

Looking into the Crystal Ball - Making Forecasts

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The Bank of Thailand's Monetary Policy Committee (MPC) has recently published a new forecast for economic growth ranging between 0-2 percent in 2009, a sizeable downward revision from the previous formal announcement in October.

Research houses, government agencies and the private sector also issued forecasts, which varied somewhat in figures but unanimously pointed towards a slowdown in 2009.

Forecasts have an important bearing on the decisions of consumers and investors, particularly when they are gloomy. While pessimistic forecasts can be a blow to confidence, optimistic forecasts can act as the light at the end of the tunnel, thus helping avoid panic. However, overzealous forecasts not only could lead to policy missteps but also loss of the forecasters' credibility. Elements of both art and science are crucial in forecasting.

Mastering the art and science of forecasting requires three import elements: forecasting model(s), assumptions and judgments. Forecasting models generally consist of mathematical equations, postulating the relationships between 'variables' in the economy. These models vary in size and number of equations, as well as the components of each equation, that is, the 'variables' included. For example, a forecaster may perceive inflation as one of the driving forces behind consumption and thereby include inflation in the consumption equation in his model. Others may not do so. Moreover, some of the 'variables', such as domestic GDP and inflation, will be the outcome of forecasting while the others, such as oil prices and trading partners' GDP, may need to be assumed. Assumptions can be obtained from numerous sources - external forecasts, experts' assessments and financial markets, and therefore vary from one forecaster to another. An example would be the assumption on Dubai oil prices in 2009, which the MPC is assuming to be \$45 per barrel on average while other forecasters may assume otherwise.

Once the model and assumptions are ready, a forecaster incorporates assumptions into the model and subsequently produces scientific 'mechanical' forecasts on the basis of actual data. The art of forecasting entails incorporating judgments to fine-tune these 'mechanical' forecasts in order to safeguard against technical or model errors. Further fine-tuning can be done to

encompass particular attributes that could take a toll on the economy but are not already included in the model or assumptions. Good examples of these attributes are irregular and significant factors such as political events and natural disaster. These are usually not captured in the past data pattern.

Bearing in mind the different size, shape, colour and content of crystal balls, users should therefore handle forecasts with care.

Source: The Nation