Intelligence MEMOS

From: Glen Hodgson

To: Canadians Concerned about a Recession

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Re: **Why Are Recessions So Hard to Forecast?**

In a recent Intelligence Memo, I discussed the factors that could create the next recession in Canada. A Canadian recession is likely to be imported, not made at home, with the China-US trade dispute and other international factors at the top of the list of possible causes.

However, accurately predicting a recession is hard to do.

Some analysts are less reluctant to forecast recessions than are others. Indeed, some recession hawks have created a personal brand for themselves by frequently calling for the next recession, citing the imbalances, excesses and policy mis-steps of the day. On occasion, they are right, but their actual batting average is not great – recessions are predicted far more often than they occur.

There are a number of reasons why a recession, usually defined as two or more consecutive quarters of economic contraction, is hard to forecast.

Expansion is the economic norm, contraction the exception. Economic forecasters use methodologies and build their forecasting models based on sustained, measurable economic relationships and behaviours. At its core, demand for economic output is a combination of changes in consumption, investment, government spending, and net trade flows. Growth is the norm through most of the business cycle, particularly for economies with a growing population base, and forecasting models inherently reflect those growth trends. In potentially recessionary conditions, the models may indicate there will be a slowing in consumer or investment spending, but they often stop short of projecting an actual contraction in overall GDP.

Not all recessions are the same. There is no one cause of recession, making it harder to model and predict. Over the past 50 years, a variety of factors have caused recessions, including: sharp movement in commodity prices; restrictive monetary policy to address rampant inflation; asset bubbles and excessive debt burdens; and spillover effects from a recession in a dominant trade and investment partner. It's hard to determine in advance when these factors, alone or together, might reach a critical mass to create a recession.

Timing matters. It's not too difficult for analysts and commentators to identify the excesses of the day and the risk factors that might create the conditions for a contraction. It's much harder to forecast with precision when those conditions would result in an actual recession.

Leading indicators can provide incomplete messages. Indicators such as rising gold prices or an inverted yield curve, where long-term interest rates are below short-term rates, reflect heightened risk and recession concerns among investors. There is a fairly close correlation between an inverted yield curve and an eventual recession, but the leading indicators don't say much about the recession's timing, severity or likely duration.

Psychology and emotion play a central role. In addition to hard economic and financial variables that can be readily observed, consumer and business confidence, or what people believe is going to happen, can drive an economy toward recession. If consumers and investors believe a recession is imminent, confidence in the economy can drop, causing consumer and business spending to pull back. In essence, the loss of confidence can become a self-fulfilling prophecy. That's why measures to boost or rebuild confidence are often part of any policy package aimed at shoring up economic growth.

Policy intervention can change circumstances. Economic policy invariably influences economic forecasts. Policy intervention, good or bad, can have a material impact on the economy's performance and the potential for a recession. In the current circumstances, for example, pre-emptive cuts to interest rates may help to forestall a recession from emerging, or reduce its severity.

Forecasting a recession accurately is hard, and today's turbulent environment is not making the task any easier. A combination of trade protectionism, large-scale fiscal deficits, calls for a renewed monetary stimulus, plus political factors like Brexit, are all in play right now. This policy turbulence is complicating the best efforts of professional forecasters to produce a realistic outlook for the economy, globally and locally. That's why few people have made the bold leap of forecasting a recession – yet.

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