A year ago at this time and in this setting, the fashionable view was that economic recovery had not yet begun and as it unfolded in 1983 it would be very moderate. As we now know, that view was wrong inasmuch as the recovery which began in December of 1982 has turned out to be twice as strong as most people expected in spite of rather high interest rates that were expected to be a restraining force. Those who treat monetary policy as a major element in their forecasting were less surprised than others. A sustained spell of very rapid money growth signaled early on a relatively strong recovery, at least in the first two or three quarters.

Now we find ourselves looking ahead to 1984-85 in which the consensus view holds that economic recovery will continue through 1984 at a more moderate pace, say, about 4% compared to the 6% or 7% we have experienced in the past four quarters. Inflation is expected to accelerate, particularly in the second half of the year and grow worse in 1985. Interest rates are expected to increase along with the maturing of the recovery and the rise of inflation.

Forecasters of a more cynical bent point out that 1984 is a presidential election year and, therefore, nothing can be allowed to go wrong, even though history does not especially support that view.

Will the fashionable view be surprised again by the actual events of 1984? Before I answer that question, I would like to discuss for a moment the pitfalls of consensus forecasts.

Pitfalls of Consensus Forecasts

As one who has for long tried to divine the future, my ear is naturally sensitive to those protestations that I frequently hear from businesspeople—those forecasts that are hazardous if not futile. Some adamantly refuse to engage in such a nefarious activity. Nevertheless, these same managers make decisions and engage in strategies that hinge critically on very specific assumptions about future conditions which are external to their business and which they insist they cannot forecast. These implicit forecasts run the full gamut from what might happen in a narrow product market to macro-economic developments arising from monetary and fiscal policies. Moreover, those decisions and strategies often involve a risk higher than assumed by the business decision maker until an event occurs which sharply contradicts his implicit assumptions.

Recall for a moment some of the surprises of the past that were extremely costly to those whose business strategies and decisions failed to anticipate events in a timely fashion. There was the rapid runup in oil prices in 1973-74, the collapse of the high multiple equity market in the mid-1970s, the extraordinary volatility of financial markets in 1979 and 1980 ending with the destruction of the bond market, and the strengthening of the dollar in the exchange markets which persists to this day. Then there was the deep recession which began in July 1981 and ran for nearly 18 months. There was a dramatic reduction in the rate of consumer price inflation, from almost 15% at its peak in 1980 to an average of less than 3% over the past 12 months. And last year we saw a very sharp rise in the value of financial assets producing a rapid decline in nominal interest rates. These events seem to underscore the futility of forecasting the future.

Dangers of Forecasting

Point-to-point predictions of financial and economic change in terms of timing and magnitude are exactly as dicey and difficult as the protesting businessmen often insist. For example, to predict that interest rates will be two percentage points higher, say, at the end of next year and then never again look at unfolding events until that year is up, fails to recognize the magnitude of the risk that such prediction implies.

The future comes upon us in small steps, and if we receive it that way and understand the theoretical and practical significance of each new bit of information, the future need not be quite as shocking as it is to those who fail to recognize the nature of unfolding change.

It is axiomatic in the literature that deals with major social, political and economic upheavals that the greater the surprise, the more entrenched is the expectation that the event will be repeated and the more forceful are efforts to protect against the same kind of loss that was incurred because of past surprises. But events are seldom repeated in ways which would validate extrapolations of history. Herein lies a potentially costly trap to business managers. Preparing for an event to occur again often means being ill-prepared for what actually occurs.

