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Comment on “Dating Turning Points for Austria: A Suggestion”

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This is certainly a high-tech contribution in the area of dynamic factor modeling in Austrian macroeconomics.

I would like to focus on the two main assumptions, which the model is based upon:

1. There are two distinct states of the economy: good and bad
2. The transition between the two states is called a ‘turning point’. It is of interest to predict these transitions.

Regarding the first point, I feel that there is no consensus in the economic literature. For one, dichotomization of the business cycle has a long tradition, including the classical contribution by Burns and Mitchell, which the current business-cycle chronology is still based upon. It is also reflected in the popular U.S. business forecasts, which tend to summarize the current state of the business cycle in the form of a traffic light—i.e., green, yellow, and red for good, intermediate, and bad. On the other hand, there is no reliable statistical backing to the claim that such a business cycle really exists, i.e. in the traditional sense, with the economy moving back and forth between clearly recognizable *peaks* and *troughs*. If that was the case, one might indeed label the phase from peak to trough as ‘bad’ and the remainder as ‘good’. However, visual impression as well as statistical methods do not yield any clear indication of cycles in real growth, beyond a known perceptory illusion: the human mind and eye tend to see cycles in random walks without any particular periodic structure.

Note that even the validity of the two-state model is not sufficient for backing the quest for ‘turning points’. The prediction of such turning points only makes sense if the lengths of cycles are relatively irregular, while the peak-trough and trough-peak phases have a certain minimum length and are sufficiently regular with regard to falling and rising, respectively. If any of these conditions is not fulfilled by economic reality, the pronounced target disappears. If cycles are regular, like seasonal cycles or sunspot cycles, peaks can simply be forecasted from previous peaks, and every lagging indicator is also some sort of leading indicator. Alternatively, if there is a chance that ‘recession’ or ‘recovery’ episodes are very

short, even short-run prediction may do better by ignoring such occasional dips. Finally, if the two types of episodes show prolonged sub periods with rising tendencies within recession or falling tendencies within recovery, labeling a current period as, for example, a recession may be severely misleading.

This could be an interesting feature of Kaufmann's research. If the basic assumptions allow more accurate modeling and prediction, this may be viewed as some sort of empirical backing for the two assumptions.

Finally, it is interesting to motivate why a *leading* indicator is possible at all. Apparently, the existence of a leading indicator requires that either there are variables in the economy that react faster to business-cycle innovations than GDP does, or that some economic agents process information faster and more accurately than economic forecasters do. Regarding the first possibility, one may surmise that adjustment costs play a role, such that increased demand does not *immediately* entail increased production. Regarding the latter option, I feel that it may be worth while to investigate where this information is formed. In other words, if consumer sentiment or business surveys regularly precede actual economic behavior, which type of information leaves such important marks on economic agents, i.e. information that is not visible from traditional economic variables.

References

Burns, A. F., and Mitchell, W. C. (1947) Measuring business cycles. National Bureau of Economic Research.