



Strategic forecasting on the FOMC

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ABSTRACT

The Federal Open Market Committee (FOMC) of the Federal Reserve consists of voting and non-voting members. Apart from deciding about interest rate policy, members individually formulate regular inflation forecasts. This paper uncovers systematic differences in individual inflation forecasts submitted by voting and non-voting members. Based on a data set with individual forecasts recently made available it is shown that non-voters systematically overpredict inflation relative to the consensus forecast if they favor tighter policy and underpredict inflation if they favor looser policy. These findings are consistent with non-voting member following strategic motives in forecasting, i.e. non-voting members use their forecast to influence policy.

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1. Introduction

At almost all major central banks monetary policy is set not by a single decision maker but by a monetary policy committee of experts. At the U.S. Federal Reserve, for example, monetary policy decisions are taken by the Federal Open Market Committee (FOMC). These committees often consist of members with heterogeneous preferences, different backgrounds and career concerns as well as different regional and institutional affiliations. Only recently, the diversity of committee members' preferences and views is studied in the academic literature.¹ A number of studies, for example, study the pattern of formal dissent of FOMC members, the role of the chairman for policy deliberation, and the differences between outsiders and insiders.²

As a consequence of heterogeneity of monetary policy committees, committee members potentially behave strategically. One aspect where strategic behavior is likely to surface is the process of forecasting inflation. Although the Federal Reserve is not an official inflation targeter, its inflation forecast is likely to be important for interest rate policy and communication with the public. In a recent study of Fed policy in a Taylor rule framework, Orphanides and Wieland (2008) show that FOMC forecasts have more explanatory power for actual interest rate decisions than observed outcomes.

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¹ See Blinder (2009) for a recent survey on the the implications of alternative designs of monetary policy committees for interest rate policy.

² For an extensive survey of the literature on the design of committees see Gerling et al. (2005). To give just a few references for applications on monetary policy committees, see Blinder and Morgan (2005), Chappell et al. (2007), and Gerlach-Kristen (2008) for research on the role of the chairman in monetary policy committees. Riboni and Ruge-Murcia (2010) find in an empirical analysis that the consensus voting model fits most central bank policies best. Meade (2005) and Gerlach-Kristen and Meade (unpublished) study the incentives for formal dissent by FOMC members. Meade and Stasavage (2008) find that releasing transcripts of FOMC meetings changes the incentive for dissent. Gerlach-Kristen (2009) shows interesting differences between outsiders and insiders in the Bank of England's monetary policy committee in the pattern of dissent and their policy preferences.

Strategic behavior of members in the forecasting process has only been studied very recently by [Ellison and Sargent \(unpublished\)](#), whose important contribution will be discussed below. This paper contributes to this very small literature. A recent compilation of data on individual inflation forecasts by each FOMC members allows us to investigate whether members use their forecast to give the policy debate a twist in a particular direction. Take as an example a member that is hawkish on inflation. Will this member submit a somewhat higher inflation rate than the remaining members in order to gear policy towards tightening? The crucial cross-sectional property to identify strategic behavior is the right to vote on interest rate policy that rotates across members. We understand strategic forecasting as a systematic relationship between the inflation forecast and the voting status.

To uncover strategic behavior of FOMC members, therefore, we exploit the rotating nature of members' voting rights. The assumption is that using the inflation forecast to influence policy deliberations is more attractive for non-voting members than for voting members. These members should instead use their semiannual forecast to influence policy deliberation. The empirical strategy identifies systematic differences between voters and non-voters in their forecasting behavior. It is shown that non-voters deviate more strongly from the forecast consensus in the direction consistent with their interest rate preference. Non-voters who expressed a preference for a looser policy stance systematically submit forecasts lower than the committee's average forecast. Non-voters with a preference for a policy tightening, in contrast, systematically exceed the forecast consensus.

While strategic behavior of macroeconomic forecasters received some attention in the literature, the issue of strategic forecasting of FOMC members has not yet been studied due to the non-availability of data. The compilation of individual forecasts submitted by each FOMC member for selected years by [Romer \(2010\)](#) makes it possible to take a first step into this direction. Thus far only the range of forecasts are published, not the individual numbers.

This paper is organized as follows. A review of the related literature is given in [Section 2](#). This section also sketches some theoretical foundations of the paper's main hypothesis. [Section 3](#) presents the data set on individual FOMC inflation forecasts. The empirical strategy and the results are discussed in [Section 4](#). [Section 5](#) draws some tentative conclusions.

2. Strategic forecasting

2.1. The case of macroeconomic forecasters

The literature provides evidence that supports the notion of strategic behavior of macroeconomic forecasters. [Laster et al. \(1999\)](#) find that professional forecasters whose wage depends most on publicity produce forecasts that differ most from the consensus. [Lamont \(2002\)](#) and [Pons-Novell \(2003\)](#) test the cross-sectional implications of theories of strategic forecasting. The null hypothesis is that the dispersal of forecasts is unrelated to the forecaster's age or other measures of reputation or career concerns. They find that forecasters who are older and more established produce more radical forecasts. Based on a panel of Japanese GDP forecasts, [Ashiya \(2009\)](#) finds that forecasters are concerned about publicity when submitting their forecast. Based on the method of [Bernhardt et al. \(2006\)](#), [Pierdzioch et al. \(2010\)](#) test for strategic behavior of oil-price forecasters. They find evidence of anti-herding, i.e. forecasts are systematically biased away from the forecast consensus. Evidence against a rational bias in macroeconomic forecasts due to reputational or financial incentives is presented by [Batchelor \(2007\)](#).

2.2. The case of the Fed

As mentioned in the introduction, strategic forecasting of policymakers has not yet received particular attention – mostly due to the non-availability of data. Nevertheless, three papers are particularly relevant in this context. First, [Capistrán \(2008\)](#) points to systematic forecast errors of Greenbook forecasts. He offers an explanation in terms of an asymmetric loss function of forecasters and finds that in the post-Volcker era the Fed's cost of under-predicting inflation was four times the cost of over-predicting.

Second, the recent note by [McCracken \(2010\)](#) is close to this paper. He also pursues the idea of strategic forecasting on the FOMC and argues that hawkish members have an incentive to forecast high inflation in order to underlie the need for tighter policy. He finds that for inflation, the midpoint of the trimmed range, i.e. the outlier-adjusted range, is a more accurate predictor than the midpoint of the full range. Put differently, controlling for outliers improves the accuracy of the FOMC's inflation forecast. Arguably, the behavior described by [McCracken \(2010\)](#) is more relevant for non-voters than for voters. To uncover strategic behavior of FOMC members, therefore, we exploit the rotating nature of members' voting rights. While [McCracken \(2010\)](#) uses the range of forecasts, we base our study on a data set with individual inflation forecasts recently made available.

Third, [Ellison and Sargent \(unpublished\)](#) argue that aggregate FOMC forecasts are not meant to be accurate descriptions of the most likely future inflation outcome, but rather worst-case scenarios used to guide policy in the presence of model misspecifications. Policymakers put greater weight on adverse outcomes, i.e. inflation being further away from target, than the staff or external forecasters. We can conclude from this study that, first, inflation forecasts matter as an important input for policy and, second, that individual FOMC members might use these forecasts strategically according to their own degree of model uncertainty which is not necessarily shared by fellow members.

2.3. This paper's hypothesis

In this paper we utilize the rotating nature of members' voting rights in order to detect strategic behavior of FOMC members in the data. The hypothesis is that a non-voter will exhibit a higher propensity to submit an extreme inflation forecast.

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