Deutsche Bank Research

Talking point

On the sense of making economic forecasts

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Year-end is usually high season for economic forecasters. Not only internal and external clients wait with bated breath to see what can be divined from crystal ball gazing. There is also hype to get positioned in the media's diverse surveys to see whose forecasts had been closest to actual outcomes during the year-end review.

Now, of all times, a proposal has surfaced for forecasters to call a time out. How is that supposed to work? Market economists know that when demand reaches a certain point a black market develops – and demand is really high at present. A black market for economic forecasts would boom, transparency would be lost, and any forecaster could spread opinions off the record without having to back them up with detailed analysis or divulge the underlying assumptions.

Indeed, given the current uncertainties scarcely any forecaster is likely to believe that his or her forecast is going to materialise exactly as it was spelled out. But forecasts do have an important indicator function that provides information on the state of the economy. Nobody would suggest to doctors that they stop measuring patients' temperatures when they are coming down with a fever.

Even during quiet times, economic forecasts can only be conditional in nature. There is no such thing as an absolutely reliable forecast for the direction of the US dollar or the oil price – which are key ingredients in any GDP forecast – using even the best of models. So critics of the fundamental idea of forecasting, such as SPD parliamentary leader Peter Struck most recently, should at least take the trouble to judge forecasts against the backdrop of the assumptions made and not consign them straight to the bin.

Besides, the economy just doesn't function like Newtonian mechanics, where a ball rolling on an inclined plane is always subjected to the same forces. In economics, the forces change and so does the surface of the inclined plane, and then the ball also starts to get a mind of its own – to stay within the metaphor.

Does this make economic forecasts worthless? By no means, and not even in the current hazy situation. And so what if forecasters' much-lambasted race to the bottom for the call on negative growth for 2009 indubitably harbours tendencies towards self-fulfilling prophecy. Even the most pessimistic forecast serves an important purpose: it gives decision-makers in business and politics an indication of the range of possibilities for the course of economic development in the coming year. For no forecaster will knowingly publicise a prediction in the conviction that it cannot materialise or is extremely unlikely to do so. The best way to address raging uncertainty as seen at present, ideally, is to draft scenarios which are consistent in themselves and describe future alternatives in the context of specific assumptions. These can offer a valuable basis for planning in business and politics. Nonetheless, this requires intensive deliberation of the scenarios – partly, for example, to be able to act appropriately (flexibly) in pursuing one's own entrepreneurial or policymaking activity. The easier approach, of course, is just to savage off-target point forecasts and thus abdicate any responsibility for having to reveal the assumptions adopted for one's own actions.

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