Optimal Forecast under Structural Breaks

Tae-Hwy Lee
University of California, Riverside
Department of Economics

Shahnaz Parsaeian*
University of Kansas
Department of Economics

Aman Ullah
University of California, Riverside
Department of Economics

Abstract

This paper develops an optimal combined estimator to forecast out-of-sample under structural breaks. When it comes to forecasting, using only the post-break observations after the most recent break point may not be optimal. In this paper we propose a new estimation method that exploits the pre-break information. In particular, we show how to combine the estimator using the full-sample (i.e., both the pre-break and post-break data) and the estimator using only the post-break sample. The full-sample estimator is inconsistent when there is a break while it is efficient. The post-break estimator is consistent but inefficient. Hence, depending on the severity of the breaks, the full-sample estimator and the post-break estimator can be combined to balance the consistency and efficiency. We derive the Stein-like combined estimator of the full-sample and the post-break estimators, to balance the bias-variance trade-off. The combination weight depends on the break severity, which we measure by the Wu-Hausman statistic. We examine the properties of the proposed method, analytically in theory, numerically in simulation, and also empirically in forecasting real output growth across nine industrial economies.

Keywords: Forecasting; Structural breaks; Stein-like combined estimator; Output growth.

JEL Classification: C13, C32, C53

*Correspondence: Shahnaz Parsaeian, Department of Economics, University of Kansas, Lawrence, KS 66045. Email: shahnaz.parsaeian@ku.edu