A case in point centers on the events of 1981-82. They provided significant opportunities for substantial financial gains that were missed by many portfolio managers. The seeds of opportunity were planted back in 1979-80. After the Carter Administration was surprised by the acceleration of inflation in 1978, they invoked a policy strategy which called for restraint without causing a recession. But since monetary policy could not provide the kind of consistent and moderate restraint needed to execute such a demanding strategy, we experienced a series of jarring stop-go episodes in each of those two years. The financial markets reacted violently to this apparent indecision and to the declining credibility of anti-inflationary policy. When the financial markets turned particularly chaotic in the first quarter of 1980, the Carter Administration responded by trying to put them in a straitjacket of credit controls. That ploy contributed to a 10% decline in real GNP in the second quarter of 1980.
the Administration abruptly removed the credit controls at the same time that a highly expansionary monetary policy fueled the economic engine. The result was a surprise of very substantial magnitude and one which was not, to the best of my knowledge, anticipated by anyone—at least not for the right reasons. Real GNP in the space of nine months turned around by 19%—from the 10% drop to a 9% gain—so that by the winter of 1980-81 inflation expectations knew no bounds in either nonfinancial or financial markets. Short-term interest rates climbed to 21% and long-term corporate rates were 17-18%.

**Decreased Use of Gapping**

This shock had a profound effect on the way in which financial institutions managed their total corporate portfolios. Gapping—borrowing short and lending long—which has been the essence of the banking industry for at least the past 2,000 years, has been substantially diminished. Maturities of assets and liabilities are now matched so that the earnings are derived from interest differentials rather than gapping. Long-term fixed rate obligations are avoided by many large financial institutions. Life insurance companies have similarly taken steps in product design to share risks with others in both assets and liabilities.

In the first half of 1981 there was a reasonable likelihood the monetary authorities would find it necessary to risk a recession in order to reduce inflation. But at that point, the probability was not so high as to warrant taking a large and speculative position in financial assets. Even by the summer of 1981, the probability that inflation would decline in the very near term had little credibility in the financial markets or with those who were tracking economic policy closely. But as we moved through the second half of 1981, it became increasingly apparent that we were in the early stages of an economic recession that would prove deep and run for at least a year, and, as it turned out, it ran for nearly eighteen months. So the probability that inflation would diminish and prices of financial assets would, therefore, rise was clearly increasing. And by the time we reached the first quarter of 1982, there was no doubt that the rate of return on real assets—everything from diamonds and gold to brick, mortar and machinery—was plummeting. At the same time, the financial markets behaved as though we were in the midst of an economic boom, with rates of return as high as 17-18% on high-grade corporate bonds and 14-15% on intermediate-term U.S. government securities. So, during the first half of 1982, there was a massive contradiction. And it could only be resolved by a rise in the value of financial assets and a reduction in their nominal yield. Nevertheless, the consensus view through the winter of 1981-82 and through the spring was that these yields would hold, that the equity markets would remain depressed and that long-term bond rates would probably pierce their previous highs some time during the second half of 1982 as the U.S. Treasury entered the market to finance the first part of its new, larger deficits.

But as we know now, the resolution of that contradiction came as a pleasant surprise to many portfolio managers, even though it would have been more pleasant for some of them had they not held back earlier in acquiring more financial assets at very low prices.

**Recent Past No Sure Guide**

The prevailing asset and liability management strategies reflect uncertainties about the future that were engendered by the disturbing events of the recent past. And they are premised on an implicit forecast that's biased by the conviction that the greater risk lies with a sharp rise of short-term interest rates so that they exceed long-term rates. In other words they expect an inverted yield curve most of the time. But in this respect it is instructive to observe that in the 60 years from 1919 to 1979 the yield curve is upward sloping—that is, long rates were higher than short-term rates—for 48 years, flat for five years and inverted for only 8 years. And at no time were the episodes of inversion longer than two years.

Yet it was inverted for three years from 1979 to 1981, and that experience provided a classic example for the consensus view that what happened in the recent past will certainly recur in the future. And it is very difficult for most people to break away from that view unless they possess superior information—that is, information that will in time invalidate the consensus view.

The practice of matching liabilities and assets is somewhat analogous to the use of index funds that followed the 1974 stock market debacle. But in that experience portfolio managers, exposed to objective performance measurements, found that investment judgments and selectivity won out over index funds.

