REPLY

On fiscal rules, gross domestic product forecasts and prediction of economic crises: a reply to ‘Macroeconomic equilibriums, crises and fiscal policy’ by Fredrik N.G. Andersson

Henrik Hansen, henrik.hansen@econ.ku.dk
University of Copenhagen, Denmark

Key words crises • forecasts • leading indicators • macroeconomics

To cite this article: Hansen, H. (2022) On fiscal rules, gross domestic product forecasts and prediction of economic crises: a reply to ‘Macroeconomic equilibriums, crises and fiscal policy’ by Fredrik N.G. Andersson, Global Discourse, 12(3-4): 689–691, DOI: 10.1332/204378921X16438984586967

This is a reply to Fredrik Anderson’s (2022) article, ‘Macroeconomic equilibriums, crises and fiscal policy’. In ‘Macroeconomic equilibriums, crises and fiscal policy’, Fredrik Anderson considers an aspect of the much-discussed problem of public debt targets in macroeconomic policy. The main message of the article is that ‘[T]he target for the debt ratio should be set low enough to allow the government to increase the public debt by 30 to 50 percentage points during a crisis without increasing the risk of a future fiscal crisis’; therefore, ‘The level of 60 per cent as the pre-crisis debt target is likely too high to avoid a fiscal crisis’ (Anderson, 2022).

Anderson argues that an important reason why public finances are often unprepared for a crisis is that macroeconomic models are ‘equilibrium models’, which neither predict nor expect crises in the near future. To illustrate the importance of the problem, Anderson shows that crises are frequent. Subsequently, he exemplifies how the equilibrium concept dominates economic thinking by analysing forecasts of gross domestic product (GDP) growth made by the Organisation for Economic Co-operation and Development (OECD) and the European Commission (EC). However, the seven conclusions from Anderson’s forecast analysis would all come out from forecasts based on the classical Box and Jenkins (1970) approach to univariate time-series models, which has nothing to do with economic equilibrium models.

To illustrate, assume that the OECD has a preference for pure autoregressions (AR) (say, AR[2]) while the EC prefers autoregressive moving average (ARMA) models (say, ARMA[1,1]). In this case: (1) there would be a strong correlation in the
one-step-ahead forecasts from the OECD and EC; (2) there would be stable forecasts over long periods; (3) there would be a constant long-run average, such that changes in mean growth are not picked up; (4) major crises would never be predicted; (5) the forecasts would be accurate when the economy is relatively stable in terms of a stable average growth rate, with only modest business-cycle fluctuations; (6) the predicted growth would move towards the average growth rate over time; and (7) the likelihood and the consequences of crises would be consistently underestimated by the forecasts.

Hence, Anderson’s forecast analysis mainly illustrates how the OECD and EC are informed by time-series models in their forecasts of the GDP growth rate. From an economist’s perspective, the troubling aspect of this exposé is that the growth forecasts may as well have been a purely statistical exercise, independent of any economic theory. Indeed, no equilibrium concepts from economics are utilised when predicting GDP growth using the Box–Jenkins approach.

In relation to economic crises, forecasting includes much more than short-run predictions of GDP growth. In fact, prediction of crises is a research area in and of itself with booms and busts following the emergence of crises. In a study of the 2008–09 financial crisis, Frankel and Saravelos (2012) select leading indicators for crisis prediction based on surveys of more than eighty research papers spanning the period from the late 1970s to 2012. Frankel and Saravelos (2012) use five different variables, in addition to GDP growth, to measure the incidence of crises, and they show that the level of international reserves is the strongest leading indicator of the crisis, followed by, among other things, credit growth and current account deficits, in accordance with results from previous literature. The research area is still very active, with Kiley (2021) focusing on leading indicators for financial crisis dating far back in time. Kiley finds a strong role for house and equity price increases in predicting financial crises. Hence, the list of potential leading indicators for crises is long and increasing, and economic thinking about crises have changed substantially over time to cover both single-equilibrium and multiple-equilibria models (see Schularick and Taylor, 2012).

This much broader approach to crisis prediction and management is also illustrated by the macroeconomic debates following the 2008–09 crisis. All major policy institutions published studies dealing with the future of macroeconomic policies and public debt targets. One example is the book edited by Blanchard et al (2016), which has a long section on fiscal policy in the future, with chapters by top policymakers and bureaucrats. Specifically, Victor Gaspar (former Minister of Finance and Minister of State in Portugal and Director of the Fiscal Affairs Department of the International Monetary Fund [IMF]) and Marco Buti (Director-General for Economic and Financial Affairs at the EC) discuss themes like ‘managing public finance risks’ and ‘rules-based fiscal policy’. Escolano (2010) from the IMF and Fall et al (2015) from the OECD also discuss fiscal sustainability and debt targets. None of the studies use equilibrium models, and none of the studies focus solely on public debt targets.

In essence, I think Anderson exaggerates the importance of ‘equilibrium models’ for practical macroeconomic policy. Both for the policy advice given by, say, the IMF, OECD and EC, and for the actual fiscal and debt policies of the individual countries. Furthermore, prudent monetary and fiscal policy involves much more than setting uniform debt targets. Variations in fiscal rules, current account balances
and financial market regulations affect the prudent level of government debt. Hence, debt targets must be country specific. Clearly, this does not preclude that a level of 60 per cent is too high for most, if not all, OECD countries, but it does call for case-by-case analyses.

Conflict of interest
The author declares that there is no conflict of interest.

References