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**THE CASE FOR MAKING ECONOMIC
FORECASTS:
ST. OFFSET AND ANNUAL PROJECTIONS**

by

Murray Weidenbaum

OP 50

December 1985

THE CASE FOR MAKING ECONOMIC FORECASTS:
ST. OFFSET AND ANNUAL PROJECTIONS

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Every profession must have some outlet for fun and games. For economists, it has become forecasting the economic growth rate and the pace of inflation for the next quarter. Because of the magnitude of resources devoted to that task -- and the widespread dissatisfaction with the results -- I feel compelled to present a warning about pinpoint accuracy.

Some years ago, one of my neighbors in St. Louis remarked that the Mississippi River was exactly 1,000,008 years old. How could he be so sure? It turned out that just eight years previously, he had heard the state geologist set Old Muddy's age at 1 million years.

Candidly, we must acknowledge that our ability to make quarterly forecasts of the American economy is on a par with my neighbor's capability to pinpoint the age of the Mississippi. Modern computers can generate numbers far more rapidly than our capacity to use them for making economic predictions. Time and again in recent years, projections of economic growth and inflation for the next three months have been off both in terms of direction of change as well as magnitude -- and so substantially as to be

Note: The author is indebted to Richard Cook for helpful research assistance in the preparation of this paper.

worse than useless. These short-term estimates are often both misleading to the users and destructive to the general reputation of economists.

Yet I do not counsel my fellow economists to rend their garments, don sackcloth and ashes, and recite from the Book of Lamentations. There is a lot that we do know about how an economy operates.

For one thing, there is near universal agreement in the economics profession on microeconomic matters that is not appreciated by the public. For example, clamp a ceiling on rents (albeit from the most altruistic motive) and you will produce a shortage of housing. Indeed, as a general proposition, artificially depress the price of any good or service, and you will soon find that more people will want to buy and consume the item than are willing to produce and sell it at that price. That elementary bit of economic understanding continues to have powerful applications in policy making.

At the macroeconomic level, the results of any one policy action -- such as cutting income tax rates or slowing down the growth of the money supply -- are harder to gauge. The basic reason is that so many other factors are at work at the same time. Unlike experimenters in the physical sciences, economists (and other social scientists) cannot hold "everything else" constant.

Thus, increasing the money supply is likely to lead to a higher level of nominal Gross National Product. But other factors simultaneously could cause a slowdown in the velocity of money that would negatively influence the level of GNP. Those two results -- more money available to the public but a slowdown in the desire to use it -- would tend to offset each other. Forecasting the performance of the economy requires taking into account a

great number of monetary, fiscal, industrial, international, and other influences.

Over a period of a year, however, many of these specific influences tend to offset each other. That is why humorists in the profession contend that St. Offset is the patron saint of economic forecasting. Indeed, the record of professional forecasters is much better at projecting a calendar year ahead than the next three months. Looking back over the last few years, I contend that annual forecasts of GNP have, on balance, served a useful purpose for business and government decision makers.

In late 1982, for example, most professional forecasters projected a substantial increase in the economy's growth rate -- typically from a decline of 2 percent in 1982 to a positive expansion in the neighborhood of 3 percent in 1983. Successive revisions in the data complicate any comparison of forecasts and actuals. Historical economic statistics are revised so frequently that one wag lamented, "The past is as uncertain as the future." Nevertheless, the actual growth in 1983 of 3.7 percent was not fundamentally off the mark. Thus, economic forecasters in late 1982 were essentially right in projecting that 1983 would be a period of reasonable growth compared with the negative trend of 1982. Those who relied on that economic assumption were not misled.

Likewise, the popular projection in the fall of 1983 was reasonably helpful. Forecasters generally anticipated a substantial acceleration in the growth rate to 5 percent or more in 1984. The expansion for the year almost reached 7 percent. The most recent experience was quite similar. Last fall, virtually every forecaster predicted a major slowdown in economic growth this

year, at one-half or less of last year's rate -- and we surely delivered. The actual figure, it now appears, will be in the neighborhood of 2 1/2 percent.

Like my neighbor in St. Louis, if you anticipate pinpoint accuracy, you will be disappointed. But prevailing economic forecasts have been helpful in indicating general directions and trends for the year ahead.

A More Formal Analysis

Let us more formally examine the track record of economic forecasters in the United States for recent years. First, let us examine the relative accuracy of the prevailing private-sector forecast. As we will see, the impressionistic survey that I have just presented holds up tolerably well. Then we will compare that performance with the federal government's official projections.