Similarly, matching reduces risk, but it must also over time reduce performance compared to the use of good information which allows measured and prudent risks to be taken. Those who employ a maturities matching strategy in all aspects of their business do not really avoid risk. They must inevitably incur opportunity costs. Opportunity costs don't appear on a profit and loss statement, so many people assume they are nonexistent. But over time they will be reflected in the relative position and performance of each business. There is also the risk, recognized by many managers, that if rates should plummet, lenders would be left with the high-cost liabilities they used to fund assets—that is, loans which borrowers have paid off by borrowing elsewhere at the lower rates.

Those who focus only on matching and ignore opportunity costs assume they have less need to anticipate the surprises of the future because unexpected events won't damage their business much. And those who do adopt strategies based on explicit forecasts are likely to run with the consensus. The latter will seek information that seems to support and validate the majority view, and they discover that such information is available in great abundance, very often free of charge.

Then there are those who elect to take prudent but calculated positions against the consensus, and this group requires superior information which is not generally available, especially in the national media and surely is not free. But don't get the mistaken view that you can get more valuable information by paying more unless you are entirely confident of evaluating information. A consensus view suffers from a number of deficiencies. In the first place it's generally plausible, if only because it revisits the familiar past and, therefore, requires no challenging analysis. Second, it implicitly and naively claims that
there are no surprises in the future. A surprise is an event which is not anticipated by the majority of people in the marketplace. And, finally, the consensus discourages and intimidates contrary views. The media give widespread attention to the consensus view and thus provide the cohesion that links it together. The media are reluctant to risk losing readers and viewers by giving prominence to a view that is unlikely to be believed. For example, the forecaster who in 1979 said oil prices would decline in the early 1980s would have been considered a fool. Likewise, forecasts in early 1982 of a decline in the interest rates of the magnitude that actually occurred were considered bizarre by the consensus.

Consensus Can Err

One of the little known facts of the game of forecasting—and it’s one that can be documented—is that many events that surprised the consensus were correctly predicted by specialists and others who, because they had views contrary to the consensus, were given very little visibility in the marketplace. I speak here of people who correctly anticipated an oil price rise in the 1970s, a break in the equity market in 1974, the acceleration of inflation and the rise in interest rates in 1979-80 and the decline of nominal rates in 1982. Their timing was sometimes off, to be sure—a fatal shortcoming for day-to-day market operations. But what’s important in virtually every case is that it was the right analysis, the right theory, if you will, that was the basis of those forecasts. And where the timing was off, those forecasts could have and did produce either financial gains or smaller losses. If you wish to begin to anticipate the next surprise, you can best begin by identifying the weaknesses of the consensus view and considering the possibility of the opposite outcome.

To repeat my earlier comment, it is fair to say that the popular view today holds that inflation and interest rates will move higher during 1984—some have it in the first half of the year and others in the second half—and that those trends will worsen in 1985, culminating at some time in a cyclical peak. There are those who believe that inflation and interest rates will continue the familiar pattern of exceeding previous peaks.

Before I play devil’s advocate with this consensus view, let me tell you that our own forecast, on average, is in some respects similar to this consensus I just described, and it gives me no great comfort. It happens because at the moment we haven’t enough information to break away.

We expect that monetary policy will not remain sufficiently restrictive to induce more than a transitory slowdown in real economic growth in the first half of 1984. As the economy continues to climb in real terms and capacity utilization rises, inflation, as well as inflation expectations, will begin to rise especially as moderate price increases occur particularly in the second half of next year and further in 1985.

Efforts to cool inflation by monetary restraint run the risk of precipitating a recession by 1986. But throughout that cycle that lies ahead, neither inflation nor interest rates, in our opinion, will equal or exceed the peaks that we experienced in 1980-81 when inflation of our gross national product hit a quarterly high of more than 11%, the prime rate peaked in the neighborhood of 21% and long-term rates at 17-18%. This forecast presupposes a cyclical pattern that is different from the past inasmuch as economic policymakers do not allow inflation to exceed previous peaks. What I am saying is that the business cycle will be alive and well in the future since recurrent recessions appear to be the policymakers’ only means of slowing the rate of inflation. But since the inflationary excesses will not be permitted to match those of 1980-81, the long-term trend of average inflation will be downward.

