APPLICATION OF EPSILON METHOD TO MODELING EXPECTATIONS IN CONSTRUCTION

Natalia Nehrebecka[1] [2], Sylwia Grodkowska[2]
[1]Katedra Statystyki i Ekonometrii UW, [2]Departament Statystyki NBP
e-mail: nnehrebecka@wne.uw.edu.pl, Sylwia.Grudkowska@nbp.pl

Abstract: The epsilon method has been applied to examine the strength of relations among selected objective and subjective factors connected with a manager's predictions of their companies' development. The aim of this research was to study which variable has the strongest impact on business expectations in construction. The results offer compelling evidence that respondents rely both on their current opinion on enterprise as well as on general economic situation. The survey was carried out based on Polish data from 2000:1 to 2008:10.

Keywords: Epsilon method, relative weights, construction

INTRODUCTION

The primary aims of the business tendency survey are forecasting the economic activity, identifying the current economic condition of the country and predicting the direction of changes in the business activity. Business survey indicates are the valuable tool for economic analysis for all types of users. Moreover, this type of survey provides information on assessments and expectations of the economic situation by actors on the market. Conventional methods often prove insufficient in collection of information regarding business tendency surveys. Therefore, it is an useful source of information about changes in aggregated economic activity.

The business tendency survey in construction usually includes: capacity utilization, plans and expectations for the immediate future, managers' views on the overall economic situation[1]. The selective key survey variables are used to construct confidence indicator which reflects the general business tendency.

---

[1] Business Tendency Surveys: A Handbook

This article aims to explaining the mechanism of formulation the respondent's expectation about business tendency in construction. It pursues factors which are closely associated with subjective expectations about future company's development. It investigates whether indices of current company's sentiment have a strong impact on future business tendency indicators. On the other hand, this paper also includes the objective, macroeconomic data, like unemployment or gross wages. The purpose is to check, if the signal from real economy strongly influences managers' prediction of development of their company. The leading hypothesis of the article is that respondents rely on their own evaluation rather than on the general economic situation.

Comparison between these two groups of regressors will be based on a relative weight method. We apply this method to estimate the relative importance of the predictor variable. The method and its usefulness will be presented in the next section. Section 2 discusses the data used in the empirical analysis. Section 3 reports the results which we obtained for the business tendency indicators. Finally, section 4 provides a conclusion.

THE EPSILON METHOD

Econometric modeling is facing a serious problem because of correlation between explanatory variables. The reason why the correlation occurs is interdependence of economic phenomena. In case of strong relationship between independent variables it is hard to separate the particular variable's influence on dependent variable from other variables. This problem makes economic analysis really complicated. It was the reason to search for a measure of relative importance of variables in multiple regression. The history of this research was described by Johnson and LeBreton (2004). Each of methods mentioned (zero - order correlations, standardized regression coefficients, not standardized regression coefficients, semi-partial correlation, the product measure, average squared semi-partial correlation, average squared partial correlation) has its drawbacks which makes this technique useless and leads to wrong conclusions.

These studies resulted in two new important methodologies - dominance analysis and epsilon method. First of these was introduced by Budescu (2003). Dominance analysis allows ranking the predictor variables. It is said that the variable A is dominate to variable B if A it is more useful than B in all subset multiple regressions. Given that the above definition is really strict, it is difficult to implement it for data sets of significant size, because it requires estimating   submodels, where   is the number of variables in the original model. The advantage of this method is that relative weights obtained from dominance sum to the model. Because of that relative importance of each variable can be calculated as the proportion of predictable variance for which it accounts [Johnson, LeBreton 2004].

This article applies the second approach - the epsilon method. It is much easier to implement than dominance analysis and lead to similar results [Johnson 2000].

The epsilon procedure presented below derives from Johnson (2000). The first step involves the following decomposition of predictor scores matrix:

$$\mathbf{X} = \mathbf{P}\boldsymbol{\Delta}\mathbf{Q}^T \tag{1}$$

where $\mathbf{X}$ is matrix $n \ x \ p$, $\mathbf{P}$ is the full matrix of eigenvectors of $\mathbf{XX^T}$, $\mathbf{Q}$ is the full matrix of eigenvectors of $\mathbf{X^TX}$, T denotes transposition, $\boldsymbol{\Delta}$ is the a diagonal matrix which contain the square roots of the eigenvalues of *XX'* and *X'X*.

