Modeling Over-Reaction in Survey Forecasts

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Abstract

Recent studies document empirical evidence that is typically seen to be at odds with the traditional models of information frictions. Does this evidence really contradict models of information frictions? In this paper, I argue that it does not. I show that the seemingly contradictory evidence is successfully accounted for by the information friction model I propose. The key distinction is that I consider an additional source of information frictions. Like traditional models, I assume people do not accurately observe the current state. Importantly, I also assume people do not accurately remember past observations. I show that introducing the additional friction changes the model prediction both qualitatively and quantitatively. Subject to two information frictions, short-term forecasts under-react while long-term forecasts over-react to recent news. This is qualitatively different from the traditional models that can only generate under-reaction. Quantitative aspect of the proposed model is also important: I find evidence that the existing literature is likely under-estimating the magnitude of information frictions.

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