Abstract: Business and financial cycle across regimes: Does the financial stress matter?

Financial factors have long been recognized as crucial drivers of economic fluctuations, as highlighted by the 2008 global financial crisis. This crisis demonstrated how financial market developments can impact the real economy, underscoring the need to include the financial sector in economic modelling. However, much of the empirical literature has overlooked financial variables, focusing mainly on real economic indicators. Recent economic and financial events have revealed the limitations of such models, which often fail to accurately predict economic cycles and financial crises.

This study proposes integrating a financial stress index into business cycle models, using the Kansas City Fed Financial Stress Index (KCFSI). Employing an innovative bivariate Markov-Switching model, the analysis compares a model based solely on real variables (R-R model) with one that includes the KCFSI (R-F model), evaluating their accuracy. The findings indicate that the R-F model significantly improves the accuracy of identifying economic cycles and financial stress conditions. Specifically, a model that incorporates information from a financial stress index performs better than a model only based on real variables, not only during a financial crisis but also, and more interestingly, in economic downturns.

The research contributes to the existing literature on the interaction between the financial sector and the real economy by highlighting the importance of incorporating the financial cycle into economic models. Moreover, it fills the gaps by integrating financial stress indicators into business cycle analysis, jointly exploring real and financial variable and clearly identifying different regimes over the last decades.

The empirical evidence provides actionable insights for policymakers, investors, and corporations to enhance economic policy formulation, investment strategies, and strategic decision-making, ultimately facilitating risk management thanks to a better identification of recent economic and financial dynamics.