



Do FOMC forecasts add value to staff forecasts?



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ABSTRACT

This paper compares the economic forecasts of members of the Board of Governors and presidents of the Federal Reserve Banks, and then investigates the value of each group's forecasts in supplementing the forecasts of the Board of Governors' staff. We find that the presidents tend to forecast higher inflation and real GDP growth, and lower unemployment than the members of the Board of Governors. We also find that the presidents' real GDP and unemployment rate forecasts add value to the real economy forecasts of the staff, while the governors' inflation forecasts add value to the staff's inflation forecasts.

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1. Introduction

Four times a year, members of the Board of Governors of the Federal Reserve and the presidents of Federal Reserve Banks prepare economic forecasts prior to meetings of the Federal Open Market Committee (FOMC).¹ These forecasts supplement the forecasts prepared by the Board of Governors staff. [Romer and Romer \(2008\)](#) report that FOMC forecasts, which they measure as the midpoint of the central tendency,² do not add value to the forecasts prepared by the Board of Governors staff in general. According to their results, when the FOMC considers forecasts of inflation and the unemployment rate as they deliberate policy decisions, they should put a weight of essentially zero on the FOMC forecasts and essentially one on the staff forecasts, even though the weights they should put on FOMC and staff real GDP forecasts are less clear cut. Furthermore, they provide evidence that the differences between FOMC forecasts and the staff forecasts are a source of monetary policy shocks, suggesting that FOMC forecasts not only provide no additional useful information to staff forecasts, but also can lead to inappropriate monetary policy decisions.³

Analyzing the individual forecasts of participants of FOMC meetings, instead of the midpoint of the central tendency, could potentially provide more information about the value of FOMC meeting forecasts if there are identifiable differences across groups that make the FOMC forecasts.⁴ In a recent contribution, [Tillmann \(2011\)](#) shows that the forecasts of voting and non-voting members of the FOMC differ, with non-voting members forecasting higher inflation than the consensus FOMC forecast if they

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¹ There are seven members of the Board of Governors and twelve presidents of the Federal Reserve Banks. While all nineteen can participate in FOMC meeting deliberations and prepare economic forecasts, only the members of the Board, the president of the New York Federal Reserve Bank, and four of the remaining presidents on a rotating basis have the right to vote on FOMC policy decisions.

² The central tendency shows the highest and lowest forecasts after removing the three highest and three lowest forecasts of members of the FOMC.

³ The importance of FOMC forecasts is further supported by [Orphanides and Wieland \(2008\)](#), which provides evidence that FOMC forecasts of inflation and output explain Federal Reserve monetary policy decisions in a Taylor rule framework better than real time outcomes.

⁴ There have been a number of papers that evaluate FOMC forecasts using the central tendency. See, for example, [Gavin and Mandal \(2003\)](#) and [Gamber and Smith \(2009\)](#).

favor tighter monetary policy and lower inflation than the consensus FOMC forecast if they favor easing monetary policy. Since five of the twelve presidents of the regional Federal Reserve Banks have voting rights at each FOMC meeting, along with members of the Board of Governors, the results suggest that there may be differences in the forecasts of the members of the Board of Governors and the presidents of the Federal Reserve Banks. Comparing the forecasts of the presidents of Federal Reserve Banks, members of the Board of Governors, and the Board of Governors' staff could potentially provide a better understanding of whether FOMC forecasts add value to the staff forecasts.

The purpose of this paper is to compare the economic forecasts prepared by members of the Board of Governors, presidents of Federal Reserve Banks, and the Board of Governors staff. We find that the presidents tend to forecast higher inflation, higher real GDP growth, and lower unemployment than the members of the Board of Governors. More importantly, we find that the presidents' real GDP and unemployment rate forecasts add value to the forecasts of the staff, while the governors' inflation forecasts add value to the staff's inflation forecasts. Comparing the mean forecast errors and mean squared forecast errors, we find that the staff inflation forecasts are more accurate than the FOMC, primarily because the presidents tend to overstate inflation risks. However, the FOMC is largely more accurate in forecasting real GDP growth and the unemployment rate than the staff, primarily because of the greater accuracy of the presidents' forecasts. We also inspect the frequency of each group being the most accurate. The frequency of having the most accurate inflation forecast is similar between the staff and governors, as is the case for the unemployment forecasts of the presidents and the staff. Only in the case of real GDP growth forecasts is there a clear difference, where the presidents are much more frequently the most accurate. Overall, the results suggest that ignoring FOMC forecasts might not lead to better policy decisions.