If none of the vectors from the matrix $\mathbf{X}$ is collinear with another one, each of element of *XX'* and *X'X* is different from zero. In these case the best - fitting approximation of $\mathbf{X}$ is:

$$\mathbf{Z} = \mathbf{P}\mathbf{Q}^T \tag{2}$$

The above equation ensures that the residual sum of squares between the raw predictors and the orthogonal variables is minimized. The matrix $\mathbf{Z}$ contains z_k variables which are orthogonal to the original predictors x_j from the matrix $\mathbf{X}$. The matrix $\mathbf{Z}$ is then used to obtain the set of relative weights. The calculation is based on regression $\mathbf{X}$ on $\mathbf{Z}$:

$$\Lambda^* = (\mathbf{Z}^T\mathbf{Z})^{-1}\mathbf{Z}^T\mathbf{X} = (\mathbf{Q}\mathbf{P}^T\mathbf{P}\mathbf{Q}^T)^{-1}\mathbf{Q}\mathbf{P}^T\mathbf{P}\boldsymbol{\Delta}\mathbf{Q}^T = \mathbf{I}^{-1}\mathbf{Q}\boldsymbol{\Delta}\mathbf{Q}^T = \mathbf{Q}\boldsymbol{\Delta}\mathbf{Q}^T \tag{3}$$

As the Z_k are not correlated, the correlation coefficients λ^*_{jk} are equal to the correlation between x_j and z_k. The squared elements of Λ^* defined as λ^*_{jk} are equal to the proportion of predictable variance in x_j accounted for by z_k. The relative contribution x_j to y can be approximated by $\sum_k \lambda^{*2}_{jk}\beta^{*2}_k$, where β^*_k is regression coefficient taken from least square estimation of y to z_k. The coefficient vector β^* is calculated as:

$$\beta^* = (\mathbf{Z}^T\mathbf{Z})^{-1}\mathbf{Z}^T\mathbf{y} = (\mathbf{Q}\mathbf{P}^T\mathbf{P}\mathbf{Q}^T)^{-1}\mathbf{Q}\mathbf{P}^T\mathbf{y} = \mathbf{I}^{-1}\mathbf{Q}\mathbf{P}^T\mathbf{y} = \mathbf{Q}\mathbf{P}^T\mathbf{y} \tag{4}$$

Each z_k is a linear combination of the x_j. The variance in y accounted for by z_k is, therefore, partitioned among the according to the proportion of variance in z_k accounted for by each x_j.

In this algorithm one can obtain the set of relative weights which sum to the model R^2. Each weight is attributed to the particular raw independent variable and reflects the effect of the variable by itself and in combination which the others.Each is a linear combination of the. The variance in accounted for by is, therefore, partitioned among the according to the proportion of variance in accounted for by each.

THE DATA

The sample period for all results is 2000:1- 2008:10. Data have been provided by the Polish Central Statistical Office. The dependent variables are equal to the following construction expectation: expected general economic situation of the enterprise, expected prices of construction/assembly works carried out by the enterprise, expected employment in construction/assembly operations of the enterprise. These indicators are equal to the difference between weighted percentages of positive (the first option) and negative answers (the third option). Weighting is necessary as the companies which are taking part in the survey vary in size. The weights are based on the value of sold construction assembly production in current process[2]. The questions are presented in table 1. Each year, ca. 2200 construction enterprises of more than 9 employees takes part in the survey.

The set of independent variables which could influence expectations consist of two parts. In the first one there are business tendency indicators of current economic situation in construction. This group includes: construction/assembly works carried out by the enterprise at domestic market, the guaranteed operating period of the enterprise, capacity utilization of the enterprise[3]. The second group consist of macroeconomic indicators: index of construction and assembly production in constant prices (2000=100), average monthly gross wages excluding payments from profit in construction, dismissals declared by enterprises[4], average employment in construction, housing loans of Monetary Financial Institution[5] to households, unemployment rate - registered[6], dwellings under construction, sale of construction and assembly production, dwellings completed.

These data derived from Polish Central Statistical Office and National Bank of Poland.

The time series used in our analysis were seasonally adjusted using TRAMO/SEATS procedure [Maravall 2005]. It was done due to the fact that in each series the seasonality was detected and in most cases the seasonal component

---

[2] http://www.stat.gov.pl/cps/rde/xbcr/gus/PUBL_business_tendency_survey_in_ manufacturing_2.pdf
[3] in percentages
[4] Number of persons which will be dismissed declared by enterprises
[5] Excluding National Bank of Poland
[6] Calculation based on number of unemployed registered in employment offices

was strong. In this situation using raw data could result in spurious correlation between variables.

