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Comment on

T. Adrian/A. Estrella, Monetary Tightening Cycles and the Predictability of Economic Activity

by

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Content

1. What the paper does?

2. Critical assessment, open questions and extensions

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1. What the paper does?

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Procedure

(1) **Identification** of monetary tightening cycles with monthly data on federal funds rate since mid 1950s

(2) **Forecast** of real activity (NBER recessions (discretionary rule), cumulative unemployment rate (mechanical rule)) following tightening cycles end with financial indicators

- Federal funds rate
- Ex-post and ex-ante real interest rate
- Real interest rate gap
- Term spread

(3) Empirical methodology:

- discriminant analysis
- logistic regression

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Results

- Yield spread predicts all recessions but one and does even better job in predicting the unemployment rate
- Other financial variables perform (significantly?) worse
- Results irrespective of statistical specification
- Statistical reasoning: spread model delivers clear-cut discriminant condition ($\rightarrow$ positive vs. negative spread)
- Future performance of the spread?

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2. Assessment, open questions and extensions

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Assessment

- Old (interesting) question with new data, methodology and variables
- Good: monetary policy (tightening) via ff
- Definition of "monetary tightening"
  - Why only ff increases between 6 and 12 months?
  - Figure 1: Problems in the mid 70s and beginning of the 80s (turbulent, uncertain times, exogenous – transitory/permanent – shocks)
- Only cyclical downturns / unemployment, but no split into cyclical and other components
- Econometrics
  - Generated variables and errors-in-variables-problem (Pagan, 1984)
  - Endogeneity / simultaneity problem and expectations of financial markets

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Open questions

- Why the first step?
- Why only bivariate analysis?
- State of the economy / general economic circumstances not taken into account (especially relevant in case of shocks, 70s, 80s)
- Methodological problems:
  - selection of fixed lead time (1 ½ years) of indicators
  - same lead for all recessions
  - methods rely on ex-post realized recession / downturn dates to examine the performance of the indicators
- Alternative : Markov Switching (e.g. Lahiri/Wang, 1996; Ivanova et al., 2000)
- Real-time problem and forecasting!!?
  - Interest rate gap
  - Real activity

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Extensions

- Other financial indicators
  - Long-term interest rates
  - Other spreads
  - Stock market variables
- Sensitivity of results
  - Other methodologies (e.g. Markov switching)
  - Other definitions of real activity (e.g., output gap, different timing assumptions)
  - Other countries

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Minor points

- Financial indicators: better end-of-month than average
- Discriminant conditions?

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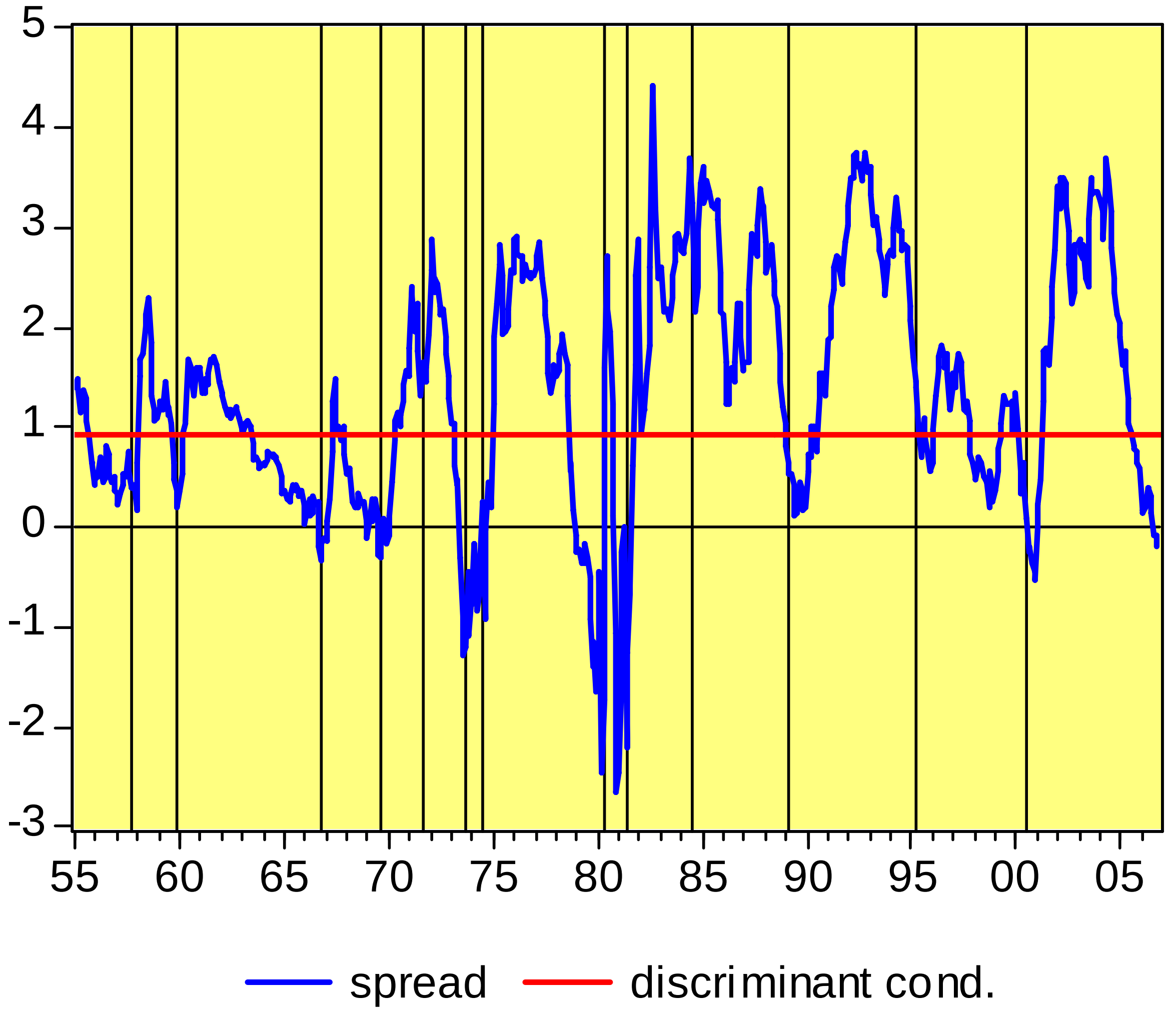
Spread: the current situation

