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Why it matters if the public has lost faith in government economic forecasts post-Brexit

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As chancellor Philip Hammond and US President Donald Trump begin work on their respective budgets, speculation is rife about changes to spending plans and taxes.

Will there be significant infrastructure investment? How fast will government spending be cut, if at all? Underpinning all these decisions lies a modelling assumption with arguably much more significance than any policy change: the potential growth rate of the economy.

This boring-sounding term tells us the government's expectation for how fast the economy is able to grow sustainably (i.e. without overheating). And it highlights well the challenges both countries face. The US Congressional Budget Office currently estimates the sustainable growth rate of the US will be just 1.8 per cent per year over the next 10 years. This compares to an average of 3.2 per cent since 1950. The UK's fall in potential growth is not quite so stark. Having been 2.2 per cent per year between 1970 and 2007, it is now forecast to be 1.9 per cent per year over the next five years. Both occur after meagre recoveries since 2008.

Why does this matter? Economic growth is a necessary condition for rising living standards. Estimating potential growth also tells us how sustainable the public finances are in the long term, and so how much spending needs to be cut to eliminate the so-called "structural deficit". But a new paper by Olivier Blanchard and Jean-Paul L'Huillier outlines a well-known potential other avenue for why this assumption is significant: downward or upward revisions to potential growth in the longer term can affect the economy today.

Consumers and investors anticipate the future. If they believe economic growth will be slower in the long term, they will expect lower lifetime incomes and tighten their belts now. In economics jargon, they are said to have forward-looking rational expectations. Blanchard and L'Huillier find evidence that downward revisions to potential growth are strongly related to changes in consumption, for example, such that a 0.1 per cent downward revision to future growth leads to a decrease in consumption growth during the year of 0.4 to 0.7 per cent.

This is what we'd expect if the forecasts were credible and consumers rational. But in reality, government revisions to productivity growth are highly uncertain. The key question then becomes: are today's projections likely to be accurate, or have governments actually worsened outcomes in the shorter term by mistakenly assuming so?

Blanchard and L'Huillier imply the latter, and hence that government's pessimistic revisions have spooked consumers. Yet if this thesis is correct then there is cause for cheer in the longer term. We'd expect, in such a scenario, that the economy will begin growing more quickly than anticipated, and over time the productive potential will be revised up and everything through to the public finance outlook will improve significantly.

The counter-argument is that consumers have adjusted precisely because the long-term outlook has really worsened. My Cato colleague Brink Lindsey outlined in 2013 why growth was getting harder, as trends suggest likely slowdowns in the growth of hours worked, improvements in workforce skills and capital deepening, as well as total factor productivity growth. Some of these things could improve, but there are good reasons to think we have picked all the low-hanging fruit and are entering a "new normal".

How does this relate to contemporary debates in the UK and US? Well, the Treasury's pre-referendum forecasts for why there would be a short-term recession following Brexit were heavily reliant on consumers believing that leaving the EU would harm long-term growth and their incomes. That it does not appear to have done so in the short term suggests that consumers do not believe Brexit will harm long-term growth to anywhere near the extent the economic consensus forecasted.

Time will tell whether this is the correct judgement, but for now it appears that downward revisions to potential growth in the future have not impacted the economy today adversely. This counters the idea that consumers take every government revision at face value.

In the US, meanwhile, Trump is reportedly ordering his economic forecasters to assume his policies will raise long-term growth back up to historic levels of between 3 and 3.5 per cent. This huge jump looks incredible, but if believed by enough consumers, then, as outlined by Blanchard, it could lead to a short-term boom too.

Economists have known for a long time that consumers react to expectations of what is going to happen in future. Raising potential output growth should also be a key aim of government policy. But government estimates of the future are highly uncertain and controversial, even if significant. We are getting good tests both sides of the Atlantic of whether the public believes their governments.

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