FINANCIAL CONDITIONS AND THE BUSINESS CYCLE

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"BUSINESS CYCLE ANATOMY" SETUP
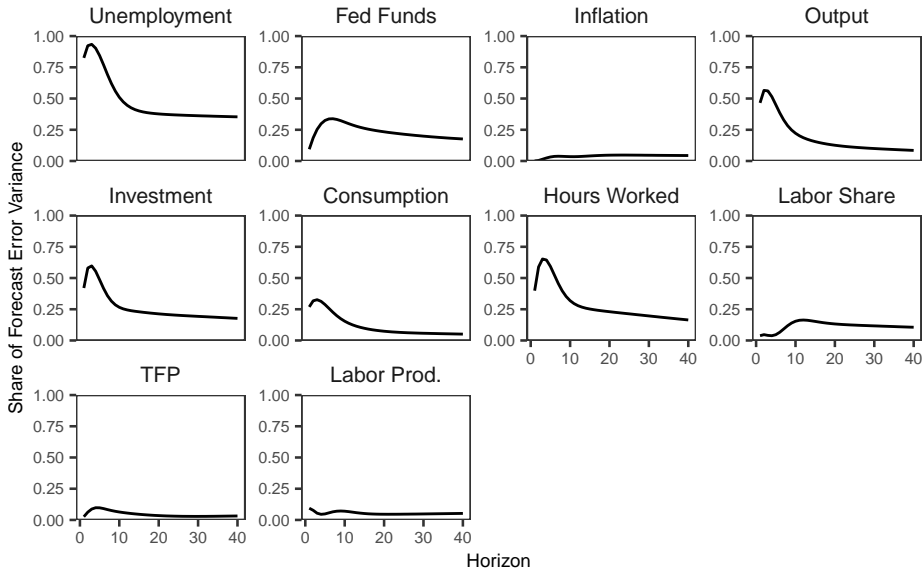
VAR with 10 variables, 1955 to 2017

Identification scheme:

Choose the linear combination of empirically estimated reduced-form VAR residuals that explains most of the forecast error variance in a target variable, at a target frequency.
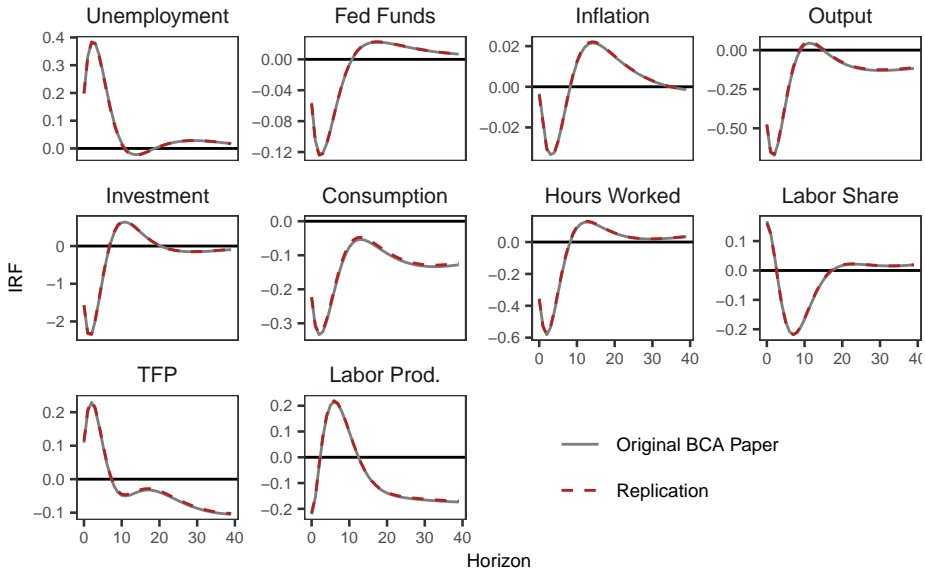
Initial Target:

- Business cycle frequency: $\left(\frac{2\pi}{32}, \frac{2\pi}{6} \right)$
- Unemployment

