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Economic Forecasting: What's the Value of Outliers?

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by Roger Martin | Comments (3)

As we wallow through slow, difficult recovery from the worst economic downturn since the Great Depression, it is instructive to go back to the first half of 2008 to see that essentially no prominent macroeconomist or important economic forecasting organization predicted that the economy would shrink in 2008 (or 2009), let alone that it would crater as badly as it has. The United States Federal Reserve Board was calling for overall growth in the US economy as late as May 2008 in its official consensus forecast. The same held for the 52 leading economists routinely surveyed by the Blue Chip Economic Indicators. The same held across the pond for the Confederation of British Industry. The list goes on and on.

This is not what intrigues or bothers me. The future is notoriously hard to predict and mistakes get made. It is really easy for every macroeconomist out there to listen to the rest of his (mainly) brethren and conform to the consensus view. I am not even bothered by the fact that numerous, if not most, macroeconomists now argue that they actually did see the downturn coming and can point to something that they said before September 2008 as demonstrating that notwithstanding their very own forecast otherwise, they knew the economy was heading toward a cliff.

I am perturbed and perplexed by something else and I was only able to put my finger on it a couple of months ago, at a fancy economic policy dinner featuring a very prominent US macroeconomist as the speaker. I go to these things because, yes, I am an economist by training, and, I confess, am a bit of a policy wonk. The macroeconomist was quite confident as he spoke about exactly what had caused the downturn and even more confident about the path the economy was going to take out of the recession. He spewed out all the terms we have come to know and love — aggregate demand this, housing starts that, fiscal stimulus this, savings rate that, blah, blah, blah.

Then it struck me. This macroeconomist, like pretty much all the rest, was confidently predicting how the US economy was going to recover from its severe 2008 real economic decline using precisely the same mindset, models and tools that he used to predict, pre-crash, that the US economy would grow in 2008. Nothing had changed.

So during the Q&A after his talk, I raised my hand and asked: "Why is it that you seem to be using exactly the same toolkit to forecast the course of the recovery that you had used to get the forecast of the severe downturn so wrong?" I got pretty much the answer that I expected. He refused to consider the premise of the question and pointed to an August 2008 speech that he had made in which he predicted a coming recession. Who knows if he actually said that in his speech or not but predicting a recession one month before its official (and spectacular) start doesn't qualify, to me, as a useful forecast. It is actually less of a forecast and more of a now-cast.

But I got my answer and it is the answer by which I am perplexed. From what I can tell, the world's macroeconomists have engaged in just about zero reflection on the flaws in their own models that caused them to be so terribly wrong in 2008. In essence, they are saying: "Our models are just fine. The 2008 economic crash was a random, outlier event that will happen regardless of how good our models are. It is not a commentary on the quality of our models, but on the variability of life on the planet."

Maybe; but I am afraid that I am not convinced. It seems to me that given how terribly, terribly wrong they were, the macroeconomists would be wise to revisit their mindsets, models and tools and ask: "What did we learn from the 'outlier' event. Maybe it wasn't actually an outlier. Maybe it could have taught us something important about the things to which we are now blind but which are actually critically important."

Important answers often lay hidden in these data. In this month's Harvard Business Review, I have a short interview with Dr. Steven Scherer, one of the world's leading autism researchers whose breakthroughs have come from looking at the non-conforming data that the mainstream of his field throws away. Says Scherer: "I call it the garbage-can approach. My belief is that answers to really difficult problems can often be found in the data points that don't seem to fit existing frameworks. To me, those little variations are like signposts saying 'Don't ignore me!'"

From what I can tell, the world's macroeconomists have ignored the signpost provided by 2008, which begs the question: Why are we still paying attention to their forecasts?

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