ECONOMIC FORECASTS

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FT Masterfile 2

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How and when to use them in business

by Giles Keating

Head of financial forecasting, London Business School
Editor, Financial Outlook

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1 Introduction

Using forecasts

Every business needs forecasts. All business decisions are based on some view about the future. Yet it is often difficult to see how the mass of macro-economic forecasts, appearing almost daily in the Press, can have any direct relevance to everyday business decisions. These forecasts are based on complicated mathematical descriptions of how the economy works. They include projections of many items describing the whole economy – unemployment, the balance of payments, etc – but little information about individual markets or sectors.

This Masterfile is a practical guide to the use of macro-economic forecasts. It tells you where to get them (Section 2), why they differ and which one to choose (Sections 3 and 4), how to relate the 'macro' numbers to your own business (Section 5) and how to deal sensibly with inevitable forecasting errors (Section 6).

Strengths and weaknesses of macro-forecasts

A macro-economic forecast provides an ordered view of the future. It describes the economy by means of a set of numbers which, even if they have no other merit, are at least consistent with one another. If you have reasons for disagreeing with one number in a macro-economic forecast and want to change it, you have to alter something else to make sure that everything still adds up. Macro-economic forecasts also give a reference point for monitoring the economy, just as businesses compare their own sales with plan.

However, no macro-economic forecast can be better than the inputs to it. Those inputs consist of a forecasting institute's view about how the economy works – based both on past experience and on economic theory – plus a large amount of judgment. The element of judgment is vital. Forecasters are economists who rarely have special knowledge about what governments will be doing in a year's time or how much oil prices will be affected by a new war. You cannot rely on their judgment about such things – you should always check to see what they are assuming, and your view of the plausibility of a forecast should be strongly influenced by how sensible their assumptions are – Section 4 suggests how to alter a forecast based on assumptions that you disagree with.

Business use of forecasts

Having chosen a forecast based on sensible judgments – and you may have to use more than one 'scenario' (set of assumptions), when uncertainties are particularly great – you can work out the implications for your own business (Section 5). Whichever forecast you use will be subject to enormous risks and uncertainties. This means that it cannot give a definite statement about what *will* happen to your business. Instead it can aid you in a different way, by helping you to identify the benefits and dangers associated with various courses of action (Section 6). However, no macro-economic forecast will tell you which of those various risks is the one to take – that is a business decision which you must make.

2 Looking at the sources

Who publishes macro-economic forecasts of the UK? Figure 2.1 shows that the first official forecasts were published by HM Treasury in the 1950s and although since 1975 the government has by law been obliged to publish these twice-yearly, it gives relatively few details. The first regularly published unofficial forecasts were produced by two research institutes, the National Institute for Economic and Social Research (NIESR) and the London Business School (LBS), from 1959 and 1966 respectively. These two institutes now publish some of the most detailed and most respected predictions of the UK that are available. They draw on a variety of funds for their forecasting and related economic research; some money comes from government research grants, some from publication sales and (in the case of the LBS) some from a 'club' of companies who pay a substantial annual subscription to use the LBS 'model' and to help in producing the forecasts.

2.1 Major developments in UK post-war macro-economic forecasts

Early developments
HM Treasury starts to prepare short-term economic forecasts for government policy-making after Second World War.

These projections, when made public, are mainly in qualitative statements rather than precisely quantified forecasts.

In the USA, Klein experiments throughout the 1950s with several 'models' of the US economy.

1958
Experimental 'model' of UK economy used for forecasting by Oxford economists.

January 1959
First publication of National Institute Economic Review, containing quantified macro-economic forecasts. A large element of judgment used. (Over the following decade the National Institute moves to more formal techniques.)

November 1966
'The Sunday Times' publishes first London Business School forecasts, based on a formal 'model' of how the economy works.

During 1970s
Great expansion in number of organisations publishing forecasts, some using formal 'models', others relying heavily on judgment.

1975
Industry Act passed, including amendment sponsored by Dr Jeremy Bray, MP, requiring HM Treasury to publish regular quantified macro-forecasts and to make their 'model' available for outside use.

Also in 1975, the severe drop in output following the oil crisis a year earlier was not correctly predicted and this caused a major re-assessment of forecasting techniques.

Throughout the 1970s, these two pioneers were joined by an increasing number of other organisations publishing forecasts and the choice is now bewildering.

