

Comments on A den Reijer and
P. Vlaar, "Forecasting Inflation:
An Art as well as a Science"

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Theme: Aggregate of forecasts vs forecast of aggregates

- Interesting question.
- MPC member expressed opinion that one should do former.
- Answer in paper seems mixed

Are the models used here the best possible?

- Will focus on aggregate HICP for Europe
- Log of it is p^{tot}
- Paper suggests that equation for it in VAR(1) system is
- $\Delta \Delta_{12} p_t^{\text{tot}} = a \Delta_{12} p_{t-1}^{\text{tot}} + \Delta_{12} z_{t-1} \alpha + \Delta \Delta_{12} z_t \gamma$
- Some of z_t exog, some endog

Exog/endo is about how treated in forecasting environment

Exchange rate is "exogenous" since given by ECB forecasts

But shouldn't assume this in estimation.

OLS seems to be estimator used

z_t variables are Table 2 last col

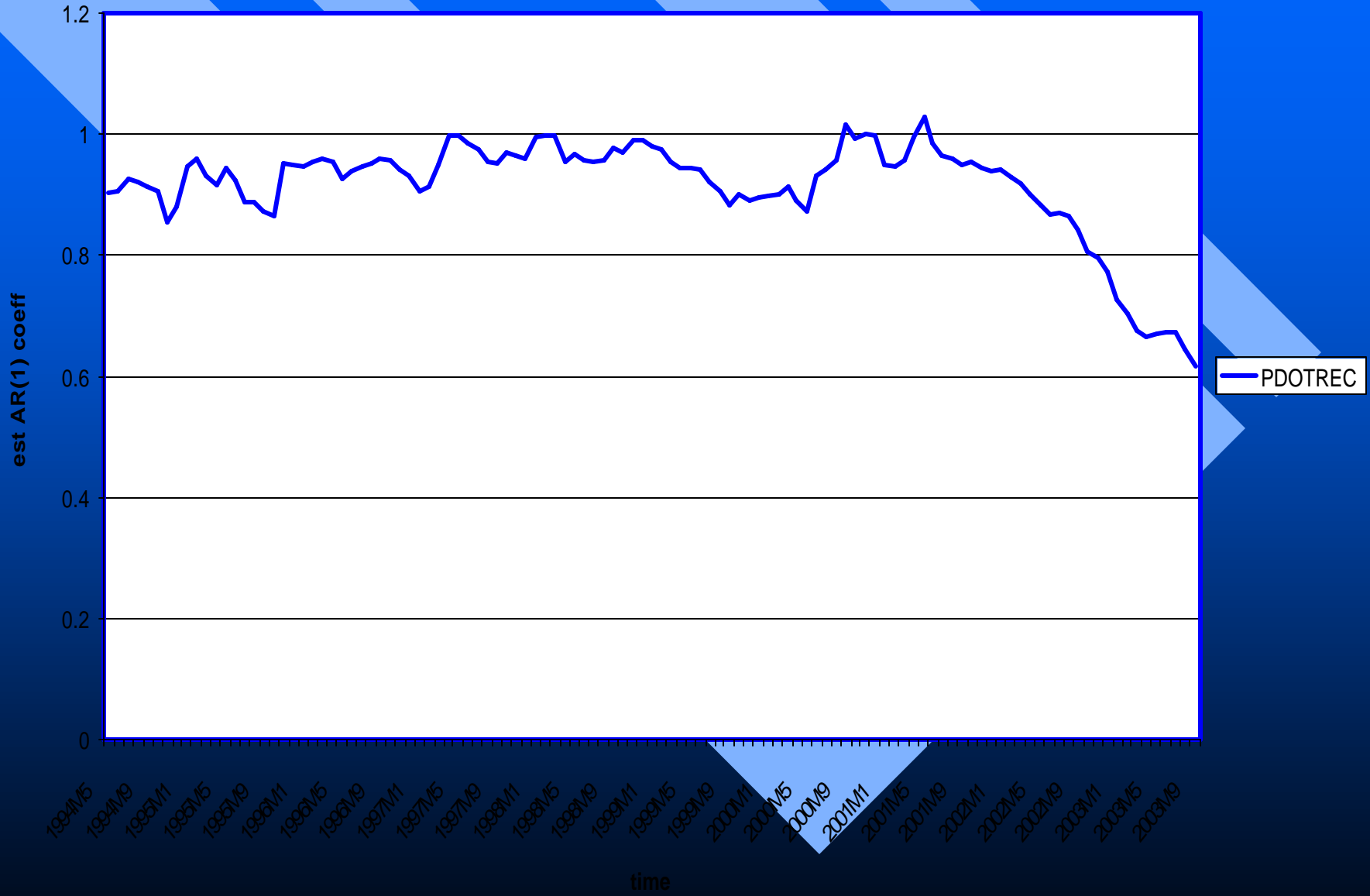
Some questions emerge from re-doing the regression above

- Final equation seems to have a lot of serial correlation. chi square (12)=38(.000)
- Can add variables to it.
- If model should be of Δp_t^{tot} rather than $\Delta_{12} p_t^{\text{tot}}$ then should allow for this by adding to RHS lagged values of Δp_t^{tot}
- $\Delta p_{t-12}^{\text{tot}}$, $\Delta p_{t-2}^{\text{tot}}$ are significant (t vals of -6.6 and -2.7). Eliminates serial corr.

