Modeling Over-Reaction in Survey Forecasts

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Abstract

Forecasts of professional forecasters are not consistent with the full-information rational expectations assumption. In particular, forecasts respond to news in a slow and dampened manner. Such forecast under-reaction is argued to be consistent with a model of information frictions. But this class of models is challenged by recent studies that document signs of over-reaction that are hard to explain with the information frictions. In this paper, I propose a model of information frictions that can explain signs of both under and over-reaction that are emphasized in the literature. The key difference from the previous literature is that my model assumes not just noisy observation of the current state, but also noisy memory of past observations: knowledge is forgotten and accumulated with noise. I show that forgetful Bayesian agents under-react to news when forecasting for the short-term, but over-react to news when forecasting for the long-term. I estimate the proposed model and find evidence that previously estimated extent of information frictions is likely to be under-estimated.

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