

A lesson to economists: value is not made by discountin...

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Andy Haldane, the outstanding chief economist of the Bank of England, [has admitted that the Bank got its Brexit forecasts wrong](#). As he has put it, the Bank's models could not adequately handle the irrational behaviour of people and so failed to predict appropriately what might happen after Brexit. To put it another way, the Bank forecast an immediate downturn after Brexit because it assumed that people would realise all the risks that this course of action entailed. And that downturn did not happen either because people did not think there were such risks, even if the Bank did or, as likely, they ignored them.

The admission is interesting. It's as significant as the admission some years ago from Adair Turner that the Bank of England had, when modelling the economy before 2008 assumed there was only risk, to which probabilistic outcomes could be attached, when in fact there was substantial uncertainty, which is another way of saying no one has a clue what might happen and so could attach no probability to it at all. Turner's admission said that the pure neo-classical view of economics was wrong because rational management of risk based on perfect current perception of the consequences of current action on future earnings is at the heart of that view.

Haldane's admission on the other hand appears to admit that the neo-Keynesian view that such understanding can exist, but takes time to form, is also wrong. The Bank may well be right to believe that Brexit will adversely impact future earnings in the UK. I think they are. But the reality is that this perception is not widely shared. As a result people have refused to behave as if a downturn is coming. Based on the evidence this may be irrational, but that's what is happening. Quite simply the view that the Bank expected to form has not materialised. Either adaptations take much longer than neo-Keynesians think, or maybe they just don't happen. This leads to three possible economic conclusions.

The first is the glaringly obvious one. This is that people do not know what will happen in the future. It's hard enough for most people to work out what is happening around them now. In that case they live now and accept that the future is unknown to them: it is simply uncertain and does not involve quantifiable risk. This means that they will

react only when events happen and not in anticipation of them. This behaviour is completely contrary to almost all forms of economic modelling that assumes that current well being is the discounted consequence of future actions. The necessity for economists is to realise that their models just do not reflect not how people are. And economists also need to accept that people are not being irrational in behaving like this. When there is only uncertainty as far as most people are concerned because they have little or no control over the future and so cannot know, let alone impact, the risks inherent in it then discounting it altogether and working on the basis of the only reliable information that they have, which is from the present and past, is rational. Economists need to change the model, and not label people as as irrational.

Second, no economic model that assumes there is a long term equilibrium state to which we aspire makes sense. And nor is it a reasonable basis for forecasting. There is no equilibrium. There are always disruptions. There will always be new understandings that alter desired outcomes. And so there will always be change. The assumption that is implicit in most macro-economic modelling that there is a stable state for the economy and that the art of economic management is in learning how to restore the real economy to that state is just wrong. There is no such nirvana. We live in a dynamic world. And real people know that. They think that things will work out because by and large they always have. And that assumption is rational, and based on fact. Of course things can and do go badly wrong. But usually we recover and life goes on. It may never do so in the way it did before but that does not matter. Through a process of adaptation and change that is quite unpredictable as to outcome life continues. The error then is, again, in the economist's modelling. The assumption that there is a 'normal' state to which we will return, which has been such a theme of post-crash economic dialogue, is just wrong. We won't. We can, and we should, go somewhere else now. Economists who think otherwise are deluding themselves as to the nature of the real world. They're the irrational ones as a result.

Third, what this says is that those elements of populist sentiment that reject activity based on economist's assumptions are right. Financial markets aren't trusted because they produce irrational outcomes (FTSE 100 highs when it is obvious the economy is in trouble) and are rightly dismissed by most people as delivering false messages. Those markets do think they work on the basis of discounting future earnings because that's what the economists have taught them to do. But most people know you can't do that. They know that these calculations can't be based on risk because they are in fact inherently uncertain. And that is why they also don't trust global companies that base such a large part of their earnings on trying to capture today the consequence of future transactions, whether by M&A profits or by financial engineering. Implicitly people know these activities, the rewards paid for them, and the profits that are declared by them are all unreal, using that word in various ways. They appreciate what economists don't, and that is that all this complexity is faux: value is not made by discounting the future. Value is made by doing the right thing now in the light of the uncertainties that we face which we may not be able to quantify but which we believe to be real. And when

economists begin to appreciate that we may get better economics.

We have to hope.