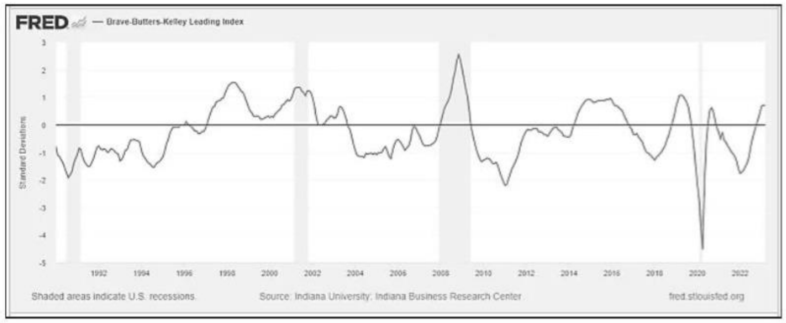
Where is the economy going?



Nobody can accurately predict the economy's future performance – at least not consistently. But that doesn't stop economists from trying. In one of their attempts, economists working for the Federal Reserve Bank of Chicago transformed 490 measures of economic activity into an index meant to predict future monthly GDP growth. They called it the Brave-Butters-Kelly Index and it appears in the accompanying graph.

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If the index worked perfectly, the economy would enter a recession about eight months after the value listed on the y-axis dropped below -1. As you can see, for the four recessions depicted in the graph with shaded areas, the index correctly predicted only the first and last of these recessions. So, the index has a mere 50 percent success rate.

Given the failure of the experts to derive reliable predictors of the economy's performance, people have turned to other, simpler ways to predict where the economy is going. In an article in U.S. News and World Report, Mark Reeth described nine unusual leading economic indicators. Each of these indices came with an intuitive story for why the index should give insight into where the economy is going.

For instance, the cardboard box index increases when more cardboard boxes are produced. The idea is that businesses order more boxes when they expect to soon be shipping more of their products (which happens when they expect to make more sales than normal). Two other indices capture the idea that people buy more luxury items when they expect the economy to do well. Quite obviously, people do not want to waste money on luxury items if they believe hard times lie ahead. One of these indices measures champagne purchases, and the other measures RV purchases. A different index measures consumer sentiment without being tied to a luxury good, as the last two indices were. The men's underwear index measures the sale of men's underwear. It relies on the notion that most men are willing to put off purchasing new underwear if they believe economically distressed times are coming.

Once people learn about these unusual indices, which are meant to predict the direction of the economy, they often begin to form their own rough and ready leading economic indicators. If you think about it long enough and pay close enough attention as you go through the day, you will encounter situations that will help you form your own leading economic indicators. For instance, when I went to get an oil change, the store manager said that they were overwhelmed with business. He believed that people were putting off buying new cars and were getting their old cars fixed instead. He attributed their behavior to their fear of where the economy was going and to their reluctance to pay the newly increased interest rates on car loans. This manager uncovered an attitude among consumers that will show up much later in the economic data when car companies report their data on monthly car sales.

Many of us would be better off if we knew where the economy was headed. If, for instance, we knew a downturn was coming, we might save more now to have financial cushions to weather the hard times ahead. This would mean we might forgo an expensive vacation or put off purchasing a new car. Economists have been unable to create indicators that make consistently accurate economic forecasts. But we can all look at the economists' leading economic indicators, along with the ones we can construct from our own experiences, to provide some intuition for how the economy will perform. These indicators can help us make better decisions when the outcome of these decisions depend on whether these forecasts are accurate.

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