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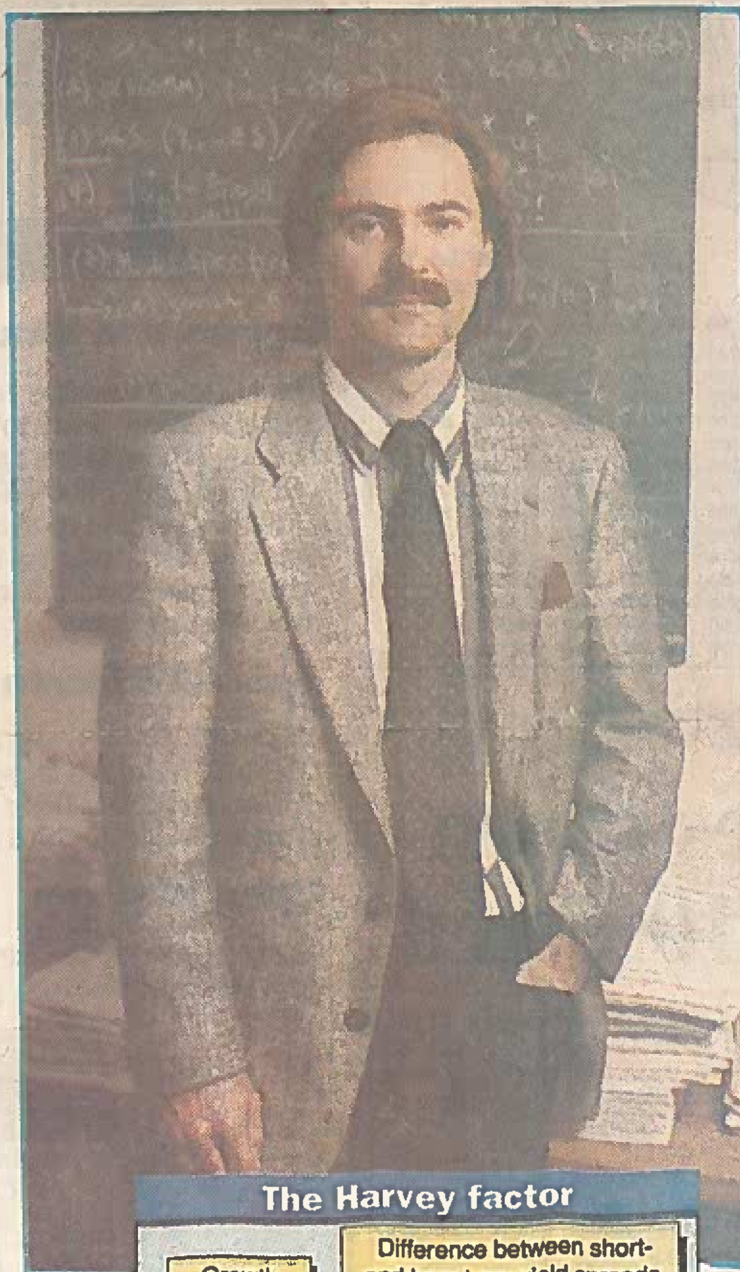
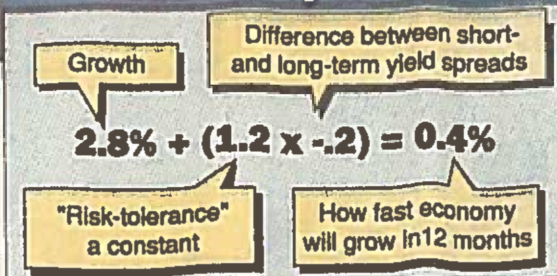
Economic forecasting made easy by professor





LOOKING AHEAD: Campbell Harvey has compiled a record of accurate, economic forecasting, using a model based on interest rate spreads.

By Jonathan Ferguson
TORONTO STAR

OTTAWA — Campbell Harvey is the sort of Canadian that blue-chip American economic forecasters wish had studied science or law — anything but finance.

