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Editor's Comments:

ATL Research Director Bob Eisenbeis is quoted on his work with Dan Waggoner and Tao Zha.

The Economy: Forecasters' Vision Clouds During Turning Points

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Where are the good forecasters when you really need them?

Economists from the **Federal Reserve** Bank of Atlanta recently studied the past 16 years of The Wall Street Journal's forecasting surveys and found that economic prognosticators are at their worst when the economy is at a turning point, just when some sound advice on the outlook is most useful.

When forecasters were polled by the Journal in December 2000, none envisioned how aggressively the **Federal Reserve** would cut short-term interest rates during 2001 in response to a slowing economy. Only a handful called the 2001 recession. And in December of last year, not a single economist anticipated that gross domestic product, the nation's broadest measure of economic growth, would increase at an annual rate of more than 6% in the first three months of this year, as it did.

The study by the Atlanta Fed economists shows just how routinely turning points are missed. The study looks at economic predictions in the Journal surveys for a range of indicators and compares the predictions with what actually happened in the economy. The accuracy of the forecasts is gauged on a scale of 0 to 100, with 100 showing the highest level of accuracy and 0 showing the lowest level of accuracy. When the economy was purring along in the middle of an expansion, accuracy scores tended to hover between 60 and 80. But at turning points, they collapsed. For example, in July 1990, the start of the '90s recession, the accuracy scores fell to just 15. Last January, they fell to 17. And in July of 1987, right before the late 1980s stock-market crash, the scores fell to 38.

"Forecasting is hard," says Robert Eisenbeis, the Atlanta Fed's director of research, who co-authored the paper with Daniel Waggoner and Tao Zha.

This is more than just an academic question for the Fed. Most monetary-policy mistakes are also made at turning points in the economy, so it makes sense for economists to try to learn which economic-forecasting models perform best in good times and bad. To that purpose, the study goes beyond gauging the performance of the forecasters as a group. It also ranked the performance of 93 individual forecasters who took part in the survey over the 16 years studied. In addition, it shone its light on the Journal rankings themselves and took issue with some of the newspaper's methodology.

The Fed economists' list of the top forecasters over time is an eclectic group, including a former **Federal Reserve** governor, a conservative TV talk-show host and a crop of banking economists. Among current forecasters, Lawrence Kudlow, who co-hosts the CNBC television program "Kudlow & Cramer," received the top score for the average accuracy of his projections, at 74.9. That rating essentially means that Mr. Kudlow's projections typically outperformed 75% of other forecasts in any given period.

The Atlanta Fed economists placed an asterisk next to his name, however, because his best performances occurred in the late 1980s and early 1990s. He was then the high-profile chief economist at New York investment-banking firm Bear Stearns & Co. and a strong voice on Wall Street for supply-side economic thought. He left the firm in 1994 to receive treatment for alcohol and drug addiction and rejoined the survey only in 2000, first as an economist with ING Barings and then as an independent forecaster. "I'm sort of stunned by this Atlanta Fed thing," he says, adding, "I've had my ups and downs in life."

Among forecasters who have been in the survey for at least the past three years, David Resler, chief economist at the New York unit of Nomura Securities International Inc., was the top dog, with a rating of 67.8. Stuart Hoffman, chief economist at PNC Financial Services Group Inc. in Pittsburgh, was also among the top current forecasters, at 67.7. Lyle Gramley, a **Federal Reserve** governor in the early 1980s, was among the top forecasters when he was part of the survey from 1987 to 1995. Economists at big investment banks finished in the middle and bottom half of the rankings.

The Atlanta Fed economists designed their own method to rank economists, arguing that the Journal approach has some flaws. That approach calculates how far forecasts diverge from the actual numbers on a range of indicators -- from interest rates to GDP to inflation. It then calculates these errors as a percentage of the actual number. For instance, if a forecaster predicted that GDP would grow at an annual rate of 4% and it actually grew 5%, then the error is 20%.

Using this approach, some indicators can get extremely high weightings as the actual numbers approach zero. Last year,

for instance, when GDP hovered around zero, economists' growth estimates played a dominant role in the rankings.

The Atlanta Fed economists came up with a more elaborate statistical package to rank economists that, among other things, adjusts the weight on various indicators and seeks to put them consistently on equal footing. The Journal is considering whether to adopt some of their recommendations, which would change the outcome of the rankings in some cases, but not all.

In the latest rankings, the simple mathematical approach used by the Journal and the more complex approach used by the Atlanta Fed produced the same winner: Daniel Laufenberg, chief U.S. economist for American Express Financial Corp., the money-management arm of American Express Co.

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