Economic forecasts: gospel or guesswork?

Scarcely a week goes by without a fresh report on the future course of the economy from research organisations, City analysts and official bodies. These often-conflicting forecasts can add confusion to pay negotiations, with employers and employees selecting the figures that suit their own argument best. This article looks at some of the main sources of economic forecasts, assessing how reliable these are and the use that can be made of them in pay-setting.

An accurate assessment of the economic circumstances, particularly on inflation, is arguably second only to affordability as a factor influencing outcomes on pay. The most reliable data is retrospective, which is one reason why pay settlements tend to lag inflation, and settlements are more likely to reflect the recorded economic circumstances of the year just gone than the predicted course of the year to come. Nevertheless, employers always necessarily have an eye on forward planning in local terms – future orders, projected demand, performance forecasts – so the ability to look ahead on a macroeconomic scale is also invaluable for both sides of the bargaining table.

The main economic forecasts used in pay setting are those for inflation – particularly the RPI – and GDP growth, as a barometer for the state of the economy and likely business fortunes for employers. Of lesser importance but still relevant are projections for the labour market and average earnings. Many forecasts are produced by City and independent analysts and collated, as with the RPI inflation predictions collected by IDS and the Treasury's monthly comparison of independent forecasts. Others are calculated and directly reported by larger agencies and official bodies, such as the Bank of England and, more recently, the Office for Budget Responsibility.

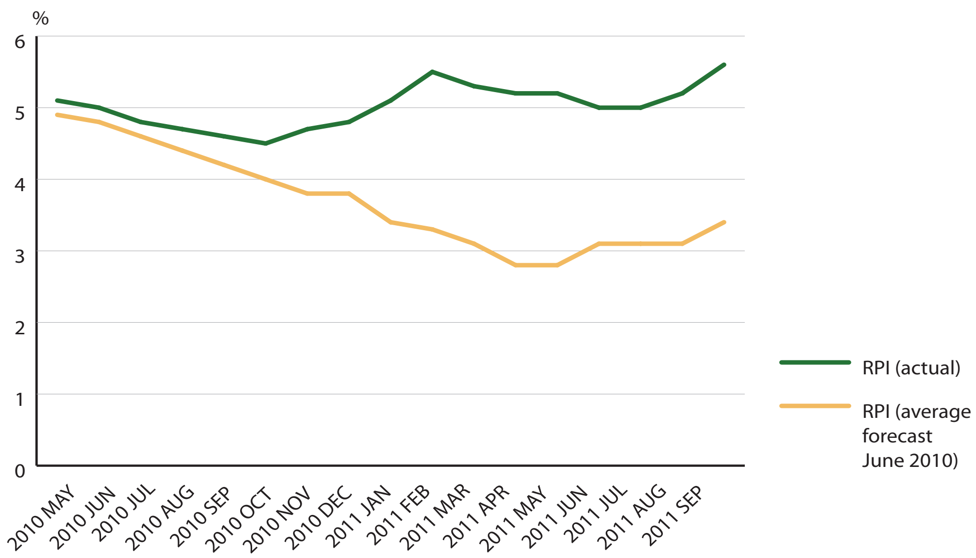
RPI forecasts collected by IDS

Four times a year, IDS collects month-on-month RPI inflation predictions from a number of different City analysts, and calculates the average of these to project the possible course of inflation. These forecasts typically cover around 18 months into the future, or six quarters.

As we might expect, testing these forecasts against actual outcomes on inflation shows that the predictions are more accurate the closer in time they are to the period in question, but are less reliable when looking further forward. The graph below shows the average RPI projection for forecasts collected in June 2010, covering the period between May 2010 (the inflation figure for May had not yet been published when the forecasts were collected) and September 2011. This is charted against the actual RPI inflation rate as published by the ONS.

