Forecasting is more than just luck
(Article published in 'Management Today', *the monthly magazine of the Australian Institute of Management, November-December 2014)*.

The legendary New York Yankees coach, Yogi Berra, is supposed to have said, "forecasting is difficult – especially when it's about the future". He was right. Forecasting *is* about the future. And because the future is inherently unknowable, it *is* difficult.

Unfortunately, however, it is also virtually unavoidable. Almost every decision we make – as individuals, parents, advisers or managers – involves some kind of assumption or forecast about something that will, may, or might not happen at some point in the future. Sometimes that forecast is merely a guess. At other times it could be an assumption, for example, that the future will be like the present. And on other occasions or in other circumstances, especially when there is a lot at stake, it may be the result of a deliberate and painstaking effort to discern what lies ahead.

Those who make forecasts are not omniscient. They shouldn't claim to be – and people who make use of forecasts shouldn't expect them to be. That is particularly the case with economic forecasts, and economic forecasters.

The models which economists use to make forecasts – whether they are a framework for thinking about how economic variables of interest (such as economic growth, inflation, interest rates or the exchange rate) might behave under certain circumstances, or a formal mathematical model with hundreds of equations – of necessity require simplifying assumptions about how the 'real world' in all its complexity actually functions, and are typically based on observed patterns of behaviour in the past.

Because economics is ultimately about the behaviour of people – as consumers, workers, business managers and owners, and economic policy-makers – and because we human beings are constantly changing, learning and adapting, people don't always behave as they did in the past, or as economic theories and models assume that they do.

Unlike most of the physical sciences, economists can't repeat experiments in tightly controlled environments in order to gain fresh insights into how households, businesses and governments respond to particular events.

Hence, those who use economic forecasts in their decision-making processes should not expect them to be exactly right – or dismiss economic forecasts as utterly useless when they turn out to be something less than exactly right.

Useful forecasts will provide some indication of the margin of error around them – as both the Reserve Bank's and the Treasury's published forecasts now do. They may also provide some discussion of possible alternatives to the 'base case' or 'central scenario', and attach probabilities to them. These margins of error, and probabilities attaching to alternative outcomes, will also never be exactly right – but they do provide valuable additional information insights into things that may be important for business decision-makers, investors or economic policy-makers.

One of the hardest things for economic forecasts to get right is the timing of major turning points in business cycles – such as the onset and end of recessions. A lot of near-term economic forecasts are extrapolations of recent developments – for example, if interest rates have risen a couple of times in the past six months, most forecasts will say that further increases in interest rates are likely. Conversely, long-term forecasts tend to be based on assumptions about what the economy looks like in 'equilibrium', with economic growth at what is often called its 'trend rate', and inflation sitting nicely at the mid-point of the central bank's target range.

But what businesses often need to know is whether recent trends can be reasonably expected to continue – or whether the risks of a break in those trends have risen materially. Even those forecasters who do claim to have 'picked' a major turning point, such as the onset of the recent global financial crisis, often turn out to have been forecasting such an event at regular intervals over preceding years – which is, in practice, of no greater benefit to users of forecasts than forecasts which fail to identify any possibly abrupt shifts in economic fortunes.

Thus, a useful economic forecast will attempt to comprehend the 'big forces' that are influencing both global and local economic trends. It will question whether any of those 'big forces' can be expected to abate, intensify or give way to others over the period of interest ahead. It will offer insights into how those who make economic policies (who set official interest rates or make decisions about taxes and government spending programs) will react to the numbers set out in the forecast, and consider how those policy-makers' reactions will 'feed back' into the economic outlook. It will offer some guidance as to the likelihood that the future will differ in important ways from the recent past. And it will give some explanation as to the possible consequences of any major variations from the assumptions underpinning it.

Such forecasts will almost never turn out to be precisely 'right'. But they can provide a basis for making more informed business or investment decisions. And that's how they should be used.