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Here's how to predict future oil prices

Experts use complicated formulas to predict the future price of oil. But commentator Justin Wolfers says he's got a simple do-it-yourself method that works even better.

Justin Wolfers (Wharton School, Univ of Pennsylvania)

TEXT OF COMMENTARY

KAI RYSSDAL: When we talk about oil prices, it's usually a futures contract that we're talking about. An agreement to pay a pre-arranged price for a barrel of oil at some point in the future, hence future contract. The art of the deal, though -- and the way to make money -- is to guess that future price of the world's most actively-traded commodity. Commentator and economist Justin Wolfers thinks he's got it all figured out.

JUSTIN WOLFERS: Important decisions about our family finances -- things like which car to purchase or where to choose to live -- all of it hinges on whether today's high oil prices are here to stay, or whether this is just a temporary blip.

And there are dozens of talking heads on TV, pontificating about the latest oil industry developments.

But in fact, you're more of an expert than any of these talking heads. Or you will be, when I give you my secret forecasting formula.

Here it is: The single best forecast of oil prices in one month, three months, or a year is -- [sound of drumroll] -- today's oil price.

With oil prices at exorbitant levels, I'm forecasting that next year's price will also be at . . . exorbitant levels. I'm not saying that prices won't change, but I am saying they're about as likely to go up as they are to go down. Let's call this the no-change forecasting rule. It won't work for everything, but it does pretty well for oil prices.

In fact, Ron Alquist and Lutz Killian, two University of Michigan economists, recently assessed the forecasting performance of the no-change rule. Amazingly, this simple rule did better than the average of dozens of professional forecasters! In fact, the no-change forecast was 34 percent more accurate at predicting oil prices in three months' time, and 18 percent more accurate at predicting prices in a year's time. While professional prognosticators might argue that this difference isn't statistically significant, it sure is embarrassing.

Others ignore the professional forecasters and focus instead on what futures markets are saying. But it turns out that even futures prices are not as accurate as our simple formula. Even sophisticated econometric models don't yield better forecasts than our simple no-change rule.

The truth is that forecasting oil prices is so darn hard that complicated formulae add nothing but complexity. And so the simplest forecasting rule also turns out to be the best. Don't you wish that all of economics was this easy?

RYSSDAL: Yes, we do. Justin Wolfers teaches at the University of Pennsylvania's Wharton School of Business.