Table 1. Business Tendency questionnaire

Question	Possible answers
Expected financial situation of the enterprise	− will be better − will remain unchanged − will be worse
Expected prices of construction/assembly works carried out by the enterprise	− will be better − will remain unchanged − will be worse
Expected employment in construction/assembly operations of the enterprise	− will be better − will remain unchanged − will be worse

Source: Monthly questionnaire in construction, Central Statistical Office, www.stat.gov.pl

The dependent variables used in our study are strongly correlated (absolute value of correlations ranging from 0,06 to 0,99) with an average absolute value correlation of 0,59. Because of strong correlation between variables, regression coefficients couldn't be used to measure of relative weight. It is the reason why in this case we have to apply the epsilon method.

RESULTS

Table 3 presents relative weights calculated for our dependent variables. These weights were rescaled by dividing them by the model R^2 and multiplying by 100, so they are equal to percentage of the model R^2 connected with each predictor.

EXPECTATIONS REGARDING FINANCIAL SITUATION

Results presented in Table 2 indicate that construction/assembly works carried out by the enterprise was accounted for almost 18% of predictable variable of expected financial situation of the enterprise. It is because this indicator denotes the number of orders which will be carried out.
The guaranteed operating period of the enterprise has also quite a high share in R^2 (12,6%) which only supports our feeling that current orders has a dominant role in predicting the financial situation. The longer the guaranteed operating period of the enterprise is the more optimism about chances of financial success the respondents' display.

Table 3. Relative weights

Variable	Expected financial situation of the enterprise	Expected prices of construction/assembly works carried out by the enterprise	Expected employment in construction/assembly operations of the enterprise
Construction/assembly works carried out by the enterprise	17,60%	14,70%	15,70%
Capacity utilization of the enterprise	2,30%	2,50%	2,40%
The guaranteed operating period of the enterprise	12,60%	12,70%	11,40%
Housing loans of MFI's to households	7,00%	7,30%	8,20%
Dwellings completed	0,50%	0,30%	0,70%
Dwellings under construction	8,00%	4,70%	9,20%
Average gross wages excl. payments from profit in construction	7,20%	14,30%	6,90%
Unemployment rate - registered	6,30%	6,90%	7,70%
Dismissals declared	10,10%	10,40%	8,30%
Average paid employment in construction	7,30%	7,30%	9,40%
Sale of construction and assembly production	8,60%	9,60%	7,30%
Index of construction and assembly production	12,50%	9,40%	12,90%

Source: own calculation

The current situation in construction sector (index of construction and as-sembly production) as well as sold construction and assembly production is also a valuable predictor of the future financial situation.
It is noticeable that data connected with employment are moderately important for respondents. For example, average monthly gross wages excluding payments from profit in construction which accounts for more than 7% of R^2. It is a direct result of rapid growth in construction during past few years in Poland. In this period the wages in construction went up because of labor shortage. The moderate relative weight of unemployment rate and dismissals declared indicates that respondents follow the situation on the labor market, particularly the future tendency (the rela-tive weight of dismissals declared is higher than the relative weight of unemploy-ment rate).

The number of buildings completed plays no role in explaining the varia-tion of dependent variable, due to the fact that it takes quite a long time to build a new building. On the contrary, respondents take into account the number of dwell-ings under construction as it is closely related with future price of dwellings. Value of housing loans of MFI's to households plays a similar role. This variable ac-

counts for 7% of R^2 and indicates the demand for new housing (the majority of buyers purchase property on the primary market).

Surprisingly, the relative weight of utilization capacity was below 2%. However, it is possible that enterprise could easily increase or decrease their utilization capacity to adjust it to the current needs. If so, this factor is not essential in explaining the dependent variables' variance.

ECTATIONS REGARDING PRICES IN CONSTRUCTION

The result of our survey shows that the expectations regarding prices in construction are similar to the outcome of the previous model. It is not a surprise that the average monthly gross wages excluding payments from profit in construction has almost the highest relative weight in this model. As the level of average wages is rising the company's profit is reduced. The company is unable to avoid these expenses, because it needs to fulfill contractual obligations. The other labor market's variables - unemployment rate and dismissals declared - have even higher influence on expectations regarding prices of construction than expectation regarding financial situation of the enterprise. These variables have a strong influence on the level of wage. Obviously, the wage claims are directly reflected in the prices of construction. On the other hand the influence on financial situation of the enterprise is not so strong - there are a set of other factors which also affect it.