Table 1 shows, for each of the last eight years, the composite projection of real growth by the 50 leading professional economic forecasters who comprise the Blue Chip Economic Indicators. The forecast made in the month of October of the prior year was selected because it is typical of the starting point for company planning and budgeting for the year ahead. For the eight years for which data are available, the average absolute error came to 1.2 percent. The poorest performance came in 1982, when the forecasting fraternity missed the direction of change and the resultant forecast error was by far the most substantial of the period.

Now let us compare, for the same period, the official economic projections by the administration then in office (see Table 2). We must acknowledge the fact that they are published several months later, typically in late January and occasionally in early February. But, given the fact that these numbers are heavily relied on in preparing the revenue and expenditure

Table 1

COMPARISON OF BLUE CHIP PROJECTIONS AND
ACTUAL CHANGE IN REAL GNP

Calendar Year	Percent Change in Real GNP		
	Blue Chip Forecast	Actual	Forecast Error
1977	4.9%	5.5%	-0.6%
1978	4.3	5.0	-0.7
1979	2.7	2.8	-0.1
1980	-0.2	-0.3	+0.1
1981	0.9	2.5	-1.6
1982	2.2	-2.1	+4.3
1983	3.2	3.7	-0.5
1984	5.1	6.8	-1.7
Average Absolute Error.....			1.2%

Source: Blue Chip Economic Indicators and U.S. Department of Commerce

Table 2

COMPARISON OF ADMINISTRATION'S PROJECTIONS AND
ACTUAL CHANGE IN REAL GNP

Calendar Year	Percent Change in Real GNP		
	Administration Forecast	Actual	Forecast Error
1977	5.2%	5.5%	-0.3%
1978	4.7	5.0	-0.3
1979	3.3	2.8	+0.5
1980	-0.6	-0.3	-0.3
1981	0.9	2.5	-1.6
1982	0.2	-2.1	+2.3
1983	1.4	3.7	-2.3
1984	3.3	6.8	-3.5
Average Absolute Error.....			1.4%

Source: U.S. Department of Commerce and various annual federal budgets.

estimates in the federal budget, the economic assumptions are usually agreed on well before their publication. In any event, the average error during the past eight years came to 1.4 percent, a little higher than the Blue Chip experience. The error in 1982 was substantial, but not nearly as large as the Blue Chip record. The large discrepancies in 1983 and 1984, in contrast, were much greater than the Blue Chip projections. I refrain from any editorial comment as to whose scenario was so rosy.

How about inflation? The common conclusion is that economists have done even more poorly on this score than in projecting real growth. Let us see. Table 3 compares the Blue Chip projections of the GNP deflator with the actual results for the last eight years and also with the official projections. A few surprises are in store for us. First of all, the average private forecaster did about as well on inflation as on economic growth (1.1 percent average discrepancy compared with 1.2 percent for the change in real GNP).

Second, and perhaps more surprising, the record of an administration in office in Washington tends to be a tad better than the prevailing private inflation forecast (off by 0.9 percent, on average, compared with 1.1 percent). Of course, no statistical significance can be attributed to that difference -- and that is what I find to be so significant.

Conclusion

Neither public nor private projections of annual U.S. economic performance qualify for the Guinness Book of World Records. Nevertheless, over the years and on average, the projections turn out to be close enough to reality to serve as a useful guide to government and business planners and decision makers. As for quarterly projections, I believe that we should seriously consider abandoning the practice until the state-of-the-art improves substantially.

Table 3

COMPARISON OF ADMINISTRATION'S AND BLUE CHIP PROJECTIONS
ACTUAL CHANGE IN THE GNP DEFLATOR

Calendar Year	Actual	Blue Chip		Administration	
		Forecast	Error	Forecast	Error
1977	5.8%	5.6%	-0.2%	5.6%	-0.2%
1978	7.4	6.0	-1.4	6.1	-1.3
1979	8.6	7.3	-1.3	7.7	+0.9
1980	9.2	8.5	-0.7	8.9	-0.3
1981	9.6	9.1	-0.5	10.5	+0.9
1982	6.0	7.8	+1.8	7.9	+1.9
1983	3.8	5.7	+1.9	5.2	+1.4
1984	3.8	5.0	+1.2	4.2	+0.4
Average Absolute Error			1.1%	0.9%	

Source: U.S. Department of Commerce and various annual federal budgets.