Understanding the Basics of Economic Forecasting

When weather forecasts are inaccurate, we can usually change our plans with little consequence in the greater scheme of things. When economic forecasts are inaccurate, however, the consequences may be more significant. While making financial decisions does involve some guesswork, an educated guess—even with elements of uncertainty—may be better than making a decision with no forecast at all.

Unfortunately, economic forecasting, like weather forecasting, is far from an exact science. Even professional economists may strongly disagree on the direction of the economy at any given point in time, based on their interpretations of conflicting economic indicators. Although many factors are pivotal in assessing the economy, let's focus on two key points that may help you better understand where our economy currently stands, and where it may be headed in the near future.

Consumer Spending

Economic forecasters are always searching for storm clouds that might signal an economic downturn. Since consumer spending has historically accounted for about two-thirds of the economy, according to the U.S. Bureau of Economic Analysis (BEA, 2012), many observers have looked to "pocketbook" issues in search of primary clues about the direction of the economy.

Consumer cutbacks on spending are not usually the primary cause of a recession. Rather, consumers may buy more on credit, which leads to greater monthly payments. But at some point, consumers can spend only what their incomes will allow. When consumer debt rises, it becomes particularly important because of the impact of total consumer spending on our economy. It may also be helpful to understand the Federal decisions that lay the foundation for our overall economic climate.

The Role of the Federal Reserve Bank (the Fed)

Even the casual observer of business news knows that "Fed watching" is a serious activity in the financial and business sectors. You may be wondering, what it is that makes the Fed so important.

While consumers can affect the economy by spending according to their own situations and financial pressures, Federal policy decisions, such as fiscal and monetary measures, also have an effect on the economy. Fiscal policy, enacted by Congress in the form of tax and/or spending legislation, is the result of the political process and the prevailing political climate. In contrast, monetary policy is the

Copyright © 2015 Liberty Publishing, Inc. All rights reserved
Distributed by Financial Media Exchange

responsibility of the Fed, whose role is to evaluate all factors influencing the economy (individual, market, and government) and take action in attempts to keep the economy on an even keel.

The Fed can manipulate the flow of money in order to obtain a desired effect over time. However, the Fed's most effective short-term policy decisions that can manipulate the economy involve short-term interest rates. Consequently, the Fed can realistically have only one target: inflation. If the Fed perceives that prevailing forces will increase inflation, it can attempt to slow the economy by raising short-term interest rates. It does this based on the assumption that an increase in the cost of borrowing is likely to dampen both personal and business spending. Conversely, if the Fed perceives that the economy has slowed too much, it can attempt to stimulate growth by lowering short-term interest rates, the theory being that lower costs for borrowing may stimulate more spending.

The Fed walks a fine line in trying to maintain this balancing act. If it doesn't tighten the reins soon enough by raising interest rates, it runs the risk of uncontrolled inflation. If it fails to loosen them soon enough by lowering interest rates, the economy could plunge into a recession. An argument could be made that the primary goal of the Fed is to keep inflation low enough that it does not affect business decisions.

Personal Debt

By observing your own spending and debt burden, and that of your friends, relatives, and business associates, you may gain some insight into the short-term future of the economy. While by no means the whole story, this small segment comprises a significant chapter since it is the one factor that consumers exercise the greatest control over. When combined with a little judicious Fed watching (e.g., several interest-rate moves in the same direction may be an indication that the Fed is on a mission), you may have a fairly good basis for general economic forecasting and appropriate financial decisions.

Copyright © 2015 Liberty Publishing, Inc. All rights reserved
Distributed by Financial Media Exchange