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Does Presidential Partisanship Affect Fed Inflation Forecasts?

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31 August 2012

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Why should we care about presidential partisan inflation forecast bias?

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

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How accurate are Fed inflation forecasts?

Forecast Errors

Our **dependent variable**:

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

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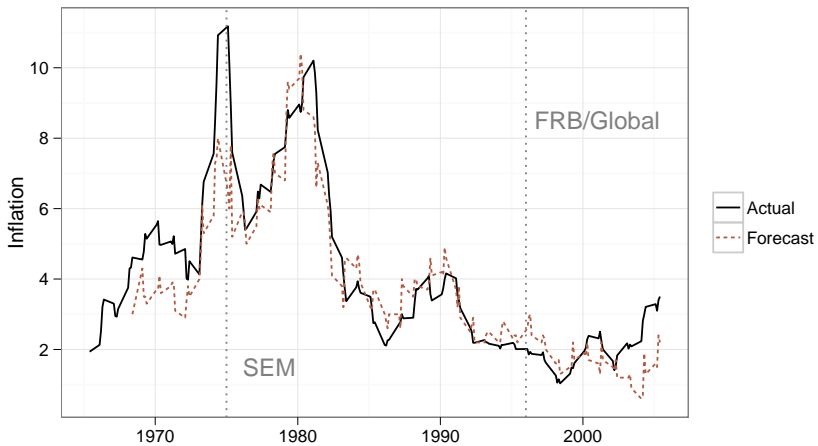
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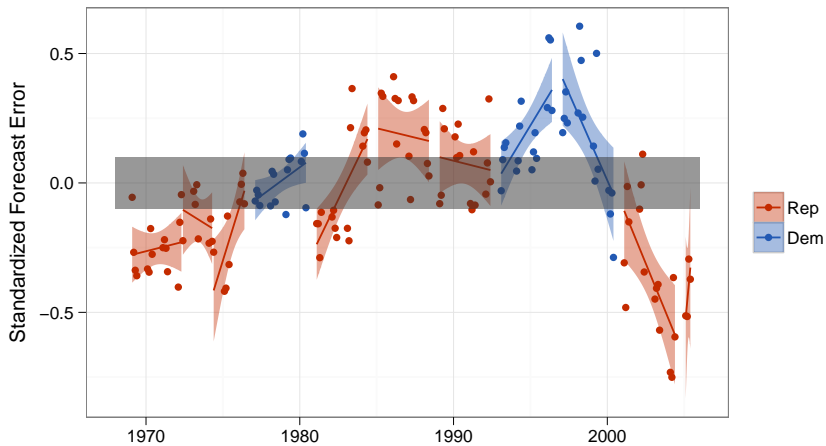
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Ideally, the mean forecast error is 0.

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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Explaining the Pattern

- ▶ Partisan Preferences
- ▶ Monetary Expectations
- ▶ Partisan Heuristics
 - ▶ Staffers expect Democrats (Republicans) to be more (less) inflationary → higher (lower) inflationary expectations

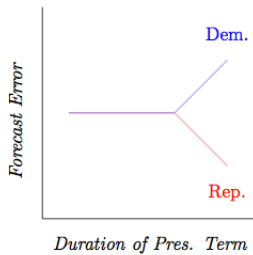
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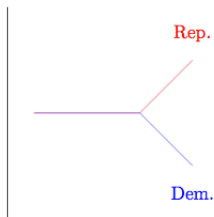
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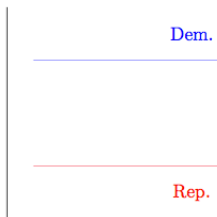
Partisan Preferences



Monetary Expectations



Partisan Heuristics



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

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

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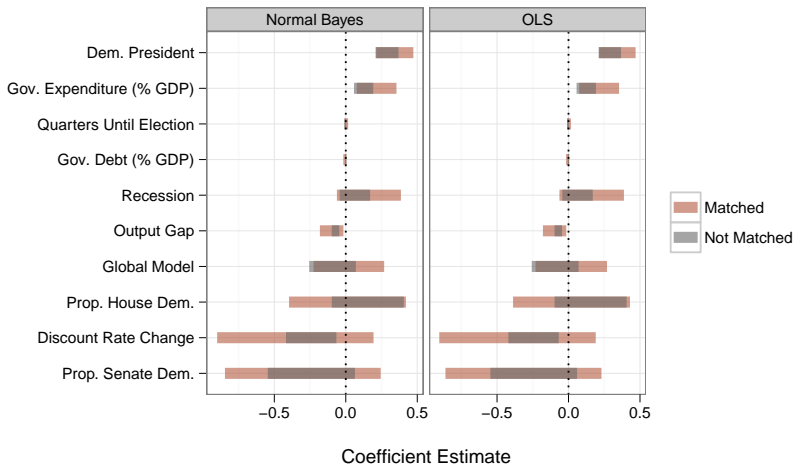
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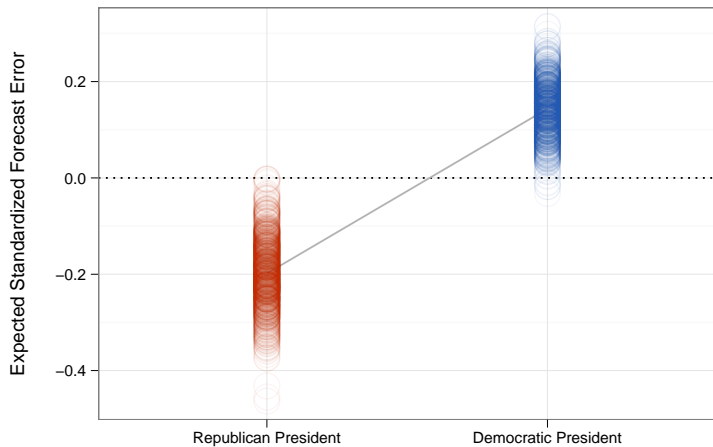
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Results?

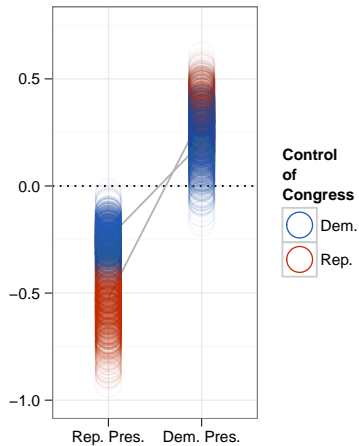
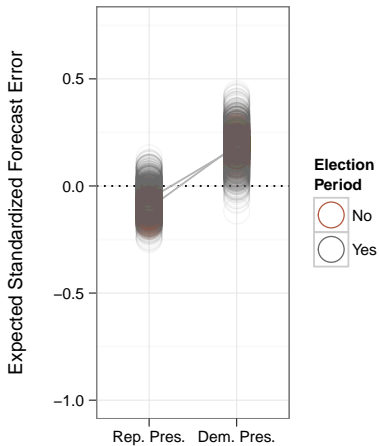
Main Results



Simulated Errors



Interactions



Does presidential partisanship affect Fed staff inflation forecasts?

Probably.

How?

- ▶ Fed staff **don't** seem to have an election-based bias.
 - ▶ They don't seem to be trying to influence election outcomes or compensate for FOMC actions.
- ▶ Fed staff **do** appear to have a **partisan heuristic** that leads to a **systematic bias** in their inflation forecasts across presidential terms.

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Possible political implications?

- ▶ Overly high inflation forecasts during **Democratic** presidencies could cause the FOMC to set interest rates '**too high**'. This could hurt Democrats' re-election chances.
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