How to deal with financial factors in forecasting and policy advice

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SHOULD MACROECONOMIC MODELS GIVE MORE ATTENTION TO FINANCIAL FACTORS?

- **Financial disruptions constitute an important source of macroeconomic fluctuations which was highlighted by the financial crisis.**
- **Key financial factors and mechanisms that explain macroeconomic fluctuations should be included in macroeconomic models, including:**
  - Financial accelerator
  - Credit frictions
  - Other factors (although generally lack of consensus in the literature)
- **Also, partial models with a more detailed financial sector or housing market can be use to broaden the understanding.**
- **However, the introduction of financial factors in macroeconomic models will only allow to us *understand* the dynamics of a financial crisis.**
- **This will give us little help in *predicting* a new financial crisis, since financial shocks is still usually modelled as exogenous events.**

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TAKING REGIME SWITCHES INTO ACCOUNT?

- **The financial crises can be regarded as a regime switch with important consequences for the economy.**
- **Financial markets can amplify cyclical fluctuations in the real economy and also affect the length of crises. Not only financial market dynamics are affected.**
- **More generally, the economic mechanisms work differently in different phases of the business cycle. This applies e.g. to consumption and investment decisions, to the effect of fiscal policy and to the functioning of the labor market.**
- **In order to better forecast economic growth and formulate policy responses, a better understanding of the dynamics after economic shocks will certainly be useful. Predicting regime switches and identifying regimes in real time, however, is a much more difficult task.**

BENEFITS FROM A MORE SYSTEMATIC TREATMENT OF FINANCIAL FACTORS

- **Developments in financial markets contain information about expectations and the real economy.**
- **Financial-market indicators can serve as an early warning with respect to imbalances building up – and the risk of a subsequent correction.**
- **Financial market indicators can provide a better foundation for implementing policy measures to help curb imbalances and unsustainable developments.**
- **An important example is The Systemic Risk Council's monitoring of systemic risk in the Danish economy.**

CONCLUDING REMARKS

- Much effort has gone into understanding and explaining the financial crisis in retrospect.
  - Improved understanding of the role of the financial side of the economy
  - Increased appreciation of systemic risk originating in the financial sector
- Not all is directly relevant for macroeconomic modelling and forecasting.
  - Better understanding of the relationship between the financial and the real side of the economy has the potential for improving macroeconomic models and forecasting.
  - Changed dynamics of the economy during a serious financial crisis – e.g. depressions, world wars, oil crises, IT/asset-bubbles, debt crises etc. – may be less relevant for macroeconomic models and forecasting in "normal times".
  - Understanding of the causes of the crisis should be (and is) used to avoid new financial crises, e.g. through regulation. To the extent that these efforts are successful, the need for new macroeconomic models and forecasting tools is reduced.