The Confederation of British Industry has since 1958 conducted highly reliable surveys of recent and expected trends in manufacturing industry. It was therefore a logical development when, in 1975, they started to publish forecasts of the whole economy partly based on those surveys. Another important development in 1975 was the passing of the Industry Act including an amendment proposed by Dr Jeremy Bray, Labour MP and econometrician. This required the Treasury to publish its forecasts and to make its economic 'model' available for outside use. To exploit this, the Economist Intelligence Unit (the consultancy arm of the *Economist* newspaper) set up an organisation called the 'St. James's Group' and British Petroleum, through a subsidiary, set up the similar 'Item Club'. Like the LBS, these organisations receive income from 'clubs' of companies who use their forecasts and help produce them. Although they use the Treasury 'model', they are not able to 'second guess' all the Treasury's thoughts, because there is far more to forecasting than the 'model' being used. This is explained in Section 3.

There are several forecasting groups based at universities. Cambridge Economic Policy Group (CEPG) research suggests that other forecasters tend to be over-optimistic about UK firms' ability to compete. As a result CEPG have tended to predict a more depressed outlook than other forecasters. To deal with this they advocate radical left-wing economic policies.

By contrast Liverpool University has recently started to publish regular forecasts based on the view that tight monetary policy will rapidly reduce inflation with only mild and short-lived adverse effects on unemployment. Oxford Economic Forecasts, based at the Oxford Centre for Management Studies, but relying partly on research by Oxford University academics, is a new group formed in 1981 which takes a less extreme view than either CEPG or Liverpool University.

2.2

Main UK forecasting groups

Organisation	Title of publication	No. of forecasts/year	Monthly update?	Approx subscription	Special Notes
HM Treasury	Financial Statement & Budget Report	2	No	£10	
National Institute for Economic & Social Research	National Institute Economic Review	4	No	£25	
London Business School	Economic Outlook	3	Yes	£65	
Organisation for Economic Co-operation & Development	OECD Economic Surveys: UK	1	No	£2	Available through HMSO, 'OECD Economic Outlook' twice-yearly gives additional UK forecasts (subscription £10).
Confederation of British Industry	Economic Situation Report	3 or 4	Yes	£110 *£80 to members*	Also includes CBI Survey results.
Cambridge Economic Policy Group	Cambridge Economic Policy Review	2	No	£15	5 to 10 years ahead, no quarterly figures.
Economist Intelligence Unit	UK Economic Prospect	4	No	£65	
Henley Centre	Framework Forecasts	12	n/a	£650	
Phillips & Drew	Phillips & Drew Economic Forecasts	12	n/a	£350 *Free to clients*	

Finally, many stockbrokers publish forecasts. Although these are generally based on excellent and up-to-date information about financial markets, they do not in most cases rely on detailed economic research. Instead they tend to be based on informed adjustment and averaging of other organisations' views. Unlike the organisations mentioned earlier, stockbrokers generally finance their forecasts from their main business and in most cases they expect to receive little income directly from publications, which are usually given away free to clients. The best known and most detailed of the stockbrokers' forecasts is produced by Phillips and Drew, who cover a wide range of economic items and predict profits by sector in great detail.

Figure 2.2 gives details of the main UK forecasts, where you can obtain them and how much they cost. The cheapest annual subscription is £2, the dearest over £600. This price variation partly reflects differences in frequency of publication and in amount of detail given.

As mentioned above the stockbrokers will usually provide their forecasts free to their clients. The Treasury Budget forecasts cost only a few pounds but it is not really worth buying them. This is because only a limited amount of information is given and this is usually reproduced in full in the Press.

2.3

A statistical measurement error, although sometimes big.

Very important measure of volume of output in whole economy

Shorthand for 'Millions of pounds at 1975 prices' indicating that these items are in volume terms

Difference between year on year and through the year: the former shows a big fall in 1981, the latter initially no change

Indicates percentage change in imports between 1981Q1 and 1982Q1. Note that this horrifying increase follows a large fall over the year to 1981Q1.

