trend growth.

The growth number was then revised to be basically in line with trend growth. Now, US growth at the start of 2015 is thought to be 3.2%.

So which number in the range of –0.7% to 3.2% is the economist supposed to be forecasting? An economist predicting 3.2% growth when the data was first released would have been ridiculed. According to the latest information we have, that economist would have been right.

Economic models produce imprecise forecasts for numbers that are revised significantly. So what can economics do?

- Economics is about relative relationships. In the real world, we believe the difference between 1.5% growth and 1.8% growth is not that much. What matters is how an economy is doing in a relative sense. What is growth relative to its trend rate? Is growth accelerating or decelerating? How an economy is performing relative to other economies?
- Economic models can also be used to compare policies. Economics can help to identify where the effects of a policy will be felt. Economics can show that ending NAFTA will raise prices paid by low-income Americans, for instance.
- Economics can identify cause and effect. Economics can show that US-Chinese trade has created about the same number of new US jobs as it has destroyed. Economics can show that there is still a

bias against women when it comes to pay. Economics can show that income inequality has risen in China.

- Economics can generally predict central bank policy. This is hardly surprising. Central banks – at least, the good central banks – are run by economists.

So ignoring the numbers, what is the 2018 story that economists should be telling?

- The world is in a mid-cycle growth position. Globally, growth should be around trend. There is very little chance of a significant global downturn in 2018 (there are no signs of the triggers of a downturn, like policy error or overheating, today).
- China and Europe are likely to be a little slower in 2018 than they were in 2017. China is likely to limit credit creation, contributing to slower growth. Consumer spending should underpin both US and Euro area growth.
- The ups and downs of the economic cycle may be less violent than they used to be. Recessions are probably less recessionary in the future (see the July Chief Economists comment "Will recessions be less recessionary in the future").
- Inflation is likely to be a little higher in 2018, in most economies. Cost pressures from labor markets should push prices a little higher, although technical adjustments are limiting some inflation measures.
- Central banks are likely to continue to slowly normalize their policies. The US Federal Reserve and the European Central Bank have been very clear about their plans. The Bank of Japan is likely to be relatively slow in tightening policy.

Don't worry about the precise economic numbers predicted for 2018. We believe investors just need to know that the world is doing OK. Inflation may rise a little. Central banks will likely slowly tighten policy. Economics is exciting enough; there is no need to get dramatic about decimal points.

Appendix

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