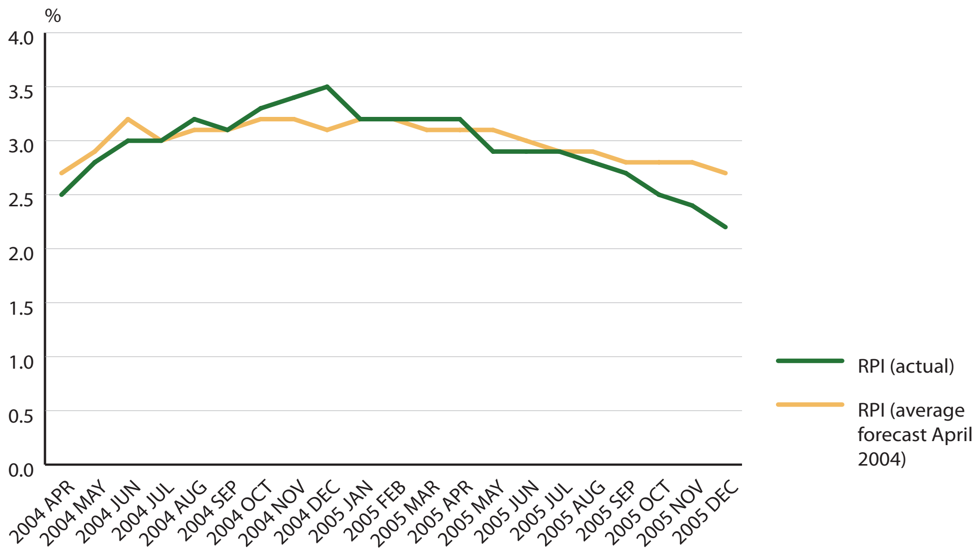
This graph shows a fairly typical picture over recent times – the first six months are comparatively accurate, differing by no more than 0.5 percentage points from the eventual outcome. Thereafter, however, the level of accuracy drops sharply, as the average prediction was for inflation to continue falling gradually, whereas in actual fact it began to rise again from November 2010. The estimates for

RPI forecasts from June 2010 vs actual inflation



Source: ONS; IDS (from collected forecasts)

RPI forecasts from April 2004 vs actual inflation



Source: ONS; IDS (from collected forecasts)

November and December 2010 are out by around 1 percentage point.

From January 2011 onwards, although RPI had been expected to fall, the Coalition's VAT increase came into effect – something not initially anticipated when forecasts were collected six months earlier. This, combined with relatively high inflation in the three 'f's – fuel, food and fares, served to raise RPI inflation back up from 4.5 per cent to its current figure of 5.6 per cent, confounding expectations that it would fall back in 2011.

Looking at a series of quarterly RPI forecasts over the past two years and taking the divergences of each forecast from the actual outcome, we found that since April 2009 there has typically been an average difference of 0.4 percentage points over the quarter after the predictions were made, rising to 0.8 percentage points the following quarter, 1.3 percentage points the quarter after that, and thereafter around 2 percentage points.

If these divergence rates seem high, it should be noted that this reflects not so much on the competence of the City analysts who prepare the forecasts, but on the volatility and unpredictability of inflation rates over the past few years. As a control, we also tested predictions from a quieter period in the economy. These forecasts show a much greater level of accuracy, with a typical example in the chart above, from April 2004, showing no more than 0.5 percentage points' divergence from actual outcomes, even more than six quarters into the future.

Bank of England's fan charts

The Bank of England also produces a quarterly inflation report, which provides forecasts for price inflation as well as a range of other economic indicators. Its main headline inflation figure is the CPI rather than the RPI, since its remit is economic management rather than measuring changes to the cost of living. The Bank produces a 'fan chart', which provides a useful visual indicator of how quickly forecasts can become uncertain. Although there is a narrow range of estimates provided in the centre of the projection, the Bank also provides a much wider range of possible although increasingly less likely outcomes – a little like weather forecasters projecting possible paths for a storm.