	TABLE 1 EXPENDITURE ON THE GROSS			
	GDP:	ADJ	GDPE:	
	GROSS DOMESTIC PRODUCT	DIFFERENCE & OUTPUT EST. GDP	GDP EXPENDITURE ESTIMATE	CONSUMEXPENDITURE
	£M75 A	£M75 A	£M75 A	£M75 A
	% CHANGES OVER PREVIOUS YEAR			
1975:	-1.8	--	-.5	-.
1976:	1.9	--	3.7	.
1977:	2.6	--	1.3	-.
1978:	3.3	--	2.6	5.
1979:	2.1	--	1.0	4.
1980:	-2.7	--	-2.1	-.
1981:	-2.8	--	-1.2	-.
1982:	1.0	--	.8	.
1983:	2.8	--	2.7	1.
1984:	2.2	--	2.2	1.
1985:	1.6	--	1.6	1.
DATA:	8201	8104	8104	820
	% CHANGES OVER SAME PERIOD PREVI			
80 1:	1.4	--	1.9	4.
80 2:	-3.6	--	-3.7	-3.
80 3:	-3.3	--	-2.8	.
80 4:	-5.2	--	-3.7	-.
81 1:	-5.1	--	-3.1	-.
81 2:	-3.9	--	-1.9	.
81 3:	-1.9	--	-.3	-.
81 4:	-.1	--	.6	.
82 1:	.3	--	.1	-.
82 2:	1.3	--	1.7	.
82 3:	1.2	--	.8	1.
82 4:	1.0	--	.8	1.
83 1:	2.2	--	2.2	1.
83 2:	2.9	--	2.9	1.
83 3:	2.9	--	2.9	2.
83 4:	3.1	--	3.0	1.

Looking at the sources

Almost all the other forecasts shown in Figure 2.1 are also reported in the Press, which might suggest that it is not worthwhile subscribing to any of them; but there is always considerably more detail given in the publications, and this detail is vital for you both to gauge how plausible a forecast is and to convert macro-economic predictions into items relevant to your own business (see Sections 4 and 5). Another advantage of subscribing is that institutes are much more likely to answer your enquiries if you subscribe. The Henley Centre, which produces the dearest publication shown, offers this as a definite feature.

What is the publication that you get for your subscription? A typical forecasting institute publishes a new forecast three or four times a year. You will be sent a publication of perhaps around 80 A4 sides containing tables giving detailed quarter-by-quarter forecasts for many important macro-economic items such as the RPI, unemployment, consumer spending etc. Figure 2.3 gives an example. The publication will contain a detailed write-up of these forecasts explaining the assumptions and how the results were obtained. Often there will be other articles discussing economic policy or analysing past economic trends. These articles often tend to be oriented towards government and academics rather than business.

C PRODUCT & KEY INDICATORS

IF	II	G	X	M	FCA:	PROD	LUKA	BAL	PC:
ED EST- IT	STOCK BUILDING	GOVERN- MENT CONSUMP- TION	EXPORTS GOODS & SERVICES	IMPORTS GOODS & SERVICES	FACTOR COST ADJUST- MENT	:INDEX OF :INDUST. :PROD- :UCTION	UK UNEM- PLOYMENT (SA)	CURRENT BALANCE OF PAYMENTS	DEFLATOR FOR CONSUMP- TION
5 A	£M75 A	£M75 A	£M75 A	£M75 A	£M75 A :	%	'000 A	£M A	75=1
.7	--	5.8	-2.5	-7.1	-1.4 :	-4.8	--	--	23.5 :
.1	--	.8	9.1	4.2	3.4 :	2.0	--	--	15.8 :
.4	--	-1.1	6.5	1.1	.8 :	3.8	--	--	14.7 :
.3	--	2.1	1.9	3.9	9.4 :	3.8	--	--	9.6 :
.6	--	1.7	2.4	11.3	4.2 :	2.5	--	--	12.7 :
.1	--	1.6	.3	-3.5	.1 :	-6.5	--	--	16.0 :
.6	--	.3	-1.7	-1.3	-2.0 :	-5.3	--	--	10.7 :
.6	--	.6	.4	8.5	.0 :	1.2	--	--	9.4 :
.0	--	.9	6.1	5.4	1.9 :	4.2	--	--	7.4 :
.1	--	.8	3.8	3.1	1.2 :	3.2	--	--	9.1 :
.1	--	.8	2.5	1.7	1.2 :	2.4	--	--	11.2 :
04	8104	8104	8104	8104	8104	8201	8201	8104	8104 :
AR									
.8	--	2.2	15.6	7.8	7.9 :	-.4	--	--	17.8 :
.1	--	.6	-5.0	-1.6	-10.9 :	-7.2	--	--	19.2 :
.3	--	1.3	-3.3	-7.6	3.5 :	-8.1	--	--	14.5 :
.5	--	2.3	-3.8	-11.4	.6 :	-10.3	--	--	12.9 :
.2	--	.2	-7.4	-12.6	-3.4 :	-9.3	--	--	11.0 :
.0	--	1.0	-3.4	-6.6	-1.0 :	-7.3	--	--	10.5 :
.4	--	1.2	.5	4.3	-3.1 :	-3.5	--	--	10.6 :
.3	--	-1.2	3.8	11.2	-.4 :	-.6	--	--	10.9 :
.7	--	.3	.6	16.9	-1.2 :	.1	--	--	10.9 :
.9	--	.7	.8	9.5	-.0 :	1.6	--	--	9.7 :
.2	--	-.2	1.5	5.1	.3 :	1.5	--	--	9.1 :
.4	--	1.7	-1.3	3.8	1.0 :	1.7	--	--	7.9 :
.8	--	1.2	7.1	5.4	1.3 :	3.6	--	--	7.6 :
.6	--	1.0	6.7	5.4	2.0 :	4.6	--	--	7.2 :
.8	--	.8	5.0	5.9	2.5 :	4.2	--	--	7.1 :
.9	--	.7	5.7	4.7	1.8 :	4.6	--	--	7.6 :