FORECAST ERROR VARIANCE MAXIMIZATION
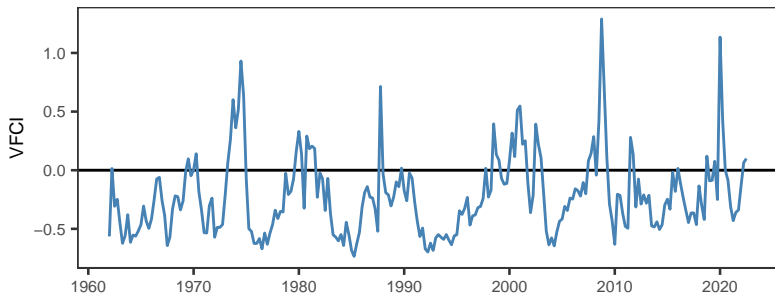
REPLICATION OF "BUSINESS CYCLE ANATOMY"

VOLATILITY FINANCIAL CONDITIONS INDEX (VFCI)

The VFCI is an estimate of the price of risk.

In many models, this would be equal to the volatility of the stochastic discount factor.

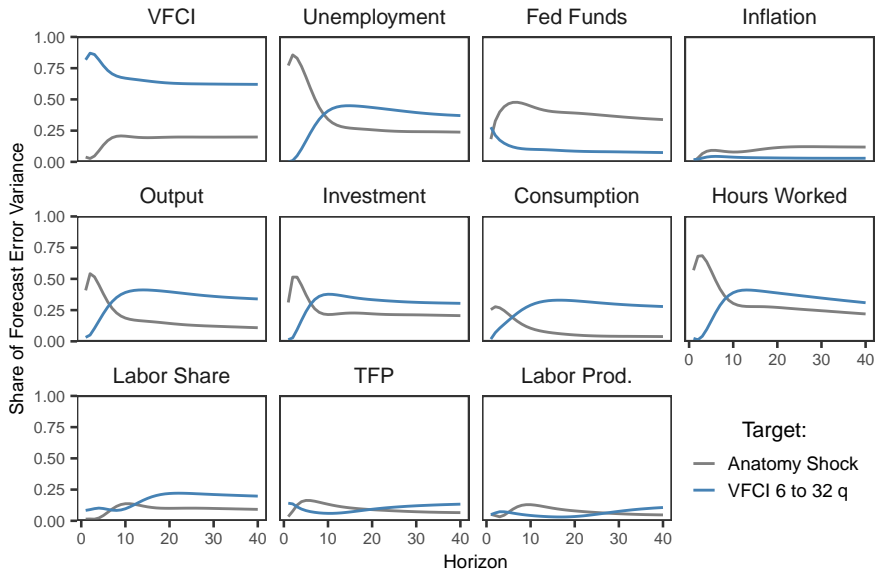Empirically, estimated from consumption and asset prices.

WHAT WE SHOW

The "Anatomy" Business Cycle shock is composed of two shocks:

1. One targeting financial conditions at original frequency

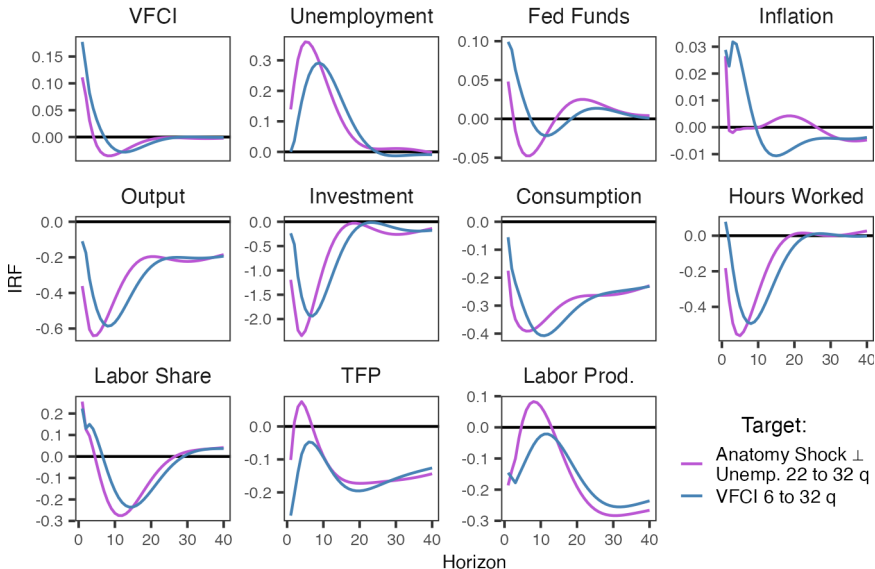2. One targeting unemployment at 22 to 32 quarters instead of
   original frequency