The results of this paper are consistent with the previous literature that finds that the Federal Reserve Bank presidents tend to prefer more restrictive policies than members of the Board of Governors.⁵ The appointment process of the presidents and the governors suggest that such policy differences reflect the different interests they represent on the FOMC.⁶ Since commercial banks play an important role in the selection of the presidents, while the governors are political appointees, the difference in monetary policy preferences is often interpreted as reflecting a desire to prevent the redistributive effects of surprise inflation on the part of the presidents, while the governors tend to have a broader focus. The structural differences in the forecasts of the presidents and the governors documented in this paper suggest that the forecasts are formulated to support the preferred monetary policies.

2. Is the FOMC a homogenous group?

We begin by evaluating the practice of using the midpoint of the central tendency as a measure of FOMC forecasts by considering whether the FOMC should be considered a homogenous group in terms of forecasting or whether the members of the Board and the presidents forecast differently. Previous research suggests that the forecasts of these two groups would differ. As discussed above, a number of studies finds that the monetary policy preferences of the presidents tend to favor tighter monetary policies than the members of the Board, so during periods when the operating target is the federal funds' rate, presidents will tend to favor a higher federal funds rate target than the Governors. Furthermore, many studies find that the federal funds rate target set by the FOMC can be largely explained by a forecast-based Taylor rule.⁷ While the difference in preferred federal funds rate targets among individual members of the FOMC who follow a forecast-based Taylor rule can result from differences in the individual's forecasts or the parameters of their individual Taylor rule, the limited evidence so far suggests that the difference results from members' forecasts.⁸ Thus, the presidents' preference for higher federal funds' rate targets than the governors suggests that the presidents would tend to forecast higher inflation and real GDP growth, and lower unemployment, than the members of the Board.

We can also provide some empirical support for grouping the forecasts of the presidents and members of the Board by analyzing the forecasts of each individual.⁹ The data set we use consists of individual forecasts of the inflation rate, real GDP growth and the unemployment rate, prepared each February and July from 1992 to 2000.¹⁰ The inflation rate forecast is for the GNP implicit price deflator through July 1999 and the price index for personal expenditures thereafter. The time horizon of the forecasts prepared for the February report is for three quarters ahead, while the forecasts prepared for the July report consist of one quarter and five quarters ahead forecasts. As forecasts are being prepared, governors and regional presidents have access to the Board of Governors staff forecast. After FOMC meetings the members have about a week to revise their forecasts. The forecast data we use are the revised forecasts, reducing the possibility that differences in individual forecasts reflect differences in access

⁵ See, for example, Belden (1989), Havrilesky and Schweitzer (1990), Havrilesky and Gildea (1991), and Chappel and McGregor (2000), that show that the presidents tend to vote more frequently in favor of restrictive policies than the governors. Chappel et al. (2005) and Johnson et al. (2012), using FOMC meeting transcripts, show that the presidents tend to express support for higher federal funds' rate targets than the members of the Board of Governors.

⁶ The governors are nominated by the President of the U.S. and confirmed by the U.S. Senate. During the sample period covered in this paper, the presidents were nominated by the board of directors of each Federal Reserve Bank, a majority of which were elected by the member banks of the Federal Reserve district, and subject to the approval of the Board of Governors. After the sample period, the nomination process was changed so an equal number of directors elected by the member banks and the directors appointed by the Board of Governors nominate the president of each Federal Reserve Bank.

⁷ See Clarida et al. (2000), Orphanides (2001), Mehra and Minton (2007), and Mehra and Sawhney (2010).

⁸ Fendel and Rulke (2012) find that individuals' forecasts and preferred federal funds' rate target (obtained from FOMC transcripts) are consistent with the Taylor rule, and that the estimated parameters of the rules for voting and nonvoting members of the FOMC are not statistically different. They do not consider differences between the members of the Board and the presidents of the Federal Reserve Banks.

⁹ The Fed has released individual forecast data as far back as 1992 and, because of the ten year lag in releasing this data, 2000 is the last year of data available. The data set is available from David Romer's website <http://elsa.berkeley.edu/~dromer>. See Romer (2010) for a detailed description of the data set.

¹⁰ In 2007 it was decided to increase the frequency of forecasts to four times a year.

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