What Does Forecaster Disagreement Tell Us about the State of the Economy?

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Abstract

This paper shows in a simple model that the part of uncertainty measured by forecaster disagreement rises in advance of and during recessions. Subsequently, it is tested using the Survey of Professional Forecasters in a dynamic probit model. It is shown that increases in disagreement help predict recessions in an out of sample context for the US.

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Keywords: Expectations, SPF, Uncertainty, Dynamic Probit

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1 Introduction

Professional forecasters have difficulties predicting recessions as defined by the NBER (see Zarnowitz (1986), Fintzen and Stekler (1999) and Sinclair et al. (2010)). Bürgi (2016) shows that information on disagreement can improve the in sample recession prediction one quarter out in a dynamic probit model.¹ This note extends the approach by creating a theoretical foundation and testing its out of sample performance for real GDP growth using forecasts from the US Survey of Professional Forecasters (SPF). Disagreement is measured by the square root of the modified coefficient of variance (mCV) as shown in Figure 1. We show that increases in forecaster disagreement provide useful information for predicting recessions.

Figure 1: Modified coefficient of variation for one quarter ahead GDP forecast with recession shading for the forecasted period. The modified coefficient of variance is defined as $mCV = \frac{\sigma}{\max(1, \text{abs}(\mu))}$, where $\sigma$ is the standard deviation across forecasters and $\mu$ is the simple average of forecasts.

¹Driver et al. (2013) showed that disagreement can improve the prediction of underlying variables. Patton and Timmermann (2010) and Döpke and Fritsche (2006) both find that disagreement rises in recessions. For further information on disagreement and uncertainty, see Batchelor and Dua (1993), Bomberger (1996), Lahiri and Sheng (2010) and Ozturk and Sheng (2016).
To show how a model with disagreement can predict recessions better than the simple average of forecasts alone, assume forecaster j forms rational expectations for period $t + 1$ as follows:

$$ F_{jt,t+1} = ax_{jt} + (1-a)F_{j,t+1} $$

That is, the forecast $F_{jt,t+1}$ for period $t + 1$ made in period t is the weighted average of the forecast for period $t + 1$ made in the previous period $F_{j,t+1}$ and some noisy new information $x_{jt}$. The weight $a$ is the Bates and Granger (1969) optimal inverse variance weight. This approach modifies the Sims (2003) noisy information model by having a fixed event instead of a fixed horizon.

Now assume that part of the signal $x_{jt}$ received in period t is that there will be a recession in period $t + 1$. This signal can create large disagreement in the following two cases: First, agents might all update their prediction, but might receive quite different information regarding the severity of the recession. This means that some predict barely negative growth, while others predict a deep recession. In the second case, there is rigidity as in Mankiw and Reis (2002) and not all agents update their forecast. Even if all agents that update receive the same information, there will be large disagreement overall due to the ones that did not update. The ones that update their prediction will predict negative growth, while the ones that do not will still predict positive growth. These cases are also broadly in line with Baker et al. (2018). In both cases the simple average will decline somewhat, but it might not be clear if a recession is expected or not. Disagreement however will become substantially larger when recessions are anticipated by at least some forecasters than in normal periods when forecasters tend to bunch together (e.g. see Bürgi and Sinclair (2017)).
3 Estimation

We estimate a dynamic probit model similar to Dueker (1997) and Proaño and Theobald (2014):

\[ \phi_t = \alpha + \beta y_{t-1} + \gamma X_{t-1} + \varepsilon_t, \]  

(2)

where \( \phi_t \) is the NBER recession dummy that takes value one if there is a recession and value zero otherwise, \( y_{t-1} \) is the real GDP growth rate for period \( t - 1 \) that was available at the end of the second month of quarter \( t \) (real time data), and \( X_{t-1} \) are additional variables included in the regression.\(^2\)

We begin with some in sample analysis. We first consider a simple Probit model which includes the lagged GDP growth rate, our disagreement measure, mCV, and the mean of the SPF forecast.\(^3\) All variables are available from Q4 1969 through Q2 2013, our sample thus has 179 observations. Table 1 reports the results. The key finding is that the disagreement adds statistically significant information above and beyond both past GDP growth and the mean of the SPF forecast and has the expected sign.

Next, three models are compared in sample: no \( X_{t-1} \), \( X_{t-1} \) being equal to mCV, and \( X_{t-1} \) being equal to the mean SPF forecast. In addition to these models, a naïve model is added that never predicts a recession (\( \phi_t = 0 \) for all \( t \)).

