

The Washington Times

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A Talent for Missing the Trends

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Published March 18, 2009



Did you notice that the major economic forecasters, both private and government, totally missed the global credit crisis and size of the recession?

The mainstream consensus economic forecasts made in December 2007 for the year 2008 for the United States, Europe and Japan predicted roughly twice as much growth as actually occurred. You may recall that a year ago, when oil prices were racing toward \$147 per barrel, the high-paid wizards at Goldman Sachs were projecting it to go over \$200 per barrel - it is now \$40-something a barrel. A few economists claim to have forecast this great recession, but most have been pessimists for years, and predicting nine out of the last three recessions is not really an example of forecasting brilliance.

The foreign policy/political forecasts were even worse. A year ago, as the presidential nominees of both parties were being selected, the widely held belief was that the great issue would be Iraq. The Democratic establishment believed Senate Majority Leader Harry Reid's words, "the war is lost."

Because of that belief, the Democrats selected their most antiwar candidate, Barack Obama. The Republicans nominated John McCain, who was the champion of winning the war, in part, through the "surge," which indeed did work.

Each candidate had essentially sewed up his respective party nominations before the extent of the economic problems became clear. In retrospect, it is unlikely Mr. Obama and Mr. McCain would have become the nominees given what we know now about the economic situation. Each party had other candidates with stronger economic credentials who would have been more credible.

In the mid-1990s, when the fear of global warming was first becoming fashionable, the global warming theorists said we had only 10 years to make fundamental changes with carbon dioxide (CO₂) emissions or the planet was doomed (i.e. the "hockey stick" thesis).

Well, it has now been more than 10 years. and the planet has actually been getting cooler over the last decade, which was not forecast by a single major climate model (oh, well). Also the polar ice cap has not disappeared, and the polar bear population is getting bigger, not smaller! It seems those who claim the variable output of the sun (sun spot theorists) has more effect on Earth temperature than CO₂ might just be right.

A major reason the global warming misinformation is still so hyped is that government subsidizes many producers of noneconomic alternative energy sources and many scientists with an economic interest in repeating the claim. Those in the political class love the idea of a climate crisis because it gives them more power and money to "do something about it."

Getting it all wrong is not new. In 1900, Europe was enjoying unprecedented peace and prosperity. The European countries, and particularly Britain, had their global empires and great military powers. There was the widespread belief that major wars were a thing of the past and European civilization would dominate the globe forever. Twenty years later, in 1920, much of Europe lay in ruins in the wake of the World War I (a war about nothing), but there was certainty that Germany was being sufficiently constrained so as to never be a threat again. Yet, only another 20 years later, in 1940, the "German Thousand Year Reich" controlled most of Europe.

In 1980, much of the United States and European foreign policy establishment believed it was only a matter of time before the communists would win the Cold War. Fortunately, Ronald Reagan and Margaret Thatcher had a different idea, and the Soviet Union collapsed a decade later to the great surprise of much of the global establishment.

The failure to forecast the current "crisis" appears to, in part, stem from the fact that few fully understood how much risk there was in the entire global financial system. There were too many mathematicians posing as financial experts and economists who did not have enough knowledge of economic history or long enough historical periods with sufficient data to measure risk as precisely as they claimed. As a result, they underestimated systemic risks.

In addition, too few - among both investors and forecasters - understood that when the rating agencies, like Moody's, were rating packages of mortgage-backed securities, they were not ranking the individual components of the package, which turned out to cause a great understatement of the risk. Few politicians understood, or wanted to understand, that the pressure they put on the banks to lend to the unqualified was putting the whole system at risk, and many of the forecasters did not fully appreciate how much the banks had lowered their lending standards.

Economic forecasts are necessary for businesses and governments to plan and operate. Insurance companies could not exist without the science of probability and risk analysis and the existence of historical data banks. Because these organizations do have the necessary forecasting skills and data banks, they are able to offer homeowners', auto and life insurance and price them properly.

Micro forecasts, where the variables are few, well-known and the data extensive, can be quite precise, fortunately, for the insurance industry. Macro forecasts, where the variables are many and often not well-understood, such as those used in climate, political and global economic models, can be wildly inaccurate and thus should be used only with great caution - and modesty.

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