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Does Presidential Partisanship Affect Fed Inflation Forecasts?

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- 1 Motivation
- 2 Describing Forecast Errors
- 3 What Might Explain Forecast Errors?
- 4 Empirical Tests
- 5 Conclusions

The working paper is available on SSRN at:

[http://papers.ssrn.com/sol3/papers.cfm?
abstract_id=2105301.](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2105301)

Presidential Partisan Inflation Forecast Bias:

When inflation forecasts are systematically different depending on the partisan identification of the United States president.

Why should we care about presidential partisan inflation forecast bias?

- ▶ Clark & Arel-Bundock (2011) find policymakers at the Federal Reserve are not politically indifferent.
- ▶ Could be that the information they receive is biased.
- ▶ Economists have not considered political preferences when evaluating Fed accuracy.

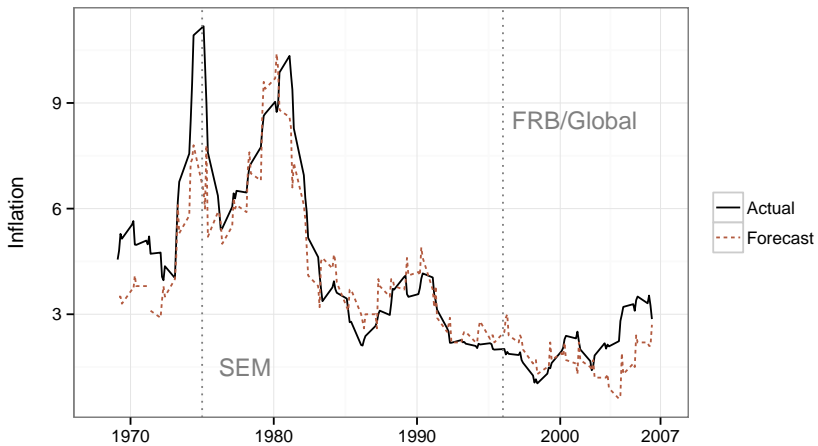
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How accurate are Fed inflation forecasts?



Forecast Errors

Our **dependent variable**:

$$E_q = \frac{F_q - I_q}{I_q}$$

- ▶ E_q = the standardized inflation forecast error for quarter q .
- ▶ F_q = Green Book inflation forecast for quarter q . (We use forecasts made *two quarters* prior).
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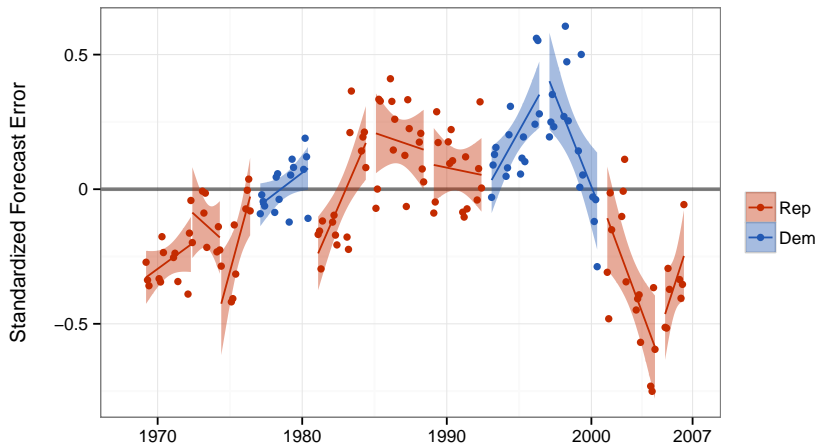
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Ideally, the mean forecast error is 0.

Consistent errors \rightarrow “wrong” policies.



What might explain forecast errors?

Traditional understanding of Fed forecasting

- ▶ Forecasts produced for every FOMC meeting
- ▶ Over long run no bias (e.g., Romer and Romer 2000).
- ▶ Periods of over- and under-estimations (Capistrán 2008).
- ▶ No research on partisan influence of forecast errors.

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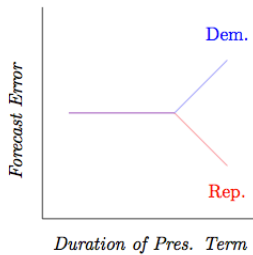
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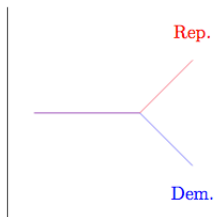
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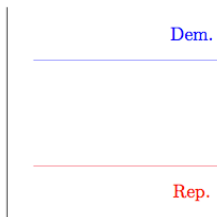
Partisan Preferences



Monetary Expectations



Partisan Heuristics



Followed Ho et al. (2010) to isolate relationship between presidential partisanship/elections and the other controls.

