

Funding the Future

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There has been lots of comment in the media on the criticisms that former chair of the US Federal Reserve and economics Nobel prize winner, Ben Bernanke, has [made of the Bank of England's forecasting techniques](#). He undertook a review of these methods at the invitation of the Bank because so much concern has been raised about how poor their forecasting has been, particularly since the Covid crisis.

In general, observers have suggested that Bernanke must have been thorough because he has made twelve recommendations for what people think to be significant reforms within the Bank. Bank of England boss, Andrew Bailey, has already said that he will act upon them. That, however, to me is the surest sign that Bernanke has missed his target. If he had suggested anything that would have created real change Bailey might have resisted his recommendations a lot more obviously.

A long time ago a wise person taught me that I should, when reading reports of this nature, not consider what is said within them, but what is left unsaid, meaning that an issue has been ignored. It is in this light that I have read the report.

Before noting those exceptions let me make it clear that I am unsurprised that he has said that (and I am summarising his twelve, heavily overlapping, recommendations when noting these issues):

- * The Bank's methodologies are out of date.
- * The Bank's technology is outmoded.
- * The Bank is over-reliant on data analysis.
- * The Bank has structures that do not encourage the promotion of expertise.
- * There has been resistance to change within the Bank.
- * Critical thinking that challenges the Bank's forecasting has been discouraged, even in the Monetary Policy Committee.
- * The Bank's systems are orientated to processing normality, and not exceptions to the norm.
- * There is a bias against narrative explanation of the Bank's opinions and forecasts.
- * Its reporting methods might be familiar due to their habitual use but they are not necessarily useful.

I stress, this is not how Bernanke puts things; I offer these as reasonable interpretations of what he says. To me they say that the Bank:

- * Is outmoded in its thinking.
- * Has failed to invest despite the enormous resources available to it.
- * Requires compliant obsequiousness from its staff.
- * Does not encourage critical thinking.
- * Hides behind opacity.
- * Lacks creativity.
- * Most of all, is seeking to reinforce what it thinks it knows rather than what might actually be happening.

Again, I stress he did not say that: it is what I think he means.

That said, there are, in my opinion, major failings in what Bernanke has done. For example, has not questioned the basis of the economic approach adopted by the bank, which is based on what is described as [dynamic stochastic general equilibrium modelling](#) (DGSE). This is unsurprising. Bernanke is deeply invested in this economic method methodology, as all central bankers are. However, the model is profoundly unsound. There are a number of reasons.

Firstly, the model is based upon microeconomic foundations. It assumes that the model of decision-making that is appropriate for individuals, households and companies is also appropriate for the state. To put this another way, the household analogy is built into it from the outset. The result is an inherent logic that the government is just another player within the economy when it is nothing of the sort. Its role is not only normally the inverse of all other actors within the economy, it also sets the rule for everyone else.

There is another problem arising from the use of microeconomic foundations. Many of the crass assumptions within microeconomics, including that markets can produce optimal outcomes and that they can clear supply and demand, are implicit in DGSE modelling, quite inappropriately. You cannot build sound economic forecast on the basis of nonsense. Bernanke does not say this.

Secondly, although it is claimed that these mathematical models can handle uncertainty, I do not think that is true. They can only handle risk, which is probabilistic. I am not convinced that they can handle uncertainty, to which probability cannot be attached, although it happens, nonetheless. This is why they were quite unable to handle the global financial crisis of 2008 and the Covid crisis. Those events simply did not exist within the range of forecast probabilities. Bernanke does not point this out.

Third, these models assume that there is such a thing as equilibrium, i.e. an optimal economic outcome to which we can aspire. There is no evidence that such a state has ever been achieved. In that case, why it is appropriate to assume that this is the basis for forecasting is very hard to explain. Bernanke offers no such explanation.

Fourth, as Steve Keen has explained, relentlessly, models of this sort are based upon the assumption of a barter economy where there is no role for money. Any adaptations within the model to include the role of money are necessarily a fudge. Why the Bank is using such a model to control monetary policy is hard to explain.

Fifth, if, instead of an equilibrium state being modelled there is instead a model that presumes that the status quo prevails (which Bernanke implies to be the case), then the model has built within it an assumption of reversion to the norm. That would be great if that norm was what everyone desired, but very clearly the norm within the economy in which we all live at present is not working. That means that the model is inherently in conflict with society - and what is happening in the real world.

Sixth, the most massive macroeconomic externality, in the form of climate change, is effectively ignored within this model, because that is what its microeconomic foundation necessitates. This fact pretty much undermines just about everything the Bank does.

I could go on, but I think that my reservations are now clear. I am, of course, aware of that I am generalising, but I also know that in almost every model of this sort where adaptation is introduced to try to accommodate the criticisms made, the assumption is that the exception from the model's requirements is contrary to economic well-being i.e. the model always tries to make prediction that resort to its implicit over-riding assumption that pure market economies must exist, fundamentally free of government interference. The reality that a central bank exists to implement government policy is in fact contrary to the implicit assumptions in the models that presume that no such thing should happen.

Bernanke mentions none of this. As a result what he says will fail us.

But that was also guaranteed for another reason. It would appear from the commentary that he has provided that he spoke to no one, at least of consequence, outside the Bank when undertaking his work. In other words, he has made recommendations for reform of the way in which the Bank works without ever once considering the opinion, or needs, of the Bank's stakeholders, whether they be the government, other politicians, society at large, or business of all sizes. His comments do, therefore, represent the ultimate statement of central banker arrogance. In the opinion of central bankers, nothing but their view matters. Bernanke did not say this, but whether he recognises it or not, it is clear that he thinks it.

Bernanke was always the wrong person for this job. He was a central banker marking another central banker's homework, without ever questioning the assumptions on which the central bank worked. This investigation was doomed from the outset as a consequence.

And these are the people that Rachael Reeves is placing her faith in to run the economy when a Labour government is in office.