Term Spread and end of monetary tightening cycle



What about the other indicators?

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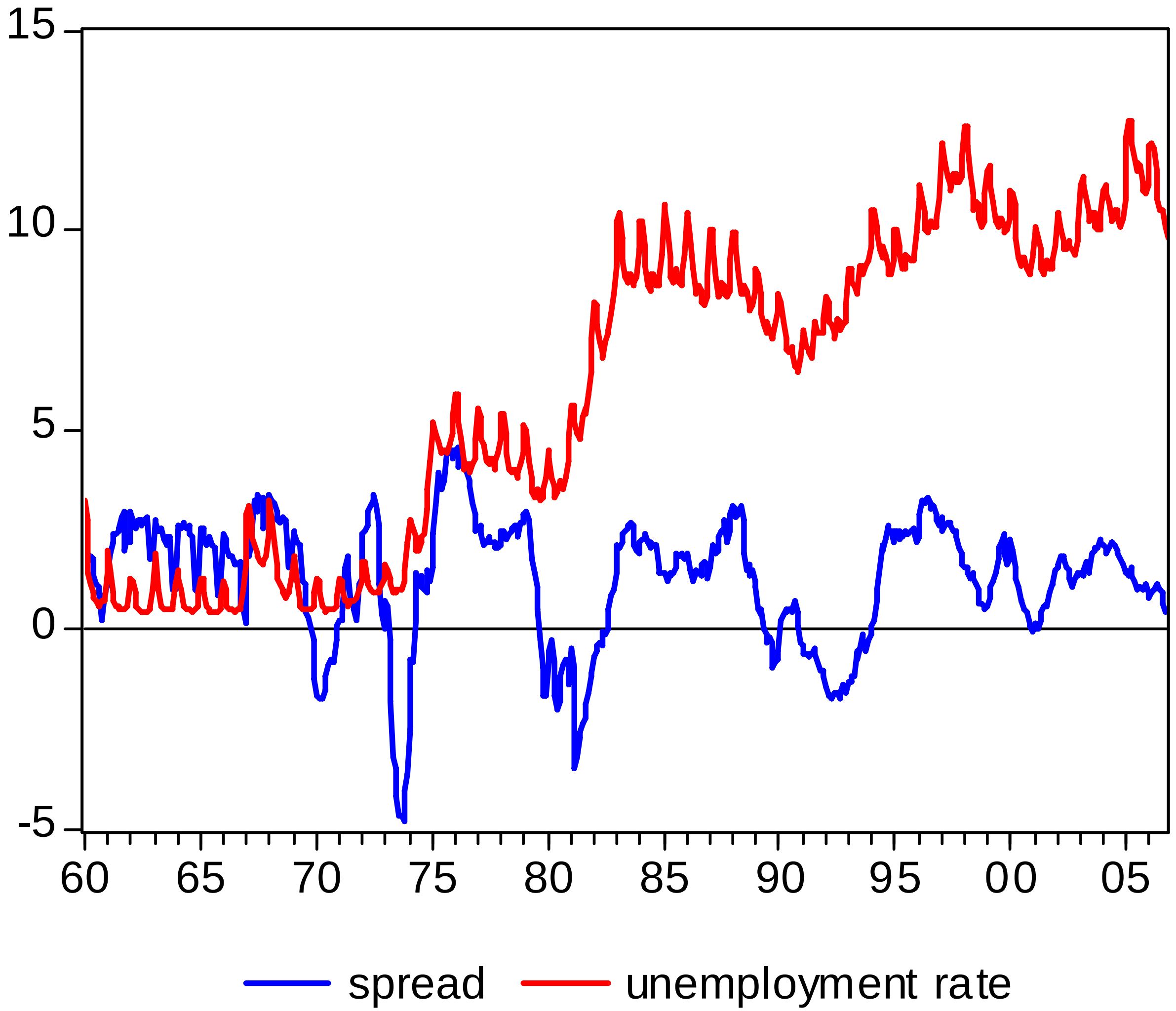
The situation in Germany



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Conclusion

- Interesting paper, old question, new results on relationship between monetary policy, financial variables and real economy
- But: too narrow focus, paper still preliminary, plenty room for improvement

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References

- Ivanova, D., K. Lahiri & F. Seitz (2000), Interest Rate Spreads as Predictors of German Inflation and Business Cycles, *International Journal of Forecasting* 16, 39-58.
- Lahiri, K. & Wang, J. G. (1994). Predicting cyclical turning points with leading index in a Markov switching model. *Journal of Forecasting* 13, 245-263.
- Pagan, A. (1984), "Econometric issues in the analysis of regressions with generated regressors", *International Economic Review* 31, 221-247.

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This is the end

Thank you for your attention!