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Abstract

The purpose of this paper, then, is to evaluate stock prices as a leading indicator of economic activity. Time-series analysis and the notion of "Granger causality" are used in this project to estimate relationships between stock prices and the economy, and to see if they are consistent with theory. In this paper, we will explore the following questions. First, does the stock market lead the real economy, in the sense that variation in its past values explains some of the variation in the real economy? Second, does the stock market "Granger-cause" the real economy, in which case past values of stock prices improve the prediction of future economic activity? And third, does the real economy "Granger-cause" the stock market, in that past values of economic activity improve the prediction of the stock market?

Recommended Citation

Comincioli, Brad (1996) "The Stock Market As A Leading Indicator: An Application Of Granger Causality," *University Avenue Undergraduate Journal of Economics*: Vol. 1: Iss. 1, Article 1.
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