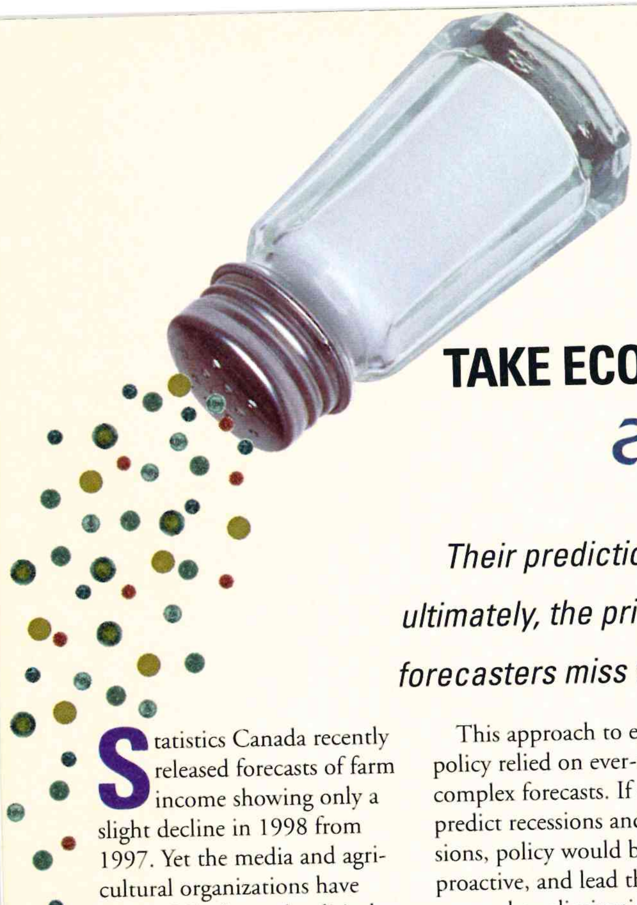

TAKE ECONOMIC FORECASTS WITH a Grain of Salt

Greg Mason

Their predictions have a significant impact on government, media and ultimately, the prices that drive the marketplace. But more often than not, forecasters miss the mark on what's really happening on Canadian farms.

Statistics Canada recently released forecasts of farm income showing only a slight decline in 1998 from 1997. Yet the media and agricultural organizations have successfully focused political attention on the need for a farm rescue package. This latest Statistics Canada forecast seems out of step with what the agricultural industry is saying and the public can be forgiven for being a little skeptical about the need for farm bailout. Most industry experts are convinced that many farmers are in serious trouble. What gives? Is the industry wrong? Are the forecasters wrong? To understand why economic forecasts go awry, we need to delve into how they are made.

Economic forecasting remains a relatively recent activity within the longer span of economics and has only become common since the Second World War. With the ascent of Keynesian economics came the idea that government could and should intervene in the economy.

According to this view of economic policy, during a recession, government should reduce taxes and incur deficits to support an increase in public spending. During expansions and inflation, government should raise taxes, lower spending and run surpluses.

This approach to economic policy relied on ever-more complex forecasts. If we could predict recessions and expansions, policy would become proactive, and lead the way to a complete elimination of the boom bust cycle, or so the theory went.

This view of the world fell apart in 1970 when "stagflation" emerged. No one predicted the coincidence of high levels of unemployment and inflation and this was not theoretically possible within the traditional Keynesian framework. Milton Friedman has also shown that how central banks set interest rates is important for managing inflation and growth.

This failure of forecasters to foresee the combination of high unemployment and high inflation was a sharp blow to economists. Throughout the '70s, '80s and into the '90s, oil price inflation and two recessions have shaken the confidence of economic forecasters. What does that have to do with forecasting and farm planning? In simple terms, when the world operated within national economies, the Keynesian framework held and predictions could be quite accurate.

But oil price shocks and, more recently, the crisis in Asia intruded on this comfortable world. As the world has changed and global forces have come to dominate national economies, forecasting frameworks have been constantly shifting. The crises in Mexico, Asia and most recently in Brazil and Russia, show that geo-political trends have become a significant factor in economic forecasts.

Prediction becomes difficult when several global forces coincide to produce a crisis. To this point, forecasters have not been able to discover ways to introduce these unpredictable changes into their neat models.

To return to farm planning, take hog prices as an example. Two years ago, booming Asian demand led many to invest heavily in this industry. The worldwide rush to meet this demand created significant new supplies. The Asian crisis led to a collapse in markets and prices, as well as the current crisis that producers in Canada are experiencing.

Some farmers may be disappointed the government encouraged them to invest in this industry. But each business makes calculations based on it's estimate of what the future will hold. Grain farmers are currently facing high levels of uncertainty about the future of prices across all cereals and oilseeds. Hog producers see prices edging upward. Can forecasts be of any help? Probably not.

At this time, everyone should doubt economic forecasts. For the past two years, economists have consistently underestimated the strength of the North American economy and overestimated the recovery in Asia. The Euro dollar was launched with fanfare and a prediction that it would become an immediate competitor to the U.S. dollar. Well The Euro has slumped, the U.S. dollar remains the currency of choice and the Dow is over 10,000 points.

The wise farmer realizes that current forecasts are "all over the map." Global trends are complex and always shifting. Farm plans need to account for increasingly wide ranges of possibilities. Focus on extracting every cost advantage, use pessimistic price scenarios, and diversify to the maximum feasible. These are old fashioned and simple rules, but in these times, basing any investment plan on current economic forecasts is foolish.

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