DOES IT REALLY MATTER IF FORECASTS ARE RIGHT OR WRONG?

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In retrospective, world stagflation (1980-1982) and later world recession (1985-86) in the 1980s affected Malaysia's economic performance. During the first half of the 1980s, despite weak export demand and falling primary commodities prices, except petroleum, Malaysia's economy grew at 5.1% per annum while its export at 6.2% per annum. But the growth was at a slower pace compared with that of the 1970s due to weak external demand, which caused a deflationary impact on GDP and export growth. Consequently, the growth in 1980-85 was largely domestic- rather than export-led. In addition, higher earnings from sales of petroleum, which was by far the most important export commodity of Malaysia in the 1980s partly, offset the deflationary impact of the external forces. But, in 1985-86, both domestic and external demand declined significantly. As a result, Malaysia's economic growth could not be sustained and went into deep recession. Again it faced with second negative economic and export growth of -1% and -6.0% respectively during the period. Malaysia, however, resumed its steady economic and export growth in 1985-90 at 6.8% and 15.9% per annum, respectively. This recovery, backed by strong global economic recovery, was mainly attributable to its restructuring program under the Industrial Master Plan (1986-90). The Plan indicated that with manufacturing-led growth, the economy is more resilient to cyclical changes in world economic activity. As for exports, in line with the Plan's structural change, its composition since the mid-1980s has been dominated by manufactures. The period was also marked by the government's liberal policy on favoring FDI as a means to accelerate the manufacturing sector growth, in particular, and the overall industrial development. In 1986-87 the government introduced the Promotion of Investment Act (1986) and the Income Tax Act (amended 1987). Ignited by the liberal policies, FDI, notably from Japanese and Asian NIEs investors, flows steadily into the economy in the early 1990s. This vitalizes the economic growth which grew at 8.4% per annum over the period 1990-1996. In July 1997, Malaysia economy once again being shaken by the Asian financial crisis and in turn depreciates ringgit: left a fatal effect on the record of a perfect growth. In percentage terms, the growth has fall from 8.6% in 1996 to 7.8% in 1997 and estimated a negative growth of 4.8% last year.

Much has been said about Malaysia's miracle economic growth. What should be of interest now is the accuracy of policy makers' predictions on the near-term prospects of the economy. Its prediction reliability should not be taken for granted and, in fact, should be analyzed periodically. In light of this and as an example we take Ministry of Finance's prediction records of Malaysia's economic growth. The review period in the evaluation of economic growth estimates and forecasts is 1985-1997. We evaluate the Ministry of Finance's forecasts of Malaysia's real GDP growth rate over the period 1985-1998. In determining the accuracy, comparisons are made of forecasts with actual annual percentage changes and of estimate with the actual annual percentage changes recorded the following year. Table 1.1 shows the Ministry of Finance's prediction (i.e. forecasts and estimates) and actual change of Malaysia's real GDP. In 1985, forecast of the GDP is 6.7% but the actual growth is -1.1%, meanwhile in 1987 the forecast for GDP showed a growth of 1% while the actual number is 5.4%. Against this background, this lead to an important question: Does it really matter if forecasts are right or wrong?

Most economists accept that beliefs about the future are an important determinant of economic behavior today. Some argued that forecast accuracy does not matter at all, if the difference in the forecast is marginal. Others pointed out that if forecasters' errors are consistently large and frequently wrong it may lead to inappropriate decisions being made, which could be costly. For example, firms may have lost economic gains, if they were to react to the modest growth forecasts, which later turned out to have been grossly underestimated. Similarly, firms could land themselves into financial difficulties if their investment decisions to expand were partly influenced by the buoyant growth forecasts, which subsequently turned out to be largely overestimated. Significant forecast errors could also lead to the adoption of inappropriate government policies, which could do more harm than good to the economy. For example, a one-percentage point error in forecasting the nominal GDP growth works out to be RM1.3 billion in error at current prices (UMBC, 1992). It remains that the task of forecasting economic growth will not be easier, in the wake of economic liberalization, financial deregulation and

globalization. Furthermore, the effectiveness of government policy depends very much on what people expect. An influential school of thoughts in macroeconomics, called the rational expectations school, argues that people form expectations on the basis of all available information, including information about the probable future action of policy makers. Proponents of the rational expectation approach claim that people on average have a good idea about how the economy works and what to expect from policy makers. Individuals and firms are aware enough of the monetary and fiscal policies pursued in the past that they could participate future policies and the effects of these policies on the economy with reasonable accuracy. Some individuals will forecast too high and some too low, but on average forecasts will turn out to be correct. In short, given a forecast, whether short-term or long-term, interest centers both on its impact for action and on its accuracy.

Reference:

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George T. McCandless Jr., Macroeconomic Theory (1991), University of Chicago, Prentice-Hall International.

Table 1: Forecasting, Estimate and Actual Trend For GDP, 1985 - 1999[1]

	Percentage Changes Over The Previous Year			% Error	
Years	Forecast	Estimate	Actual	Forecast - Actual	Estimate - Actual
85	6.7	5.2	11.1	7.8	6.3
86	6.0	0.5	1.2	4.8	-0.7
87	1.0	2.0	5.4	-4.4	-3.4
88	4.0	7.4	8.9	-4.9	-1.5
89	6.5	7.6	8.8	-2.3	-1.2
90	6.5	9.1	9.7	-3.2	-0.6
91	8.0	8.6	8.6	-0.6	0.0
92	8.5	8.5	7.8	0.7	0.7
93	8.0	8.0	8.3	-0.3	-0.3
94	8.2	8.5	9.2	-1.0	-0.7
95	8.5	9.6	9.5	-1.0	0.1
96	8.5	8.2	8.6	-0.1	-0.4
97	8.0	8.0	7.8	0.8	0.8
98	7.0	-4.8	?	-	-
98/1	?	?	-2.8	-	-
98/2	?	?	-6.8	-	-
98/3	na	na	na	-	-
98/4	na	na	-8.6	-	-
99	1.0	?	?	-	-

Note: 98/1, 98/2, 98/3 and 98/4 features the negative growth rates in the first, second, third and fourth quarter of this year.

Chart 1: Forecasting, Estimation and Actual Trend For GDP, 1985 - 1999[1]