

Book Reviews*

The Fortune Sellers: The Big Business of Selling and Buying Predictions

By William A. Sherden, New York, John Wiley & Sons, 1998, pp. 308, \$29.95.

The Fortune Sellers is a sharply worded, often sarcastic attack on forecasting that also at times is entertaining and informative. William Sherden has created a comprehensive reference for cost-cutting managers, doubtful clients, and those who simply want to take a poke at “experts.” If you’re a forecaster, the book will help prepare you for arguments you’re likely to face. But forecasters aren’t treated very sympathetically. Sherden wants to show that virtually all forecasting effort is wasted, and at times it’s even dangerous. In general, he presents a strong but, in the end, incomplete case.

The book has nine chapters, with an introduction and conclusion sandwiching seven chapters that examine forecasting in different subject areas. Sherden examines the subjects in a progression of “hard science” to complete “pseudo science.” He tackles weather forecasting, economic forecasting, stock market forecasting, population forecasting, technology forecasting, social forecasting, and corporate gurus. The order indicates where forecasting is most legitimate. Weather forecasting places first because it is based on physical laws and because forecasts have improved over time, showing “scientific” progress. None of the other fields, according to the author, can claim either.

In later chapters, Sherden widens his sights. In the first four chapters, he mostly evaluates explicit numerical forecasts: where the hurricane hit, how fast GDP grew, how much the stock market rose, whether birth rates rose or fell. In the last three chapters, he evaluates more qualitative predictions. In the chapter on social forecasting, Sherden illustrates the harm caused by bad “predictions” by looking at the consequences of ideas such as Manifest Destiny, the Domino Theory (with respect to Southeast Asia in the 1960s), and the inevitability of communism. The same chapter examines the records of trendspotters such as John Naisbitt and Faith Popcorn, who, Sherden argues, are mostly, if not entirely, wrong. The last chapter debunks theories of management science gurus like

Tom Peters (*In Search of Excellence*) and Bob Waterman. In most cases, Sherden dismisses these management scientists as either providing commonsense or complete nonsense.

The book continually returns to three ideas. First, all forecasters, regardless of field, are only about as accurate as an appropriately chosen “naive” forecasting system. For example, in economic forecasting, Sherden suggests that an appropriate benchmark might be forecasting next quarter’s GDP growth by using the previous quarter’s GDP growth. The book itself was born out of an evaluation that Sherden conducted of inflation forecasts, where he concluded that nobody outperformed the simple rule that tomorrow’s inflation would be equal to today’s inflation. The evidence that Sherden cites in his first four chapters is quite good, and, in general, fairly convincing.

Sherden’s second theme follows from the first. Because forecasters aren’t more accurate than a naive system, forecasters are charlatans—albeit sometimes unwitting charlatans—who are mostly wasting their clients’ money. His clearest examples appear in the chapter on stock-market forecasting, where he points out that, although market gurus don’t outperform the market, they do extract fees. Correct predictions are mostly the result of luck. He examines Elaine Garzarelli’s predictions, showing that, after her one spectacularly correct call of the market crash of 1987, she has performed worse than a system based on coin flipping.

Sherden’s third idea explains why forecasters are bound to fail. He suggests that it’s largely because all interesting systems are “complex, nonlinear, and chaotic,” and therefore “unforecastable.” These are the buzzwords of the relatively new field of complexity, whose spiritual home is the Santa Fe Institute. Sherden’s argument relies heavily on the complexity theorists’ idea that systems with interacting parts generate unexpected system-wide outcomes, and that these effects are nonlinear. A quantitatively small cause can, and will, lead to unexpectedly large consequences. He cites Adam Smith’s Invisible Hand (in which a society of individuals interested in only increasing their own welfare interact to produce increased welfare for all) as an example of a complex system generating unexpected results.

In his conclusion, Sherden advises users to consider five qualities that people can use to discriminate good forecasters from charlatans. Good forecasts are based on “hard” science, done with “sound” methods,

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by forecasters with “credible” credentials and “proved track records.” In addition, he advises forecast users to make sure that they don’t accept forecasts simply because they like a particular outcome, i.e., users need to be aware of their own biases.