Interest Rates and Inflation

Let me now play the devil’s advocate with the consensus view of interest rates and inflation and, in effect, challenge our own forecast. Monetary policy shifted in the direction of significantly less expansion in July. After growing for most of the previous year at an annual rate of 12-13%, it appears that money growth has been essentially flat since August. In our view, this slowdown constitutes a monetary shock to the economy. And it is even more deceptive because its implications for the economy are not highly visible to most people in the marketplace, especially those who are accustomed to measure monetary ease or restraint by changes of interest rates. But analytical techniques have demonstrated in the past a close correlation between changes in the rate of growth of money and changes in the growth of nominal income. Following a fourth quarter in which the economy is likely to be modest—real growth perhaps as high as 6%—a slowdown to a rate of only half that or less for three to six months is the probable outcome of this shift in monetary policy.

Our opinion at this time is that the fears of an aborted recovery will pass. But experience demonstrates that such a restrictive policy can overshoot the mark and sharply arrest the recovery by more than we are currently anticipating. Such a mini-recession, if I can call it that, could very well alter the pattern of inflation and at least delay any significant increase in prices with the attendant decline in inflation expectations as sales and order books suddenly stop growing. And it could also result in lower rather than higher interest rates in 1984. That surely would be a surprise.

The very high real interest rates that have prevailed since 1980 have not been adequately explained by anyone, and that lack of explanation provides no assurance that they will remain high indefinitely. There are a number of interesting, ad hoc explanations. I for one don’t personally believe that the large federal deficits explain more than a very small part of the present height of real interest rates, hard as that may be to believe.

The facts are that interest rates climbed to the relatively high real levels that we have experienced in the last three years before the deficits ever became a source of concern and discontent in the financial markets. In fact, interest rates peaked in the spring and summer of 1981 in nominal terms and moved lower till the early part of this year. Uncertainty about the future must certainly play a significant role in causing today’s high real interest rates. The unwillingness of many financial institutions to buy long-term fixed-rate obligations without some hedging protection provides pervasive evidence of a significant change in the attitude toward such instruments.

This protective posture reflects a substantial degree of skepticism about the ability or indeed the willingness of economic
policymakers to deliver on their too often repeated promises of reducing inflation and its corrosive effect on the value of financial assets. But this widely held suspicion may very well be the element that compels policymakers to deliver on their promises. Witness the quick response of short-term traders in the financial markets to evidence that monetary expansion has exceeded the Federal Reserve's publicly announced targets. The day when the Federal Reserve could pursue an ultimately inflationary trajectory in monetary growth without precipitating a quick discount in the value of financial assets ended more than four years ago. Deliberate disregard of these early inflation expectations in the financial market can only be voided by imposing once again the harsh constraint of credit controls accompanied by price-wage controls in the real economy. But only a minority of economists and past policymakers continue to argue in support of such action, given the widespread international evidence that it can only lead to chaotic conditions and widespread human distress.

**Conclusion**

Therefore, one can look toward a rising probability that even with intermittent cycle peaks in interest rates and inflation, the future will begin to become more certain than it has been as market participants come to realize, as Paul Volcker has insisted, that the Federal Reserve no longer has the degree of flexibility it once had and that inflation, on average, will be lower over the balance of this decade. If that in fact happens, the attractiveness of financial assets will increase. And as this occurs, the present financial management strategies that minimize both risk and gain should begin to unravel, and, in the process, there may be some casualties among those who believe they bore little or no risk as long as they believed inflation and interest rates would move higher.

Forecasts of the future have value only as they are monitored in light of the current events which will cause probabilities to ebb and flow. And such information has in the past and will in the future be of significant value to portfolio managers and business strategists. This kind of information is now delivered online, and its design and application will become more elegant with specific applications in the near future. It's available for your information.

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**ABOUT THE AUTHOR**

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