The Fed’s New Economic Projections

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Today, the Federal Reserve made a giant stride toward its goal of taking the mystery out of monetary policy. The Fed released a detailed forecast of the economy, describing, in greater detail than it has ever done before, how it thinks major economic variables will change over the next several years.

Until today, the Fed only gave us a glimpse of its forecasts twice a year, when the Fed chairman testified before Congress in the Humphrey-Hawkins testimony. And although those forecasts provided some insight, the Fed did not provide nearly the detail about the forecasts shown in today’s release. Two major changes in the forecasts occurred today: the Fed told us what it was thinking would happen further into the future, and it provided information about how uncertain it is about the path of key economic variables.

The forecasts released today by the Fed extend to 2010. By looking three years into the future, the Fed is giving us a view about what its long-run forecast is. The projection of real GDP growth of 2.5 to 2.6 percent is surprisingly low, given that in the late 1990s real GDP growth averaged about 4 percent. The Fed is clearly thinking that productivity growth is slowing relative to what it was doing in the 1990s.

The other forecasts for 2010 are less surprising. The Fed foresees the unemployment rate in 2010 running about 4.7 to 4.9 percent. But the unemployment rate is notoriously difficult to forecast, so such projections are unlikely to materialize. The Fed’s forecasts of inflation in 2010 are in the range of 1.6 to 1.9 percent, which is in the comfort range that many people think is desirable. A few hawks on the FOMC might like to see those inflation numbers a bit closer to 1 percent, but for most FOMC members the range of 1.6 to 1.9 percent is far enough from zero to avoid worries about deflation, and low enough that inflation is not a major concern of households and businesses.

The second innovation in the forecasts released by the Fed is the use of charts to illustrate the range of the forecasts by the FOMC participants, as well as a discussion of the uncertainty each participant has about the forecasts. Chart 1 in the Fed’s press release suggests that, over time, the Fed may move in the direction of the Bank of England’s inflation report, which provides a detailed analysis of the uncertainty of its forecasts in a “fan chart”. This would provide even more useful information about how much uncertainty the Fed has about its forecasts.

The Fed in the past was mysterious and secretive. But under former chairman Alan Greenspan, the Fed began to communicate its intentions a bit more clearly. Today’s advance under chairman Bernanke makes a much bigger change in Fed transparency. The ultimate goal of chairman Bernanke and the Fed might surprise you—to make monetary policy so obvious and clear that no one pays much attention to the Fed any more. Instead of seeking star status, as Greenspan had, Bernanke seeks to minimize his role. He would
like the Fed to be seen as a competent institution in the background—one that is not worthy of much attention, but whose role is respected by everyone. Bernanke would like it if he could walk down the street unrecognized and if no one knew or cared who he was.

Why does the Fed want people to know what it will do? Because economic research suggests that monetary policy works better when it doesn’t surprise anyone. As chairman Bernanke described in this speech last week, Fed transparency helps monetary policy work more effectively in four major ways: it reduces the uncertainty faced by investors, firms, and households so they can make better decisions; it ensures that interest rates move in the direction the Fed intends when it changes policy; it helps stabilize people’s inflation expectations; and it allows the Fed to receive useful input from firms and households.

A less important change made in today’s release by the Fed is that the Fed is providing forecasts of both the overall level of consumer prices (measured by the price index for personal consumption expenditures) and the level of prices excluding food and energy prices, which is often referred to as “core inflation.” The core inflation forecast has been the Fed’s main focus for the past three years, on the theory that shocks to food and energy prices often distort the inflation picture. But people must pay for food and energy, so ignoring the prices of those items leaves out too many of the items that affect people’s budgets. So, the best measure of inflation is the overall measure. By forecasting both, the Fed keeps its eyes on the ultimate goal of policy (the overall measure) while making policy respond more to the core inflation measure, which is usually more indicative of where inflation is trending.

Though the Fed’s release of its forecast made news this afternoon because of the slow growth rate of GDP in the fourth quarter this year and below average growth rate next year, the real news is the Fed’s increased transparency. This is definitely a step in the right direction for the Fed, and U.S. citizens should applaud this step.

Where should the Fed go from here? The main thing missing from the Fed’s forecasts is the “policy path,” which is the assumption that the Fed makes in its forecasts about short-term interest rates. When private-sector forecasters make their predictions, their views of short-term interest rates tell you whether they think the Fed will ease or tighten monetary policy. Since the Fed has never wanted to tip its hand, it has never released the policy path of its forecasts. Doing so would be an even bigger step towards increased transparency.