Source: *Economic Outlook* © Centre for Economic Forecasting, London Business School

Symbols used by forecasters as shorthand

No percentage changes because meaningless — see another table for level of stockbuilding

This item is similar to the retail prices index, so these numbers are approximations to familiar 12-monthly retail price inflation.

In addition to this basic three or four times yearly publication, some of the institutes provide monthly updates or give other information in the months when they have no forecast (eg the CBI gives its survey results).

The 'clubs' offered by several of the forecasters were mentioned above. These offer member companies the opportunity to make their own special forecasts using an economic 'model'. Usually member companies' own economists can use the 'model' from computer terminals in their own offices, or alternatively staff of the forecasting institute will prepare the special forecasts. In addition member companies can influence the forecast published by the club and ask the forecasting institute's staff for advice and information. Annual subscriptions to these clubs vary but all are measured in thousands of pounds; special forecasts usually cost extra, from about £25 up to £150. Clearly club membership is only of interest to medium or large companies. If a company that is not a club member requires a special forecast, many of the forecasting institutes will be prepared to produce it. However, they will usually charge a substantial consultancy fee.

Conferences provide another means of finding out about forecasts. For example, once or twice a year the CBI holds conferences on economic forecasting (and on the more specialised subject of currency forecasting). Speakers from three or four of the leading forecasting institutes describe their projections. Conference delegates can ask questions and receive handouts showing main features of the forecasts covered by the speakers. For a fee of well under £100 for half or three-quarters of a day, these conferences provide a useful introduction for those unfamiliar with forecasting or, for someone who subscribes to one of the major forecasters, a convenient source of information about what the others are saying.

Because conference handouts lack the detail of the forecasting institutes' publications and because information from a conference is not updated regularly, most companies should use conference attendance to complement a subscription to a forecasting publication, not substitute for it. When choosing which forecasting conference to attend, the description given above should be useful as a yardstick of good value. Some forecasting conferences cost much more but include speakers from only one forecasting institute, which gives too narrow a view.

Forecasts of other countries

All the UK forecasters shown in Figure 2.2 give some information about recent and likely future developments in the world economy and most (with the notable exception of HM Treasury) give some information about the individual economies of the major industrialized nations. However this information is fairly limited. Most forecasting institutes provide quantified forecasts only of one or two major items, such as output growth and inflation, for each country. This lack of detail reflects the purpose of such forecasts: they are mainly intended as an input to the institutes' projections for the UK rather than as useful forecasts in themselves. The UK institutes do not have the resources to prepare detailed forecasts of other economies.

Businesses needing more information about foreign economies than is given in the UK institutes' publications can either use the OECD predictions or go to national sources. The OECD (Organisation for Economic Co-operation and Development), based in Paris, has as members all major industrialized nations. It produces a detailed report on each of its members' economies once a year (its report on the UK is shown in Figure 2.2) together with a twice-yearly document called 'OECD Economic Outlook' covering all of the OECD countries in a fair amount of detail. OECD publications are available in the UK (with a slight delay) from HMSO. They have several advantages. They are cheap, costing only about £2 for an individual country report and £10 for a subscription to the two issues of 'OECD Economic Outlook'. They are prepared by a staff large enough to permit one or more economists to specialise in each country. Also, they are in English and readily available.

Obtaining detailed forecasts from national sources, in English, is generally more difficult. One of the most easily available is the DRI (Data Resources Inc.) forecast of the US, obtainable from the London offices of that organisation but costing about £5,000 for an annual

subscription; the IFO-institute predictions for the West German economy are available in English on an annual subscription of about £60 from Gower Press in the UK (who also publish the London Business School forecasts of the UK). Other foreign forecasts are sometimes reported in the Press, but the detailed publications are generally difficult to obtain and often more expensive than UK forecasts. A comprehensive worldwide list is given in George Cyriax's 'World Index of Economic Forecasts' (published by Gower, price £65). However, it is possible that detailed national forecasts will become available in the UK more easily over the next few years. This is because some of the large commercial US forecasting bodies are starting to market in the UK their predictions of both US and other economies. This may encourage the UK forecasting institutes to make more use of the links with foreign forecasters that they already have.

