Economic forecasting made easy by professor

By Jonathan Ferguson
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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 too, 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 put 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 inveiver 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, which held 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.

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

Swings in economy forecast

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Given 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 said work.”

New York Times economics columnist Bernard L. 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 research papers 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 with the Office of Duke’s Fuqua School of Business, in Raleigh, N.C., whose faculty he joined after completing a Ph.D. in finance at the 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 is the only variable in the model.

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

After fine-tuning his ideas, particularly the notion that rate fluctuations communicate 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 science graduate who didn’t take one business course, much less across town to York. Harvey finished 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 recession, Harvey said, they will transfer their money into longer-term investments such as bonds as a hedge against potential inflation or investment losses.

That drives up the price of the bonds, which in turn moves the economy in the opposite direction.

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

In any case, Harvey believes 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.