Uncertainty and economic projections

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Just as we can appreciate how seismologists are unable to predict the exact time and date of the next earthquake, nor that experts on epidemics can tell where the next outbreak of a new deadly virus will be, we economists are not in possession of a crystal ball by which we might foretell the economic future. While a wide array of phenomena can be forecast, the reality succumbs to economic decisions adopted by either individuals or groups under the influence of innumerable factors. No easy matter trying to predict how the economy is going to behave. Keynes would refer to animal spirits to describe the influence exerted by confidence or psychology on how consumers and enterprise make decisions. The recent Nobel laureate Nobel Richard H. Thaler has spent decades studying how minor anomalies or the coming together of a host of seemingly irrelevant factors prompt decisions that appear irrational or difficult to explain.

All of which is worth noting given how the political crisis in Catalonia, and its effects on recovery, has in recent weeks cast a shadow over the economic debate, specifically now that the world economy and Europe are growing in a robust, stable and very synchronized manner. Adding to the usual tribulations of building economic scenarios in a changing world is the fact that we stand before a situation without precedent, with efforts are being made to bring about a unilateral change to the existing legal framework of an autonomous community.

The usual manner of assessing the effects of changes to the economic environment consist in analysing what lessons may be drawn from similar episodes from the past and to extrapolate them to what is occurring in the present. For example, if the price of oil and the interest rates rise or if there is a notable hike in the exchange rate, it is possible to evaluate the consequences on inflation, GDP or employment by extrapolating to the future the estimated effects of similar changes when they occurred in the past. This can also be done to assess an increase in the economic uncertainty, for example, due to political instability. For this purpose we require an indicator that can adequately reflect changes in the uncertainty. Economic researchers have spent years working on this. The www.policyuncertainty.com website is one fine example of how things stand in this field today. Based on those indicators, all we have to do is to evaluate the intensity or lag in which in the past production, investment or employment have responded in the past to changes in uncertainty.

With the case at hand, devising the uncertainty indicator for Catalonia does not prove to be the most complicated task. This is what we have done at BBVA Research in applying “big data” techniques to databases monitoring news across all communications media. The indicator we get from this paints quite a picture. After the 9-N vote in 2014 no volatility of any kind was observed. The Spanish general elections in 2015 and 2016 or Brexit brought with them significant increases in related uncertainty. And those figures have been dwarfed by the increased in uncertainty in October of this year.

It is hardly difficult to anticipate that uncertainty will have a negative impact on consumer spending decisions and on the investment decisions made by companies. However, translating those effects into figures and predicting how they will develop is another matter. The impact will depend on how intense this uncertainty becomes, how it persists over time and how much it spreads to the rest of Spain. On the last point, we have proof how the activity of such a large economy as Catalonia influences other communities. Predicting intensity and duration here becomes more complicated, given how this is an unprecedented situation.

Taking as a given the current intensity of the uncertainty and supposing that it will gradually moderate over the coming months, as has happened in the past during other episodes, albeit owing to very different reasons, an estimate can be made of the effects. Left to the attentions of an automaton, it would extrapolate the effects of the increases in uncertainty on the GDP and employment to the case in hand. The lower range would be determined by those situations where increases in uncertainty had minimal consequences in the past. The upper range by the cases where those effects were maximal. In this way we find that the current increase in uncertainty could reduce growth in Spain in 2018 by between two and eleven tenths of a point. We economists introduce a bias to the estimate of those effects depending on the information that we come across.

For the time being, the financial conditions have not been seriously impacted. The risk premium is in fact below the levels prior to the vote on 10 October, also thanks to the extension to the ECB purchasing programme. A marginal recovery is seen in investment fund flows from abroad. While the Spanish stock market is displaying greater volatility, there is no accumulated differential behaviour of relevance in the European stock markets. The Social Security contribution figures for October show a surprising minor increase. The same has happened with company confidence. All of this evidence suggests we situate ourselves in the lower range of potential effects. Based on current information, we anticipate that the negative effect on Spanish growth in 2018 stands at around three-tenths. On top of the potential consequences of this lag, we ought to be prudent and avoid complacency, at least for two reasons.

Firstly, it is still early to know how events will unfold in Catalonia and what consequences they will ultimately produce. If is important that the situation returns to normal quickly and that political debate resumes its normal course as soon as possible with the elections on 21 December. There will be greater and more equitable progress, particularly in the long term, the better institutions can function, with legal certainty and the rule of law prevailing, with clear rules respected by all parties. Under such conditions, even in a situation of considerable political fragmentation after 21 December, this would have only minor economic effects. The uncertainty would only have a passing effect and Catalonia could continue to grow above the Spanish average, just as it has been doing since the economic recovery began.

Secondly, with the country's political debate being dominated by the political tension in Catalonia, this has a high opportunity cost for Spanish society. True, the growth characteristics of recent years are very different from those pre-2008. The Spanish economic is growing faster than Europe, gaining in competitiveness, with contained growth in inflation, unit labour costs, and the margins of prices compared with other countries in the Eurozone. Households and companies have reduced their levels of debt, even below the Eurozone average. Unemployment figures have fallen by almost 11 points to 16.4%. Social Security contributions have recovered 68% of what was lost during the crisis, maintaining a surplus in our external payment balance. This is all unprecedented in our recent history. Yet much work remains to be done, and not just to return to 2007 employment levels. It is necessary to continue with reforms to create more improved jobs, with a more efficient and fairer labour market, to continue securing the sustainability of the welfare state, to improve the autonomous community and local financing system, to make the most of the opportunities offered by the process of technological and digital transformation in progress, and also in public administrations, and to improve the efficiency of institutions and human capital in the long term.