What is a suitable benchmark model?

- ECM system seems to provide better forecasts than “no change”
- No change in annual inflation forecast implies that annual inflation is $I(1)$
- Is this correct description of inflation?
- Look at rolling regression of 40 months

Rolling Regression Annual Inflation in Ptot on lagged value



Always well below but big drop off after formation of EMU

Largely in forecast period

Not surprising that other model is superior?

Problem is whether benchmark shouldn't take account of institutional features.

If inflation target is to work inflation cannot be $I(1)$

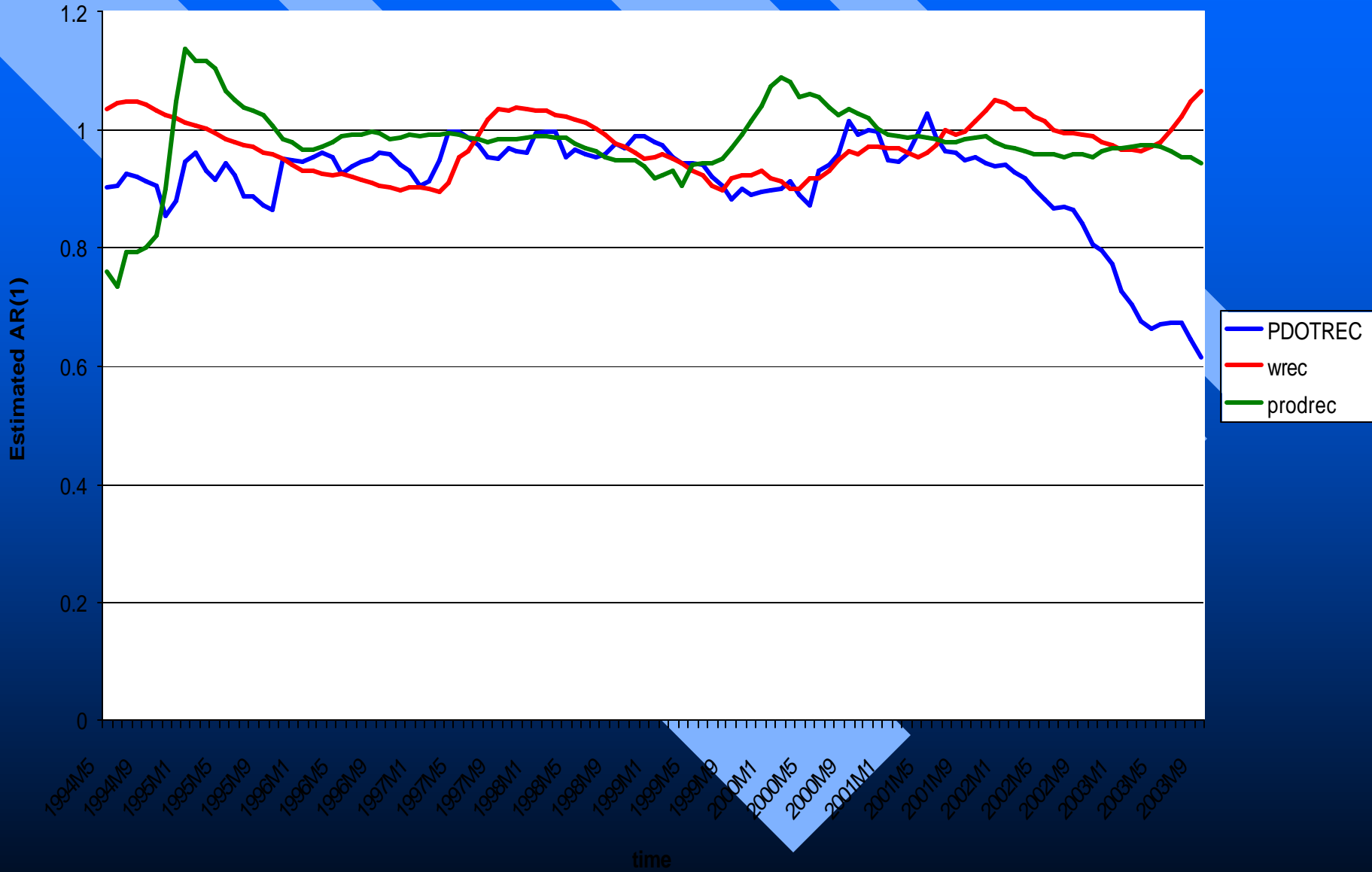
Might be threshold process so $I(0)$ looks like $I(1)$

Suggests need to choose benchmark as the inflation target

Is the model likely to be successful in future?

- Look at equilibrium determinants
- These are given as annual changes in wages and producer prices
- So called " cointegrating terms"

Fitted AR(1), Rolling Regression, Ptot, wages and Pprod



Clearly no evidence that persistence in them has changed.

So estimated equilibrium relation would be poor thing to adjust towards

Hendry's argument about difficulties with this mechanism in a forecasting context

Is forecasting an art as well as a science?

- Little on it in paper despite title.
- Comparison is given of Netherlands model forecasts and official forecasts
- Latter superior.
- Does this prove art is very important?
- Would need to be happy with the Netherlands ECM model

Old work on judgement vs model forecasts

But in this case it is like comparing two non-nested models

Really want to look at adjustments made to a fixed model forecast.

Some evidence in MPC case that it makes a difference, although not entirely clear cut