

Problem Set #3: Macroeconomic Indicators

Revised: November 11, 2013

You may do this assignment in a group. Whatever you hand in should be the work of your group and include the names of all of the contributors.

1. *Cyclical businesses (20 points).* Rate each of the following businesses as not cyclical, cyclical, or very cyclical. Explain your reasoning.
 - (a) Machine tools (5 points)
 - (b) Grocery stores (5 points)
 - (c) Family practice medicine (5 points)
 - (d) Mercedes S-class sedans (5 points)

Solution:

- (a) Durable good, very cyclical.
- (b) Nondurable goods, moderately cyclical.
- (c) Service, not very cyclical.
- (d) Luxury durable good, very cyclical.

2. *Monthly indicators (40 points).* The idea is to apply some of the tools we've developed to establish the cyclical patterns of various economic indicators.

We'll use data from the St Louis Fed's [FRED](#). Download monthly data from 1990 to the present for industrial production (series INDPRO), nonfarm employment (PAYEMS), housing starts (HOUST), retail sales (RRSFS, starts in 1992), and the purchasing managers index (NAPM).

Construct year-on-year growth rates for each series. With them in hand:

- (a) Compute and report the standard deviation of each one. (10 points)
- (b) Compute and report the correlation of each variable with industrial production. Which variable has the highest correlation? Are any of them counter-cyclical? (10 points)
- (c) Compute and plot cross-correlation functions for each variable with industrial production. Which variables are leading indicators of industrial production? Which are lagging indicators? (20 points)

Solution:

- (a) See below. These numbers are for continuously-compounded year-on-year growth rates for the period starting January 1990. If you use some other growth rate, or a different sample period, your numbers could differ, but typically not by a lot.


Series	mean	std dev	corr w/ IP
Industrial production	1.98	4.27	1.00
Nonfarm employment	0.95	1.74	0.81
Housing starts	-1.81	20.56	0.57
Retail sales	2.00	3.42	0.81
Purchasing managers index	3.20	14.82	0.25

- (b) See last column above. All the correlations are positive in this case, so they are procyclical. The largest one is with employment, with retail sales a close second.
- (c) Cross-correlation functions below. The ones we used in class (and in the book) start in 1960, these start in 1990, so they're a bit different.



Back to the question. From the figure, it seems that employment is a lagging indicator, retail sales is leading, housing starts are leading (although the correlation is smaller than for retail sales), and the purchasing managers index is lagging (the correlation to the right is larger).

in absolute value than the correlation to the left, although you're free to use both).

For experts only: The figure was computed in R, a popular open-source statistics program. If you'd like to give it a try, save this pdf file, open it, and click on the pushpin: 

3. *Near-term economic conditions (40 points)*. You are delighted to have a summer internship at JP Morgan. Your first rotation: the foreign exchange trading desk. On your first day, the Managing Director gives you a small project to get your feet wet. Noting that currency markets are driven partly by macroeconomic news, she asks you to write a report summarizing the near-term prospects for the US economy, specifically the next two quarters.

You go (again) to FRED and download 6-8 of your favorite economic indicators. (If you're short of ideas, look at the Bloomberg [economic calendar](#) and the [resource page](#).) After collecting the data, you:

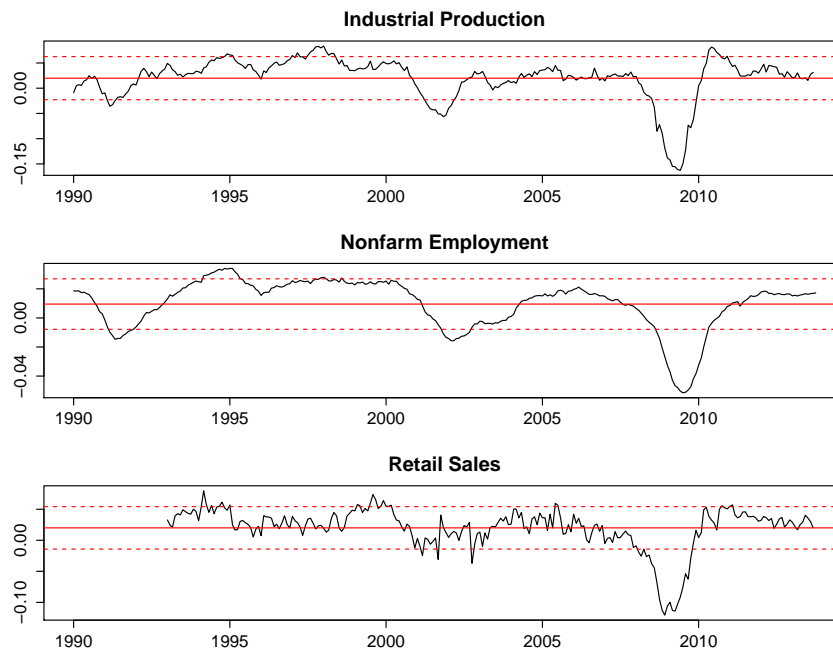
- Explain (briefly) why you chose each indicator. Comment also, if you like, on why you used the indicator, its growth rate, or some other "transformation." (10 points)
- Graph each indicator (suitably transformed) over some sensible sample period. What are the advantages of a long sample period? Disadvantages? Include on the graph lines representing the sample mean and plus/minus one standard deviation. (10 points)
- Summarize your findings in a business cycle scorecard, as outlined in the notes. (10 points)
- Overall, do they indicate above-average, below-average, or average growth of the US economy? What judgemental factors would you add to your analysis? Where do you think the US economy is headed over the next 3-6 months? (10 points)

Solution:

- You'll have to use your own judgement here. Part of the judgement involves which series to use. Generally you want to use series whose ups and downs are strongly correlated with those of the economy. Another part is whether to use levels or growth rates. Generally you want to use whatever works best; unfortunately, there's no mechanical method to determine that. With housing starts, for example, the growth rate looks pretty good right now, but the level still looks bad. Which is more informative? Hard to say, we haven't been in this situation before.

- (b) Generally a long sample period has the advantage of giving us more data: as a rule, the more data we have, the more precisely we can estimate patterns. But if the world changes, then the risk with a long sample period is that the old data does not represent current patterns. So there's a tradeoff. In the previous question we started in 1990, which seems like a reasonable compromise. We'll do the same here.

The plot below includes three of the series (their growth rates, actually) we looked at above with the requested lines added.



- (c) In the figure above, all three indicators show up as weak positive: above the mean, but below the mean plus one standard deviation. In a business cycle scorecard, that would look like this:

Indicator	Strong Negative	Weak Negative	Weak Positive	Strong Positive
Industrial production			x	
Employment			x	
Retail sales			x	
Summary	0	0	3	0

- (d) Right now, most indicators seem to suggest average to slightly above average growth. That could easily change, but that's how it looks now.

As for the future: the leading indicators suggest the same, so the mainstream view is that the economy will continue to grow at a steady pace.