



## The trouble with economic forecasting

As Finance Minister Jim Flaherty's March 4 budget nears, it's worth noting that projections often miss the mark, sometimes wildly

OTTAWA — From Tuesday's Globe and Mail Published on Tuesday, Feb. 23, 2010 Jeremy Torobin

In late November, 2008, as global policy makers were crafting expensive bailouts and the U.S. economy looked to be in a death spiral, Finance Minister Jim Flaherty projected a budget surplus for the next fiscal year and the absence of a recession in Canada.

Three weeks later, on Dec. 17, Mr. Flaherty acknowledged his initial take was dead wrong. He said the economy would contract and that federal government would run its first budget deficit in 12 years. About six weeks after that, he was pencilling in \$64-billion in deficits over two years.

The episode illustrates the maddeningly inexact science of economic forecasting, especially in volatile times. Predictions can diverge wildly, depending on what assumptions economists use, how much weight they give to each factor and, in the case of government number-crunching, whether political concerns get in the way.

That's worth remembering as Mr. Flaherty's March 4 budget approaches.

Some leading economists and watchdogs, such as Parliamentary Budget Officer Kevin Page insist that Canada will carry a permanent, or "structural," deficit of about \$19-billion even after stimulus spending fades and economic growth picks up. That stands in contrast to the Harper government's position that it can balance the books within a few years without raising taxes.

Since economists use different models, some pay too much or too little attention to things like the potential for economic and fiscal shocks - for example, the plunge in global energy prices early last year and the resulting negative impact on Canadian corporate profits and government revenues.

As a result, their models may yield a distorted outlook for the economy, for spending and, consequently, for the tax revenue required to help steer Ottawa back into the black.

Mr. Flaherty was far from alone in missing the mark during his early stages of planning last year's budget. When a group of private sector economists presented their forecasts to the minister in late 2008, many were, in hindsight, "dramatically" more optimistic than they should have been, Toronto-Dominion Bank chief economist Don Drummond said.

"There was just such a huge range of views," he said. "The irony is that while I was at the bottom of the pile, I still wasn't weak enough." For Mr. Drummond, himself a former senior Finance Canada official, the

discrepancies were a reminder that sometimes the most reliable data comes from within the department, so ministers should be wary about relying too heavily on private sector data.

"The very first thing that [Liberal Finance Minister Paul] Martin did in 1993 was he ordered an independent review of the forecasts that had been used for budgets in the prior 20 years," Mr. Drummond said. "The most accurate forecast over a 10-year period and over a 20-year period had been the Department of Finance forecast. Whether they had been manipulated by politicians or not, they were more accurate than any other forecaster."

Well, that was then.

Ralph Goodale's October, 2004, fiscal update said the government's budget surplus for 2003-2004 had unexpectedly swelled to \$9.1-billion from a projected \$1.9-billion. The next year, former Bank of Montreal chief economist Tim O'Neill, who had been hired by the Liberals to probe Ottawa's fiscal forecasting, concluded that a rigid no-deficit policy had made bureaucrats "overly cautious" and contributed to a series of "upside surplus surprises" starting in 1997-98.

Even the Bank of Canada, armed with hundreds of economists and free from political considerations, has had some notable misses. As late as July of 2008, for instance, central bank Governor Mark Carney was saying growth would pick up through the rest of that year, and quicken in 2009 as well as into 2010.

In reality, the economy shrank 2.5 per cent last year.

And while Mr. Carney's January, 2009, prediction of a 3.8-per cent expansion for 2010 no longer looks outlandish, at the time it was almost double the median of private forecasters.

None of this is to say that forecasts are useless - just that they are merely approximations, snapshots, or best guesses.

"People are too hard on forecasting, because they don't realize that they're not giving one number set in concrete. What they're producing is the middle of a range," Stephen Gordon, an economist at Laval University who does some forecasting for his blog, said in an interview. "Nobody knows these things for sure."

Because economic forecasting involves "a whole sequence of conditional probabilities," he said, errors can pile up rapidly - like dominoes. Canadians should keep in mind the practice is like predicting the weather, Prof. Gordon said.

"The future is inherently unpredictable," he said. "Even if you have the perfect model, you're still going to get things wrong."

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## A MADDENINGLY INEXACT PRACTICE

Economic forecasts have been front-page news since the global downturn began in the fall of 2008. But how reliable are they? Here's a look at three recent misses:

### **JIM FLAHERTY'S 2008 FALL FISCAL UPDATE**

After Jim Flaherty consulted with private sector economists to assess the economic outlook, the Finance Minister projected a tiny surplus for the next fiscal year. Three weeks later, he reversed himself, saying the economy would shrink after all and the country would run its first budget deficit in 12 years. Toronto-Dominion

Bank chief economist Don Drummond, one of those who had met with Mr. Flaherty, said the "huge range of views" in the forecasts yielded averages that were out of step with reality.

## **MARK CARNEY'S**

### **JULY, 2008, QUARTERLY OUTLOOK**

The Bank of Canada is regarded by some economists as the most reliable forecaster because it has hundreds of analysts using sophisticated modelling and is insulated from political considerations. But that doesn't mean it's infallible, especially when conditions are changing as rapidly as they were in 2008. That July, central bank chief Mark Carney said economic growth would pick up through the rest of the year, quickening in 2009 and into 2010. Instead, the economy was in recession by the end of 2008; it shrank 2.5 per cent last year.

## **RALPH GOODALE'S**

### **2003-2004 \$9.1-BILLION WINDFALL**

Then-finance minister Ralph Goodale sent jaws dropping when he reported in his 2004 fiscal update that the Liberal government's projected \$1.9-billion budget surplus for 2003-2004 had ballooned to \$9.1-billion. A few weeks earlier, the Liberals had commissioned a study of government forecasting to try to get to the bottom of a series of windfall shockers. The report found that pressure to balance budgets had made bureaucrats "overly cautious," leading to conservative forecasts - and massive surpluses.