VFCI SHOCK EXPLAINS LONGER HORIZONS
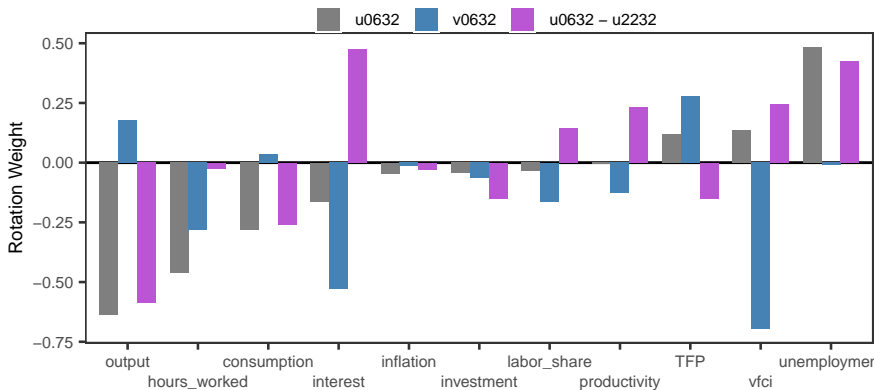
SECOND SHOCK DIFFERENT THAN ANATOMY SHOCK

Target:
— Anatomy Shock
— Unemp. 22 to 32 q
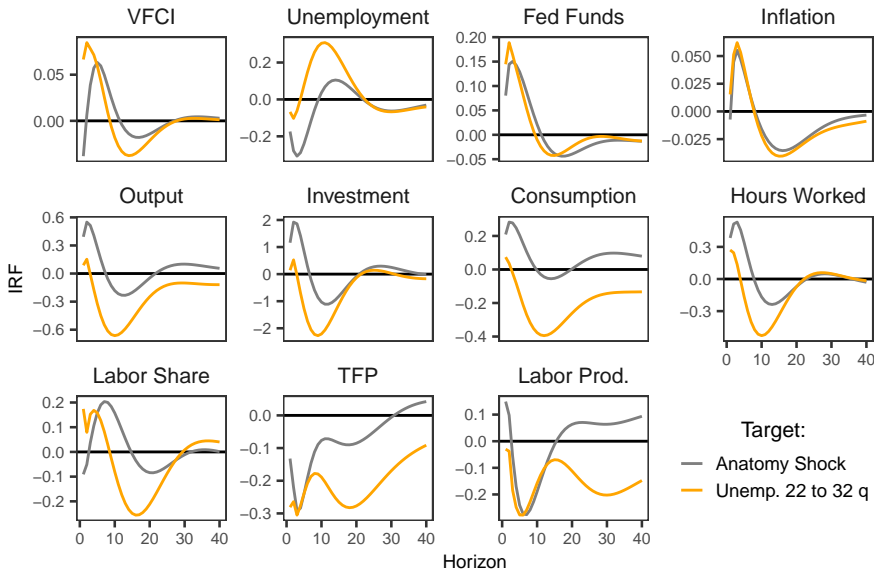
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APPENDIX

ROTATION WEIGHTS

EMPIRICAL SHOCK WEIGHTS