Identifying Drivers of Deviations From Rational Expectations: Using a New Irrational Index for Inflation Forecasts

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Abstract-

Most studies on inflation forecasts have studied behavioral biases, informational frictions, or external shocks in isolation, without considering how these factors jointly drive deviations from rational expectations. We therefore adopt an integrated framework that simultaneously estimates the behavioral, informational, and external determinants of deviations from rationality. To measure the deviations, we develop a novel irrationality index—following Rossi and Sekhposyan's (2016) Fluctuation Rationality Test—to measure experts' time-varying deviations from rationality in US year-ahead inflation forecasts between 2010 and 2022. We then estimate the impact of different behavioral, informational, and external drivers on deviations from rationality using panel models. Our results indicate that external information shocks, interest rate expectations, as well as geopolitical risk all significantly drive the deviations from rationality. These findings highlight the value of a unified approach to expectation formation, moving beyond the isolated analyses that are common to the literature.

Index Terms- deviations; inflation; rational expectations; rationality test

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