Construction/assembly works carried out by the enterprise have a very similar wage as average monthly gross wages. It is because they are the fixed term contracts so provisions of an agreement cover the prices. On this basis the enterprise can estimate their future revenues and costs.

EXPECTATIONS REGARDING EMPLOYMENT IN CONSTRUCTION

In comparison to models discussed above, the average employment in construction has quite a strong influence on expectations of employment. It is because the high wage level reduces the enterprise's capability to increase employment.

It is not strange that the number of dwellings under construction and the housing loans of MFI's to households occur to be a satisfactory predictor of dependent variable. If dwellings are under construction it is obvious that enterprises need their employees to finish it, so they would not reduce the labor force in near future. The value of housing loans indicates that households are interested in property purchase. This trend has been observed in Poland since 2002, so respondents anticipate that it will remain unchanged.

CONCLUSIONS

For the purpose of this article we have applied the epsilon method in order to describe the weighting strategies used by respondents when making an overall performance evaluation. Although this procedure is valid when the dependent variables are correlated, it is recommended to consider that none of two variables measure the same thing. In this case one of them should be removed as the relative weight will be spread out of them [Johnson, 2000].

Results of our survey show that both the enterprise's evaluation of the current economic activity and the general economic situation in Poland has a strong impact on respondent's expectation about business tendency in construction. The most valuable predictors are construction/assembly works carried out by the enterprise and the guaranteed operating period of the enterprise. The average relative weight were equal to 16,0% and 12,2% respectively. On the other hand, average monthly gross wages excluding payments from profit in construction and index of construction and assembly production, which are included in general economic situation's indicators, have influenced explaining the variance of dependent variables (13,7% and 11,4% respectively).

REFERENCES

Budescu D. (1993) Dominance analysis: a new approach to the problem of relative importance of predictors in multiple regression, Psycholgical Bulletin, no. 114
Business Tendency Surveys: A Handbook, ODCE.
Budżety gospodarstw domowych w 2007 r., Główny Urząd Statystyczny, Warszawa 2008 r.
Dominitz J., Manski C. (1994) Using Expectations Data to Study Subjective Income Expectations, National Bureau of Economic Research
Forsells M., Kenny G. (2002) The rationality of consumers' inflation expectations: survey based evidence for euro area, European Central Bank Working Papers, n. 163, Frankfurt
Johnson, J. (2004) Factors Affecting Relative Weights: The influence of Sampling and Measurement Error, Organizational Research Methods, Vol. 7, no. 3, 283-299
Johnson, J., LeBreton J. (2004) History and Use of Relative Importance Indices in Organizational Research, Organizational Research Methods, 2004
Johnson J. (2000), A Heuristic Method for Estimating the Relative Weight of Predictor Variables in Multiple Regression, Multivariate Behavioral Research, no. 35
LeBreton J., Ployhart R., Ladd R. (2004) A Monte Carlo Comparison of Relative Importance Methodologies, Organizational Research Methods, Vol. 7, no. 3
Maravall A. (2005), An Application of the automatic procedure of TRAMO and SEATS; Direct versus Indirect Adjustment, Banco de España Working Papers n. 0524

Wall M., Rechtsteiner A., Rocha L. (2003) Singular value decomposition and principal component analysis, in: Berrar D., Dubitzky W., Granzow M., A Practical Approach to Microarray Data Analysis, Springer

Westerhoff F. (2006) Nonlinear expectation formation, endogenous business cycles and stylized facts, Studies in Nonlinear Dynamics and Econometrics, Vol. 10

Zastosowanie metody epsilon do modelowania oczekiwań koniunktury gospodarczej w budownictwie

Streszczenie: Metoda Epsilon została zastosowana do badania siły powiązania między wybranymi obiektywnymi i subiektywnymi czynnikami związanymi ze spodziewaną kondycją dyrektorów przedsiębiorstw w przyszłości. Celem artykułu było zbadanie, która zmienna ma największy wpływ na oczekiwania koniunktury gospodarczej w budownictwie. Wyniki przedstawiają przekonujące dowody, że respondenci polegają zarówno na własną opinią sytuacji przedsiębiorstwa, jak również na ogólny stan gospodarczy. Badanie zostało przeprowadzono w oparciu o Polskie dane z okresu 2000:1 do 2008:10.

Słowa kluczowe: metoda Epsilon, wskaźnik relatywnej wagi, budownictwa