'Specialist' forecasts

As mentioned above, the regular publications of the main forecasting institutes give a considerable amount of detail for the UK. They break down total demand into purchases by consumers, fixed investment by companies, fixed investment by government and other broad categories; the forecasts state how much of total demand is likely to be met by imports, discuss the implications for the balance of payments and comment on the outlook for unemployment and inflation. In almost all cases detailed quarterly predictions are given for all these items and many others for at least two or three years ahead. Despite this large amount of information, these 'macro-economic' forecasts provide little direct information about individual markets. For example most of the standard forecasts break total consumers' expenditure down no further than into the broad categories of durables and non-durables; often the only exchange rate given is the sterling – dollar rate or sterling's effective rate against a 'basket' of important currencies.

2.4

Selected 'specialist' forecasts

Title	Publisher	Issues/year	Approx Subscription
Exchange rates			
Exchange Rate Outlook	Gower	12	£185
Forecasts of exchange rate movements (major currencies)	Henley Centre	12	£450
Foreign Exchange Outlook (non-OECD currencies)	Henley Centre	4	£350
Currency Trends	Phillips & Drew	6	£250 *Free to clients*
Individual industries and individual consumer products			
Industrial subscription sevices (Forecast of 40 sectors of the economy)	Cambridge Econometrics	Several reports, consultancy, conferences, access to model	£8250
National Institute Economic Review	National Institute of Economic & Social Research	1 (Note: industrial sector forecasts included as special article usually once a year in the normal quarterley publication)	£7
Retail Business	Economist Intelligence Unit	12	£140
Planning Consumer Markets	Henley Centre	4	£500
Financial assets			
Financial Outlook	London Business School	3 (from late 1983)	£70

Section 5 discusses how these 'macro-economic' forecasts can be used to provide a reasonable amount of information relevant to individual markets. Because this can be difficult and is not always possible, a number of 'specialist' forecasting services have started over the past few years. These give more details about exchange rates, individual industries, financial assets etc than are provided by the forecasting institutes' standard publications. A selection of these 'specialist' forecasts is shown in Figure 2.4 and some are discussed further in Section 5. They are subject to rather larger margins of error than the less detailed 'macro-economic' predictions, partly because nobody has had as much experience at preparing them.

3 Why forecasts differ

The various economic forecasts described in Section 2 often show slight differences up to about six months ahead and larger differences for predictions further ahead. Often the differences are significant. For example in spring 1981 the National Institute predicted that total UK output would have *fallen* slightly further over the year to the first half of 1982, while HM Treasury forecast a *rise* of about 1 per cent over the same period. (The outturn was a marginal increase). This section explains why such differences can arise and Section 4 suggests how to choose a forecast.

Economic forecasts differ from one another because of differences in four main areas:

- the assumptions made about government policy;
- the forecaster's assessment of the recent and current state of the economy;
- the forecaster's view about how the economy works. Some idea of this can be obtained from the 'economic model' being used (for example in some 'models', lower money supply growth leads to lower inflation, in some, to lower output and in others the effect varies), but forecasters always alter the results from the 'model' by judgmental adjustments.
- the forecaster's view about items such as world trade which are little affected by economic developments in the UK. These 'exogenous variables' are forecast judgmentally before the 'model' is used.

Differences in forecasters' views about how the economy works usually account for much of the discrepancy between two institutes' forecasts over periods more than six months ahead. For example during 1981 the London Business School was consistently more optimistic about the prospects for UK output than the National Institute. The main reason was that the London Business School expected rapid beneficial effects from the government's tight budgetary policies while the National Institute felt that those same policies would weaken the economy.

Forecasts from two institutes can also differ because they take a different view about what government policy will be during the forecast period. Until relatively recently, forecasters attempted to make predictions on the assumption that there was no change in government policies from those in force at the time when the forecast was made. This assumption was called 'unchanged policies' and, although there were sometimes certain relatively minor discrepancies in the way this assumption was interpreted, it meant that almost all institutes were using roughly the same assumption. This made comparison of different forecasts easy. However, many business users complained, because they wanted a prediction of what was most likely to happen, not a forecast of 'unchanged policies'. As a result of these complaints some forecasters such as London Business School and Economist Intelligence Unit now make their projections using their best assessment of likely policy developments while others such as the National Institute and Confederation of British Industry still use 'unchanged policies'.