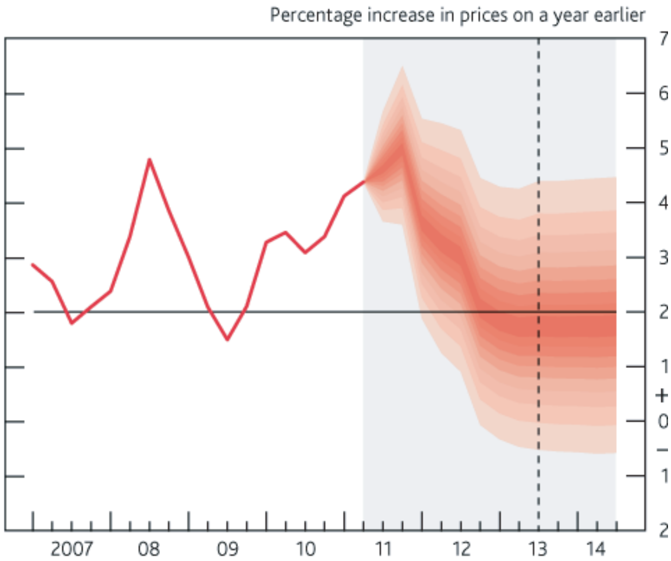
In the example of the CPI forecast from the Bank of England's August 2011 inflation report, reproduced opposite, we can see that for the third quarter of 2011 the Bank predicted a CPI inflation figure of around 5 per cent. This appears to have been relatively accurate based on current available figures, but it is worth noting that even then, the Bank acknowledged that changes of circumstances could have resulted in figures anywhere between around 3.5 and 6.5 per cent. By mid-2012, although the headline prediction is for CPI inflation of around 3 per cent, the potential range given is large, running from around 1 to 5.5 per cent. As a historical guide, the CPI has not been recorded outside this range since 2002.

When looking at the Bank of England's inflation projections, the other point worth noting is that part of the Bank's remit is to *control* inflation. So it is no surprise to see that long-term forecasts for CPI inflation tend to converge around 2 per cent – the target rate. On these measures, the Bank's forecast for inflation is not so much a prediction as it is an aspiration.

Financial crisis – what hurricane?

Reading past economic forecasts with the benefit of hindsight can be slightly cruel, but it is hard to look back at projections from early 2008 without being reminded of Michael Fish's infamous 'don't worry,

Bank of England CPI inflation forecasts at August 2011



Source: Bank of England

there will be no hurricane' weather report from 1987. Three years down the line, and economically speaking, the trees brought down by the unforeseen 2008 crash are still lying across the nation's power lines. So did no-one at all see the warning signs?

The Treasury's comparison of independent economic forecasts, compiled from a large number of major City and independent analysts, suggests not. The table overleaf shows the averages for medium-term forecasts from February 2008, painting a future picture of steady GDP growth at and above 2 per cent, CPI inflation only just above the Bank of England's 2 per cent target, and steady claimant-count unemployment at below 1 million. In the event, GDP would shrink by 1.1 per cent in 2008 before collapsing to a 4.4 per cent fall in 2009 and would only recover slowly in 2010 and 2011. Monthly CPI inflation shot to a high of 5.2 per cent, falling back to 1.1 per cent before returning to 5.2 per cent again in the most recent figures. The claimant count, meanwhile, rose rapidly to 1.5 million by April 2009, and has remained around that mark ever since.

Perhaps even more startling than the inaccuracy of the average figures was the lack of a dissenting voice. Of the 12 City forecasters and 11 non-City forecasters sampled by the Treasury in February 2008, not one predicted GDP growth at less than 1.5 per cent for 2008 and 1.3 per cent in 2009. None predicted claimant unemployment to rise to more than 1.33 million at any point over the next five years.

Even in August 2008, on the brink of the crash, forecasters failed to see the storm brewing. A few warning signs led to predictions for growth being scaled back, but average predictions collected by the Treasury still showed subdued but positive GDP growth in both 2008 and 2009. Not one of the 41 analysts in the survey anticipated an overall contraction in GDP for 2008, and only two did so for 2009. Just one month after these forecasts were published, in September 2008, Lehman Brothers collapsed, marking the beginning of an economic crisis that the world is still struggling to react to today.