The Fortune Sellers presents a strong but not airtight case against forecasters. Some of the claims are wrong and some of the arguments don’t hold water. Consider these two examples, drawn from the chapter on economic forecasting.

“After the October 1987 stock market crash, most economists predicted a severe downturn in the economy similar to what happened after the 1929 stock market crash...” (p. 55)

“...the [employment] survey does not take account of the fact that people give up looking for work after months of doing so with no success. Thus, a household full of people who quit looking for a job will be interpreted in the government’s statistics as fully employed.” (p. 76)

Neither of these statements is true. Virtually no reputable economist maintained the idea that a 1930s-style downturn was imminent after the 1987 market collapse. The late Joseph Livingston, who as a columnist for the *Philadelphia Inquirer* conducted the longest running survey of macroeconomic predictions (now being run by the Federal Reserve Bank of Philadelphia), summarized the results of his December 1987 survey this way: “The stock market crash didn’t impel the economists to conclude that a near-term recession is likely. Quite the contrary. Recession fears diminished.” (*Philadelphia Inquirer*, December 27, 1987.)

Sherden is similarly wrong about the employment survey. Discouraged workers explicitly appear in the monthly employment release, along with several different measures of the unemployment rate. In the measure typically used (U3), discouraged workers are neither counted as employed, nor in the labor force. U4 contains discouraged workers both in unemployment and in the labor force.

In other cases, Sherden is simply overzealous. He wants to show that economic statistics are unreliable. In support, he cites a revision to GDP growth of more than 20 percent. But the percentage revision in a growth rate is nearly meaningless. If growth were estimated initially to be zero, any revision would be an infinite percentage revision. Sherden appears to be looking at the data around 1992-93, when real GDP growth was around 1 percent. Thus the 20-percent revision in growth was likely less than 0.5 percent of real GDP.

The Fortune Sellers is also too quick to generalize. Sherden attacks all economic forecasting, but he only presents evidence about macro forecasting, and then,

only about real GDP growth and inflation forecasts. There are no examples of error rates for company sales or input-cost forecasts, which are arguably a more important part of a typical business forecasters’ product. Thus, there’s no direct evidence that much of economic forecasting is worse than a naive forecast. Further, he fails to point out that forecasters can add value even if they are only as accurate as a naive forecast. For example, a forecast based on an economic model can have a smaller error range relative to a naive forecast (a lower error variance), even if both forecasts have the same average error. The smaller variance can be a cost saver, by eliminating the need to plan for situations with extremely low likelihood. In some cases, especially in trying to create hedging strategies, the size of the range of errors can be more important than size of the average error. Finally, Sherden ignores the point that naive forecasting methods can’t answer the “what if” questions that take up so much of a typical forecaster’s time.

Many of the book’s arguments are less than convincing. For example, Sherden rebuts Faith Popcorn’s “cocooning” hypothesis by showing that consumer spending on decidedly “noncocooning” items such as travel and restaurants rose for several years. Yet he fails to show sales at video rental stores, home-fix-it shops, or even whether more spending on restaurants was on take-out, all of which might be consistent with cocooning. Nor does he show that the goods he cites grew more rapidly than consumer spending on average. Faith Popcorn may be completely wrong about cocooning, but Sherden’s evidence doesn’t show it.

The book is marred by many little, but jarring mistakes. Among the examples: Sherden says that the Commerce Department’s Bureau of Economic Analysis publishes consensus forecasts; they don’t. He identifies Joseph Schumpeter as a nineteenth century economist; he’s a twentieth century economist. He identifies Worms as the city in which Martin Luther nailed his ninety-five theses to a cathedral door; it was Wittenburg. Of course, none of these mistakes—or the others that litter the book—are individually fatal, but they cast a pall over all of Sherden’s arguments and are faintly ironic in a book that prizes accuracy so highly.

In spite of these shortcomings, *The Fortune Sellers* is a useful, entertaining book—the story of the ecological disaster that befell Easter Island is compelling and the chapters on stock market and population forecasting are good. If you’re careful with its claims, and you read *The Fortune Sellers* to stimulate your own thinking, you’ll be amply rewarded.

