Abstract

This paper is an attempt to develop a new Early Warning System (EWS) model for predicting the state of an economy, based on a multinomial logit model. It is shown that most of the EWS approaches based on binomial discrete-dependent variable models can be subject to crises-bias and false signals. This bias arises when no distinction is made between tranquil periods, recession and crisis periods, and growth and expansion periods. These are the periods where economic fundamentals may go through an adjustment process before reaching a more defensible level or growth path. Therefore, it would be better if we predict the state of the economy, instead of predicting the crises as a binomial variable. To achieve this, we tried to show that applying a multinomial logit model, which allows distinguishing between more than two states, is a valid way of finding a solution to this problem and constitutes a significant improvement in the ability to forecast not only the crises but the state of the economy. The empirical results reveal that, for a dataset of four emerging markets from 1970 till the present, given the particular GDP growth of an economy we can establish the current regime of the economy.