The Toronto-born Duke University professor has developed a model that forecasts the ups and downs of the U.S. and Canadian economies with uncanny accuracy.

And it's easy to use to boot, requiring little more than a calculator and the financial pages of a daily newspaper.

Such a tool is invaluable to investors and savers trying to determine where to park their funds for the best returns on one hand, and how to cushion themselves from an economic downturn, on the other.

Harvey, 31, has used his formula to compile the kind of record that leaves the other forecasters panting with envy.

It's based on the notion that you can predict consumer confidence by watching the gap between short-term and long-term interest rates.

As consumers become more worried they buy longer-term investments for security. As the economy picks up, they buy things with shorter terms to catch the highest possible rates for the shortest period of time.

It's that simple. Consider some recent predictions stemming from the model:

☐ After the stock market crash in October, 1987, Harvey bucked the trend by forecasting robust 4 per cent growth for the U.S. economy in 1988. Many others called for a recession. He was almost bang on the mark.

☐ Harvey predicted a "soft landing" for the U.S. economy well in advance of the consensus. His model is signalling growth of 1.7 per cent from the third quarter of 1989 to the third quarter of this year. The

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Swings in economy forecast

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consensus has since become 1.5 per cent.

That success has helped him win rave reviews from some leading economic thinkers and publications south of the border.

"The relatively simple and seemingly clear application of this model makes it very distinct from others," Harvard economist John Kenneth Galbraith says of his fellow Canadian's work.

"Anything that promises to help forecast the economy with accuracy and reliability is solid work."

New York Times economics columnist Leonard Silk, Business Week, Barron's and the International Herald Tribune have all featured Harvey's work as the model worthy of attention.

The model basically revolves around the notion that the bond market has the ability to forecast growth. Governments and companies are active in bond markets, which they use to raise money.

Harvey said only a pocket calculator, a newspaper and some data from his research paper are needed to use the single-equation model, based on the spread between interest yields on short-term and long-term treasury bonds.

"It's a simple model that any investor can use," he said in an interview from his office at Duke's Fuqua School of Business, in Raleigh, N.C., whose faculty he joined after completing a PhD in finance at the famed University of Chicago.

"It captures so much information about what is happening in the economy that you can predict where it is going.

"There aren't a lot of complex equations and detailed analyses to confuse people."

The key is the so-called "yield curve" difference between short- and long-term rates. Indeed, it's the only variable in the model.

"Interest rates are really interesting," Harvey said, explaining that he began to think about how rates can be a "powerful tool" to make economic forecasts while completing an M.B.A. at York University.

After fine-tuning his ideas, particularly the notion that rate fluctuations summarize what people think is happening to the economy, Harvey headed to the University of Chicago.

"Most people show up not knowing what they're going to do," Harvey said. "I was convinced I had the ideas, knew exactly what I wanted to do, and it turned out well."

Not bad for a University of Toronto economics and political graduate who didn't take one business course until moving across town to York. Harvey financed most of his undergraduate studies working as a copy boy at The Star.

Harvey's thesis is that the yield curve indicates individual consumers' expectations about the business cycle and the economy as a whole.

Consumers, he noted, account for about two-thirds of the total economic output in both the U.S. and Canada, making them the most important force in the economies.

If they believe the economy will slow down or tip into a recession, Harvey said, they will transfer their money into longer-term investments such as bonds as a hedge against potential salary or investment losses.

That drives up the price of the bonds — Harvey prefers them to stocks because the market is less volatile — and reduces their yield to investors.

Short-term interest rates, which are generally below the rates on long-term bonds, move higher as the long-term bond yields move lower.

As a result, the yield curve flattens, or even inverts its slope.

If individuals believe an upturn in economic activity is around the corner, the opposite occurs. They shift their money from bonds into short-term investments, lowering short-term rates and raising long-term bond yields.

The yield curve responds by plotting along a steeper slope.

"All I've done is take this idea and put it in the context of a mathematical model," said Harvey, who enjoys playing the keyboards or a round of golf.