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The Accidental Theorist: And Other Dispatches from the Dismal Science

By Paul Krugman, New York, NY, W.W. Norton, 1998, pp. 204, \$25.00.

The Accidental Theorist is a lively account of current economics, with Krugman deflating many popularly held shibboleths on the “new economy,” globalization, calling it “globaloney,” along with supply-side economics, and corporate downsizing, among others.

Krugman, Ford International Professor of Economics at MIT, author, scholar, columnist for *Slate* and *Fortune*, presents a collection of his memorable shorter pieces from the past several years about subjects in the Dismal Science. Krugman understands that economics is important to everyone, not just to academics or practitioners. However, many otherwise well-informed and knowledgeable people are confused or muddled in their thinking about economic issues. Quoting Keynes, Krugman reminds us that economics is, “a difficult and technical subject, but nobody will believe it.”

He goal is to write in plain English about economics and to “... explode some plausible-sounding idea that happens to be false or to promote some implausible, disturbing idea that happens to be true ... (and) the additional purpose of demonstrating what it means to think, really think, about economics.” The book is divided into six sections covering jobs, supply side economics, globalization, growth, currency markets and speculation, plus a concluding section with a hodgepodge of what appear to be his personal favorites. Each section has three to five brief essays; the longest is just shy of a dozen pages and the shortest only three. To each of these essays, Krugman brings clarity of thought and sharp wit to the topic at hand.

One particularly fine essay is “Four Percent Follies,” a discussion of economic growth and monetary policy in the United States. His first point is that you need a model, preferably a simple model, to understand how the world works. The issue is the relation between monetary policy and economic growth. The model he proposes is described in an article by Joan and Richard Sweeney entitled “Monetary Theory and the Great Capitol Hill Baby-sitting Co-op Controversy.” The Sweeney’s were members of a baby-sitting co-op where couples agreed to sit for each other’s children on a rotating basis. To facilitate the operation, coupons were used entitling the bearer to one hour of baby-sitting time.

As Krugman points out, there needs to be a fair number of coupons in circulation. A couple might need to go out several times in a row, using coupons but not earning coupons. Coupons were also held in reserve for emergencies. After a while there weren’t enough coupons in circulation. Typical couples had a limited reserve of coupons and were reluctant to use

them. The fear was that they would not have coupons available for an important future occasion if they used them now. Opportunities to earn coupons were hard to come by because everyone was saving them. Eventually the co-op “...consisted of couples sitting glumly at home, unwilling to go out until they had more coupons, unable to earn more coupons because nobody was going out either. In short, the co-op had managed itself into a recession.”

Many of the group’s members were lawyers, so a regulation requiring each member to go out twice a month was tried. The few economists in the group eventually convinced the group that the problem was essentially monetary, and the group issued more coupons. The results were astonishing to the noneconomists. With larger reserves, couples became more willing to go out, which led to more opportunities to baby sit, which made more couples willing to go out, and so on. Then, of course, the co-op issued too many coupons, which lead to, well—you know what it leads to. So, as Krugman asks, how do you feel about the story?

According to Krugman, if your answer is, “Well, that was a cute story, but I don’t see what it can have to do with the U.S. economy,” you get a D. If your answer is, “What’s this all about? I want to talk about globalization and the new information economy, and he’s telling me about baby-sitting,” you get an F. By studying the model, “...we can gain some very important insights that many people who believe that they are knowledgeable about these things never do seem to grasp.”

Economists understand the role of monetary policy; most people don’t. Krugman writes with joy and humor about a variety of other economic topics and succeeds in dispelling much of the pernicious nonsense in the popular press that passes for reasoned thought. To a well-schooled economist, little in Krugman’s book will be groundbreaking, beyond the demonstration that it is possible to write with lucidity about technically complex subjects. Reading *The Accidental Theorist* will be time well spent. It is enjoyable because of the simple pleasure of reading well-crafted prose written about our technical and complex subject. The book will also be useful to economists to give to others who believe that they are knowledgeable about economics and are ready for the next level.

So the next time a friend or a noneconomist colleague advocates the return to the gold standard, abolition of the income tax, or is critical of the measurement of productivity, give them *The Accidental Theorist*. Be prepared for a debate if that friend is Jack Kemp.

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