

Bayesian Combination for Inflation Forecasts: The Effects of a Prior Based on Central Banks' Estimates

Working Paper No. 853 Keep in mind

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Typically, central banks use a variety of individual models (or a combination of models) when forecasting inflation rates. Most of these require excessive amounts of data, time, and computational power; all of which are scarce when monetary authorities meet to decide over policy interventions. In this paper we use a rolling Bayesian combination technique that considers inflation estimates by the staff of the Central Bank of Colombia during 2002-2011 as prior information. Our results show that: 1) the accuracy of individual models is improved by using a Bayesian shrinkage methodology, and 2) priors consisting of staff's estimates outperform all other priors that comprise equal or zero-vector weights. Consequently, our model provides readily available forecasts that exceed all individual models in terms of forecasting accuracy at every evaluated horizon.