Action point: When reading a forecast you should check what assumption has been made about government policy and whether it agrees with your own view.

Changes in the forecaster's assessment of the current state of the economy and of 'exogenous variables' such as world trade (see the list above) are the most frequent reason for one institute changing its own forecast. Examples of the influence of these items occurred during summer 1982 when various factors including weaker than expected official figures for industrial production, a depressed CBI survey and a rapid fall in the inflation rate caused many forecasters to re-assess their view that the economy was picking up. This in turn altered their view about the shape of the future recovery. At the same time and clearly related to the weakness of the UK economy, most institutes revised down their projections for world trade.

In many forecasting publications, there is a description of the factors that have caused a revision since the previous forecast was produced.

Despite all the factors that cause forecasts to differ, predictions for periods up to about six months ahead are often similar to one another. This is partly because much of what happens in the immediate future is determined by investment plans, pay settlements and other decisions that have already been made. It is also partly because economists in the various forecasting institutes tend to talk to one another and to read one another's predictions. A consensus about likely developments in the immediate future often tends to develop. The user, looking at several forecasts all saying more or less the same thing, feels fairly confident – yet it is possible for all to be wrong. For example in summer 1979, the London Business School, National Institute, CBI and many other institutes all predicted little change in output between 1979 and 1980. The outturn was a substantial decline.

Action point: Agreement among forecasts is no guarantee of accuracy.

The large differences usual among forecasts for periods more than six months ahead are shown by the comparison tables published regularly in the *Financial Times* and every week in the *Investors Chronicle.* The one which appeared in the *Financial Times* on 5 July 1982 is reproduced as Figure 3.1. Figure 3.2 shows the table which appeared in the *Investors Chronicle* on 2 July 1982.

Despite the differences among the forecasts, it is very difficult to decide whether one institute has a better track record than another. This is partly because forecasts are based on official government data describing recent developments in the economy; by the time the performance of the forecasts is being assessed, those data may have been substantially revised to reflect extra information received by government statisticians. Given these revisions, one institute might have predicted the level of output correctly, the other the percentage change. Another problem in comparing forecasts is deciding whether or not to adjust forecasts made on the assumption of 'unchanged policies' to allow for alterations in policy that occurred. Yet another difficulty arises when an institute predicts one item such as inflation correctly and another item, for example output, wrongly, while another institute is in the opposite position; there is no single rule for deciding how much weight to give to different items.

Because of these difficulties it is not possible to state that one of the UK forecasting institutes has a track record that is clearly better than the others. However it is possible to make some observations about past performance. Of the main UK forecasting groups shown in Figure 2.2, HM Treasury, National Institute and London Business School have all been publishing forecasts in some form since the second half of the 1960s. All have reasonably respectable track records, although all have made serious mistakes. After the particularly large errors made in 1975, when all these institutes failed to predict the severity of the slump, there were several reviews of their forecasting performance. A committee appointed by the Treasury suggested that the London Business School had a slightly better track record than the other two. A later report by Professor Jim Ball, chairman of the earlier committee and head of the

3.1

...ease in im- ... expected, reflect- ... increase in import ...etration as well as the moderate recovery of economic ... predict almost no improvement while others take the Treasury view that an improvement of 3.5 per cent to 4 per cent can be expected.

A comparison of the FT ... of forecasts.

This FT average is a little higher than it might be because no allowance is made for the fact that some forecasts are for an average annual rate.

Most groups continue to predict a worsening unemployment trend, except for the Liverpool group which predicts a substantial fall in the jobless to 2.5m next year.