If it seems unkind to dwell on this failure in forecasting, it is worth noting the longer-term impact this has had on confidence in expert analysis. That such an extreme event should be outside the realms of normal prediction is one thing, but the complete lack of any warning of the worst financial collapse in 70 years heavily dented public confidence in the ability of analysts to predict the next crisis.

Office for Budget Responsibility

A new source of official forecasts is the Office for Budget Responsibility (OBR), established by the Government in 2010 with a remit to analyse the state of public finances. As part of this task, it provides projections for a range of economic indicators, including GDP growth, inflation and public expenditure. Although the OBR is a newly-created body, and so has little back catalogue to examine, it is required to assess the accuracy of its forecasts on an annual basis. The first of these evaluation reports, published in October 2011, assesses the accuracy of forecasts made at the time of the June 2010 budget.

This shows that the OBR underestimated growth for 2010, having predicted 1.2 per cent growth against the eventual figure of 1.8 per cent. The reason for this is slightly unexpected, however, since the extra unanticipated growth actually came in the first half of 2010, before the Coalition came to power and before

Treasury averages of independent forecasts, February 2008					
	2008	2009	2010	2011	2012
GDP growth (%)	2.0	2.2	2.6	2.6	2.5
CPI inflation (%)	2.3	2.0	2.1	2.2	2.1
Claimant unemployment	900,000	960,000	950,000	930,000	920,000
Source: HM Treasury					

Actual outcomes, 2008–2011				
	2008	2009	2010	2011 (average so far)
GDP growth (%)	-1.1%	-4.4%	1.8%	0.2%
CPI inflation (%)	3.6	2.2	3.3	4.4
Claimant unemployment	906,000	1,528,000	1,497,000	1,511,000
Source: ONS				

the OBR was created. Growth in the second half of the year was lower than expected, and the OBR's report at the time of the March 2011 budget further downgraded growth expectations for 2011. Other findings from the OBR's forecast evaluation report suggest that it underestimated the course of RPI and CPI inflation for 2010, and overestimated likely growth in productivity.

So how accurate are forecasts?

From a quick look through the output of a few of the main providers of economic projections, it seems analysts have a mixed record, particularly in the recent years of economic uncertainty. When the economy is running 'business as usual', forecasts can be fairly reliable, as stability allows experts to look at small changes in a limited range of variables and predict their influence on the overall picture. However, when the economy is as unpredictable as it has been over the last three years, with a large range of variables and external factors with a large influence on the domestic outlook, it is best to take forecasts with a pinch of salt.

This is especially true the further into the future you look. Predictions six months into the future tend to have a respectable degree of accuracy, even taking into account an unstable financial climate. Beyond this, however, forecasts more than two quarters into the future are open to significant doubt, and beyond a year in advance they sometimes represent little more than best guesses. Analysts are currently predicting a gradual return to a sort of normality over time, but this is a typical stance during a crisis, and may yet be preceded by a second recession. The predictions of recovery will come right at some point, but sadly they have not yet done so over the past few years.

But in the context of pay setting, uncertainty over longer-term forecasts need not have too large an effect. Pay negotiations are determined by a range of factors around employer affordability, the market and a series of economic indicators. Many of these economic indicators are at least as useful looking backwards as forwards. The retrospective nature of pay reviews means that if the previous year's award differed significantly from inflation, discussions would likely focus on an element of catch-up for employees or claw-back for employers, at least as much as the future course of inflation. Similarly, when deciding what settlement levels are viable, employers are likely to give affordability in the present moment greater consideration than predictions for GDP and the implications they present for future financial performance.

That is not to say that forecasts are currently of no use – having an idea of likely future trends is invaluable, and even a reasonably reliable look six months into the future can have a large impact on pay outcomes. But with so many chaotic variables influencing the economy at present, medium- and long-term forecasts should be treated with caution. As the economy returns to a more 'normal' state, they will become more reliable once again, but for now should be treated as a guide rather than a manual.