1. Two data sets **matched** on:
 - ▶ *presidential party ID*
 - ▶ *election period*
2. Used these in **parametric models** with standardized inflation forecast errors as continuous dependent variable.

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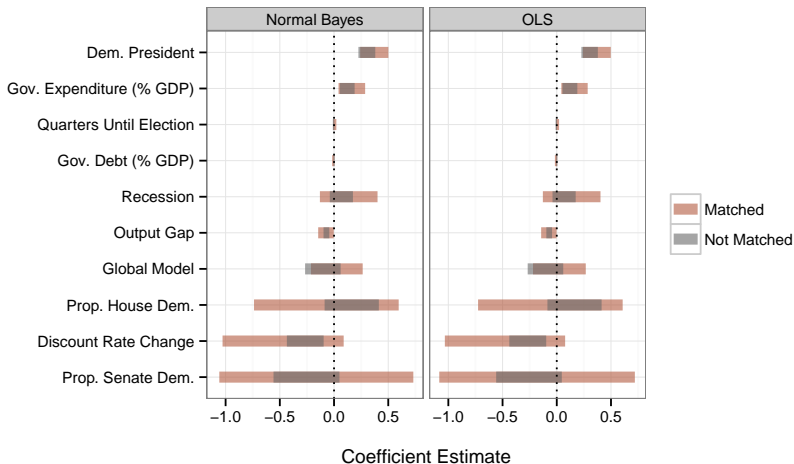
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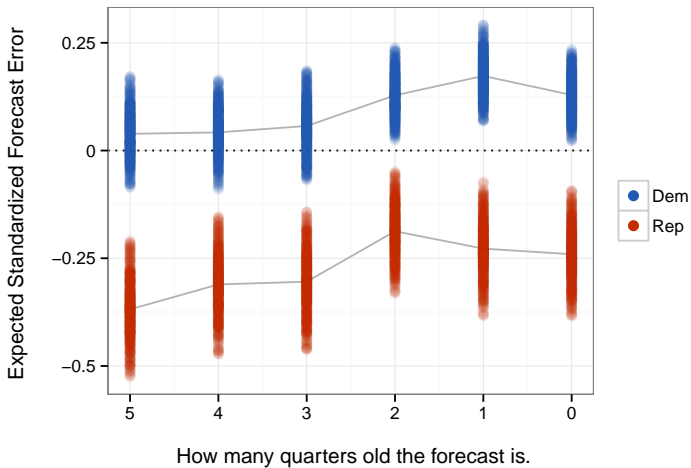
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Results?

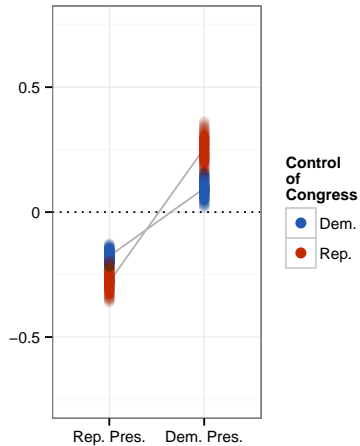
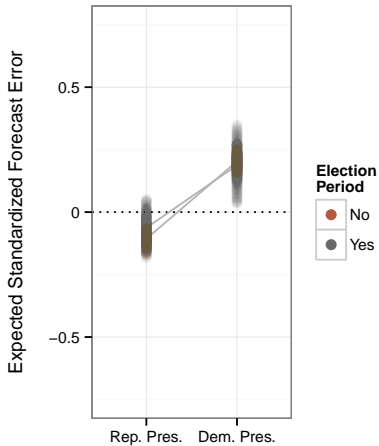
Main Results (2 Quarter Old Forecasts)



Simulated Errors (All Forecasts)



Interactions (2 Quarter Old Forecasts)



Does presidential partisanship affect Fed staff inflation forecasts?

Probably.

How?

- ▶ Fed staff **don't** have an electoral bias.
 - ▶ Don't seem to try to influence election outcomes or compensate for FOMC political preferences.
- ▶ Fed staff **do** use a **partisan heuristic**
 - ▶ Leads to **systematic bias** in inflation forecasts across presidential terms.

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Possible political implications?

- ▶ High inflation forecasts during **Democratic** presidencies → interest rates '**too high**'.
 - ▶ This could hurt Democrats' re-election chances.
- ▶ Low forecasts during **Republican** presidencies → interest rates '**too low**'.
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- ▶ Does not explain Clark and Arel-Boondock's interest rate finding.
- ▶ Of course, **more research is needed**.

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