THE UK ECONOMY: COMPARISON OF FORECASTS

Percentage change year on year in 1975 prices unless otherwise stated		Gross domestic product		Consumer spending		Exports		Imports		Retail price inflation (year end)		Unemployment (adults) fourth quarter m		Balance of payments; current account £bn		Public sector borrowing requirement £bn	
		1982	1983	1982	1983	1982	1983	1982	1983	1982	1983	1982	1983	1981	1982	1982–83	1983–84
Treasury	(Mar)	1.5	1.9	0.5	0.5	3.5	3.0	9.5	3.5	9.0	7.5	—	—	4.0	3.0	9.5	—
IMF	(April)	0.8	1.6	0.5	—	3.8	—	10.1	—	10.2	—	—	—	4.7	—	—	—
National Institute	(May)	1.0	1.1	0.2	0.3	2.7	4.0	7.4	3.3	9.5	8.7	3.0	3.3	6.2	8.6	7.9	7.1
London Business School	(Jun)	1.0	2.8	0.6	1.9	0.4	6.1	8.5	5.4	7.9	7.6	3.0	3.1	2.2	2.9	8.8	9.6
Confederation of British Industry	(June)	0.9	2.0	0.6	1.4	0.4	4.9	6.6	5.5	8.5	6.8	2.9	3.0	3.0	1.8	8.7	9.5
Cambridge Economic Policy Group	(April)	−0.4	0.4	−0.9	3.0	−1.5	−0.6	5.4	6.0	8.5	6.2	3.1	3.4	—	—	—	—
Economist Intelligence Unit	(May)	1.3	2.3	0.6	1.8	4.2	3.0	9.6	4.8	10.1	10.6	2.98	3.0	3.6	2.7	9.2	9.5
Liverpool University	(June)	2.5	4.7	—	—	—	—	—	—	7.6	4.3	2.8	2.5	5.1	3.5	8.6	3.9
Cambridge Econometrics	(June)	1.5	3.0	−0.3	2.6	4.8	5.5	5.5	9.9	10.0	8.8	3.2	3.2	4.0	0	—	—
Phillips & Drew	(July)	1.4	2.4	0.1	2.8	1.8	3.5	6.6	5.1	7.6	7.0	2.9	3.0	2.5	0.7	9.4	9.5
Simon & Coates's	(July)	0.9	3.1	0.3	2.6	1.6	8.0	7.0	9.3	9.1	9.5	2.9	2.9	2.0	−0.8	8.0	7.5
Laing & Cruickshank	(July)	1.6	2.0	0.0	1.4	3.1	4.3	6.5	5.4	8.4	9.6	3.1	3.2	3.2	0.3	8.6	9.3
Staniland Hall	(April)	1.3	3.0	−0.6	2.7	—	—	—	—	—	—	2.9	2.9	4.0	—	—	—
James Capel	(June)	0.8	2.0	−0.3	3.7	4.1	4.9	9.0	9.7	8.6	8.5	2.95	3.05	3.1	1.5	8.0	—
Capel-Cure Myers	(July)	—	1.5	0.4	2.0	0.5	3.0	6.5	5.0	8.5	8.0	3.2	3.3	3.5	1.5	10.5	9.0
Average		1.2	2.3	0.1	2.0	2.3	4.1	7.6	6.1	8.8	7.9	3.0	3.1	3.7	2.1	8.8	9.0

NOTES:
Retail prices: IMF. National Institute, CEPG average for year, Capel-Cure Myers second half of year.
Unemployment: CEPG, Liverpool, Cambridge Econometrics, annual average.
Treasury: 1983 forecasts all first half compared with first half of 1982. PSBR is first half at annual rate.

Private housebuilding recovery

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Source: 'Growth Forecasts average 1.2% this year and 2.3% in 1983', by Max Wilkinson, *Financial Times,* 5 July 1982.

3.2

Forecast of forecasts

Forecast and publication date		Output growth % 1982	Output growth % 1983	Inflation % 1982	Inflation % 1983	Balance of payments (£bn) 1982	Balance of payments (£bn) 1983	Unemployment (millions) end 1982	Unemployment (millions) end 1983
Cam Econometrics	6/82	1·5	3·0	10·0*	8·8*	4·5	nil	3·2	3·3
CBI	5/82	1·0	2·0	9·4*	7·1*	3·0	1·8	2·9	3·0
Datastream	5/82	0·5	2·0	9·5	9·5	3·5	−0·8	3·0	2·9
Henley Centre	5/82	1·0	2·7	9·5	9·9	4·9	4·5	3·0	3·1
Hoare Govett	3/82	2·2	3·0	9·2	7·2	4·7	2·8	2·8	2·6
London Business Sch	6/82	1·0	2·8	9·4*	7·4*	2·2	2·9	—	—
NIESR	5/82	1·0	1·1	9·5	8·7	6·2	8·6	3·0	3·3
Phillips and Drew	5/82	1·7	2·4	8·8*	7·8*	3·2	1·5	2·9	2·9
DRI-Econ. Models	3/82	1·1	1·8	9·7*	9·1*	3·9	5·1	3·0	3·1
Treasury	3/82	1·5	2·0†	9·0‡	7·5§	4·0	3·0¶	—	—
Average		1·3	2·3‖	9·4	8·5	4·0	2·8‖	3·0	3·0

* Consumer prices. † 1st half 1983/1st half 1982. ‡ 4th qtr 1982/4th qtr 1981. § 2nd qtr 1983/2nd qtr 1982. ‖ Excluding Treasury. ¶ 1st half annualised.

