1997 conference

Price Stability, Inflation Targets and Monetary Policy

Proceedings of a conference - May 1997

Session 6 - Discussion

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Johnson agreed with Paulin's suggestion that other factors that might affect either the forecast errors or credibility should be investigated. He admitted that the data set was limited to current and one-year-ahead forecasts and that this short forecast horizon was problematic. He also recognized the discrepancy between the measure of inflation that had been forecast in his data set and the measure targeted by some of the central banks.

He also supported Miller's proposal that future work should include an analysis of the learning process. With respect to the regressions she suggested, Johnson agreed to consider these more carefully. He indicated that at first glance, however, it would not be possible to have the regressions take into account the year-specific draws, and suggested that he still preferred the random effects analysis-of-variance (ANOVA) model approach. He argued that forecasters in the survey data set should be treated as a sample drawn from a much larger set of agents forming expectations. Forecasters enter and leave the data set each year, so it is not really a panel data set. He emphasized that the survey data set is best characterized as a series of draws from a larger group of forecasters over several years, with some of those years being targeting years. He recognized that might limit the use of the data set but argued that it was the right way to think about the data.

John Galbraith introduced an issue previously discussed in the literature on forecast evaluation: Forecasters may have asymmetric loss functions. Consideration of a client's response might make it rational to publish a biased forecast. If so, one cannot infer irrationality from bias. Whenever this occurs, the forecast produced will not represent the forecaster's true expectations as assumed. Charles Freedman offered a historical example of Galbraith's deliberate bias. In 1991, individual inflation forecasters had admitted that while they did expect that the Bank of Canada could meet its inflation target, their clients did not share the same view and they were therefore reluctant to include their true expectations in their forecasts at that time.

Irene Ip raised the point that the use of this data set assumes that the forecast group is representative of all the users of inflation forecasts. She suggested that when forecasts of inflation are presented to clients, the clients often do not accept the forecast and will base their decisions, such as how to structure their debt, on a very different profile for expected inflation. It might be worthwhile to look at alternative data sources, such as union contracts and the structure of debt, to determine the credibility of the inflation forecasters.

Murray Sherwin noted that one possible difficulty associated with using an international data set was the unique experience of individual countries, including the difficulty of dating regime shifts precisely. He mentioned in particular the Reserve Bank of New Zealand's experience, in which floating the exchange rate in 1985 changed its ability to conduct monetary policy. He also noted that credibility is not instantaneous. In New Zealand, credibility is likely to be closely linked to the reliability of the Reserve Bank's forecasts, which are published as a key part of its communication process. Sherwin also noted that surveys done on inflation expectations in New Zealand suggest that household expectations of inflation are consistently higher than the expectations of businesses, which in turn are consistently higher than those reported in a survey of economists and market forecasters that is conducted by the central bank.

Finally, Seamus Hogan suggested that it would be worthwhile to investigate the importance of the interactions between central bank independence and how well the six countries did on credibility.