Since we are focused on a binary outcome, the performance of these models is assessed on the area under the receiver operating characteristic (ROC) curve, which plots the true positive rate against the false positive rate for all possible probability thresholds (for background on the ROC, see Berge and Jordà (2011).\(^4\) The area is 0.5 if the probabilities are a coin toss and

\(^2\)For real time data we use the second release which is released at the end of the second month of the quarter. This release has a slight informational advantage compared to the SPF forecast made earlier that month.
\(^3\)Results are similar if we use the median of the SPF, see Mboup et al. (2018). We also explored models with CPI inflation and the unemployment rate. For inflation we did not find a cyclical pattern in disagreement, consistent with the inconsistent cyclicity of inflation in this period. For the unemployment rate we found a weaker, but similar, pattern in disagreement to what we report for GDP growth.
\(^4\)Proaño and Theobald (2014) instead use three measures that are commonly used for continuous outcomes,
Table 1: Single model probit results in sample

<table>
<thead>
<tr>
<th>Full sample (N = 179)</th>
<th>Coef.</th>
<th>Std. Err.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-0.98**</td>
<td>0.39</td>
</tr>
<tr>
<td>Past GDP growth</td>
<td>-0.03</td>
<td>0.04</td>
</tr>
<tr>
<td>Mean SPF forecast</td>
<td>-0.23**</td>
<td>0.10</td>
</tr>
<tr>
<td>Disagreement (mCV)</td>
<td>0.75***</td>
<td>0.24</td>
</tr>
</tbody>
</table>

*, **, *** significant at the 10%, 5%, and 1% level respectively

the area is 1 if there is a perfect fit. For most model comparisons, the ROC curves intersect, which means that none of the models is dominant for all probability thresholds. That is, one model might be better if 30% is the threshold probability for recessions and another model might be better at an 80% threshold. Thus, a larger area under the curve does not necessarily reflect an improvement at all thresholds, but can still be a guideline as to which model is better.

Table 2: Separate probit models ROC results in sample

<table>
<thead>
<tr>
<th>Full sample (N = 179)</th>
<th>ROC Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disagreement (mCV)</td>
<td>0.87</td>
</tr>
<tr>
<td>Mean SPF forecast</td>
<td>0.88</td>
</tr>
<tr>
<td>Past GDP growth alone</td>
<td>0.75</td>
</tr>
<tr>
<td>Naïve no recession</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Table 2 reports the in sample performance of the different models. In sample, the best model is the one which includes the mean of the SPF forecasts, closely followed by the model namely root mean squared error (RMSE), mean absolute error (MAE), and the Theil coefficient. For robustness we considered these measures as well and found that the results were broadly consistent with our findings based on ROC.
which includes our disagreement measure, mCV. There is a clear gap between these two models and the models without $X_{t-1}$.

Table 3: Out of sample results (Estimation through Q4 1987)

<table>
<thead>
<tr>
<th>Post 1987 performance (N=103)</th>
<th>ROC Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disagreement (mCV)</td>
<td>0.84</td>
</tr>
<tr>
<td>Mean SPF forecast</td>
<td>0.83</td>
</tr>
<tr>
<td>Past GDP growth alone</td>
<td>0.73</td>
</tr>
<tr>
<td>Naïve no recession</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Figure 2: ROC Curves for the three models starting 1987

What is important, however, is how the models perform out of sample (OOS), not in sample. We therefore perform two different (pseudo) OOS exercises.\(^5\) For our first OOS exercise,

\(^5\)This analysis is pseudo out of sample in the sense that we are performing this analysis after the events occurred, but we estimated the model only based on data through Q4 of 1987 and 1995 respectively. Also note that if both the mean SPF forecast and disagreement are included, the out of sample results are indistinguishable.
exercise shown in Table 3 and Figure 2, the same models as in Table 2 are estimated again using data only through Q4 1987. Subsequently, the models are used to predict the recession probabilities from Q1 1988 onwards, which includes the next three recessions (1990, 2001 and 2008). The mCV model performs best overall, but only slightly better than the mean SPF forecasts.

Table 4: Out of sample results (Estimation through Q4 1995)

<table>
<thead>
<tr>
<th>Post 1995 performance (N=71)</th>
<th>ROC Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disagreement (mCV)</td>
<td>0.86</td>
</tr>
<tr>
<td>Mean SPF Forecast</td>
<td>0.84</td>
</tr>
<tr>
<td>Past GDP growth alone</td>
<td>0.73</td>
</tr>
<tr>
<td>Naive no recession</td>
<td>0.50</td>
</tr>
</tbody>
</table>

Figure 3: ROC Curves for the three models starting 1995

For our second OOS exercise the models are estimated over a longer period, through Q4 of
1995, and their performance compared for the 2001 and 2008 recessions. The results become stronger as shown in Table 4 and Figure 3.

In both cases, the ROC curves with disagreement or the SPF mean dominate the model with just past GDP growth. The disagreement model dominates the GDP growth model more. No direct comparison between the disagreement and SPF mean models is possible, as the ROC curves cross.

4 Conclusion

This paper shows that the part of uncertainty measured by disagreement in the Survey of Professional Forecasters can aid the prediction of recessions in an out of sample dynamic probit model. Indeed, while disagreement does not dominate the average forecasts at all probability thresholds, it dominates the past GDP growth model by more than the average when business cycles since 1987 or 1996 are predicted.

The results presented in this paper leave several questions for future research. First, we are focused here on uncertainty about the future state of the economy, but other forms of uncertainty, such as those discussed in Bloom (2009) may also be a source of change in the state of the economy themselves. Learning more about how different types of uncertainty interact might improve forecasting models further. Second, we presented two potential reasons for why disagreement rises around recessions, and we would like to identify which one is the main driver. Finally, while disagreement is predictive of recessions, it was not compared to other approaches. Future research might compare it to other measures like the slope of the yield curve.
References