Source: *Investors Chronicle,* 2 July 1982

London Business School, suggested that the Treasury had performed marginally better than the others.

Some idea of the reliability of the forecasts made by these institutes is given by the average error of 1½ per cent in Treasury forecasts for whole-economy output a year ahead (technically this figure is the 'average absolute error for forecasts made between 1965 and 1979, adjusted for fiscal policy changes'). But there were several errors much larger than the average, with a 3½ per cent error in the forecast made by the Treasury in November 1974 for output growth over the year to the first half of 1975. For more details about error margins, see Section 6.

Among the other forecasting groups shown in Figure 2.2, the CBI, the OECD, Economist Intelligence Unit, Henley Centre and Phillips and Drew have all established reasonable reputations for accuracy although most have not been publishing forecasts for as long as the 'big three', so it is more difficult to make a rigorous assessment of their track record. Where reviews of these organisations' track records are available, they suggest that their average errors are of similar order of magnitude to those of the 'big three'.

The last of the institutes shown in Figure 2.2 is the Cambridge Economic Policy Group. This organisation tends to concentrate on medium-term prospects and policy issues, being less concerned about the short-term outlook over the next 18 months or so. Perhaps partly reflecting this lack of concern about the short-term, the Cambridge Economic Policy Group Reviews published in March or April of 1977, 1978 and 1980 all contain estimates for output growth in the *previous* year that differ from current (late 1982) estimates by 1 per cent or more.

Not shown in Figure 2.2 but of some interest are the Liverpool University forecasts. These have recently included predictions for output and inflation that were far more optimistic than the projections made by other forecasters. So far, this optimism has not been justified and the Liverpool University forecasts have been noticeably less accurate than others.

Action Point: HM Treasury, National Institute and London Business School have all demonstrated reasonably respectable track records and their forecasts should be given particular attention. Most of the other forecasts in Figure 2.2 have shorter but fairly similar track records.

4 Choosing a macro-economic forecast

The last section explained that although there are almost always significant differences among forecasts, none of the institutes mentioned has a track record that is undoubtedly better than the others. This leaves the user with a bewildering choice: lots of different views about the economy and many expensive publications, but no obvious way of deciding which view is 'best' or which publications are worth buying.

This section describes some typical attempts to resolve this problem and explains why some of these attempts are unsatisfactory and others sensible.

Bad approaches

One common but bad approach involves subscribing to none of the forecasting publications, instead making your own 'seat of pants' forecast and then looking at newspaper reports to check that one or two forecasters agree with you. The trouble with this approach is that it is usually self-justifying. This is partly because your own 'seat of pants' view was probably influenced by earlier Press reports and partly because most forecasts already have a 'seat of pants' element built into them from discussions between the forecasters and people in business. Another objection to this approach is that you do not see a publication produced by one of the forecasting bodies. These publications usually warn about the least certain parts of the forecast; describe the assumptions about government policy, etc, used to obtain the forecasts (which might be completely different from what you were assuming, even if your 'seat of pants' forecast for, say, output was the same as the institute's); and give much more detail than is published in the Press.

Another bad approach is to subscribe to one publication and always accept the forecasts in it without checking the assumptions and details. This approach involves handing over too much responsibility to the forecasters. Even if they are good economists they may base their economic projections on peculiar assumptions. For example they might assume that the next election is won by the incumbents while you might feel that a change of government is likely.

Good approaches

A good low-cost strategy is to subscribe to one of the institutes' publications and to note the assumptions which it has made about government policies, oil prices and one or two other vital 'exogenous variables'. You can then compare these assumptions with your own judgment about likely developments. If your own judgment disagrees markedly with the institute's assumptions, you would obviously not accept its projections as the most likely view of the future. If the publication contains an 'alternative scenario', you can check to see if it is based on more sensible assumptions (see Section 6 for more about 'alternative scenarios'). If there is no suitable 'alternative scenario' you can try making 'rule of thumb' adjustments to the forecast to allow for the dubious assumptions. For example if you thought the assumed rise in oil prices was too low, you should edge up the inflation projection somewhat and perhaps lower the output forecast slightly. Making such adjustments is clearly a tricky business (although it is what forecasters themselves are doing all the time). If you are not able to quantify the adjustment you can at least decide the direction in which it should be made and you can bear this in mind when using the forecast for planning.