The FOMC Stands Pat

The Federal Open Market Committee (FOMC) met in March and reaffirmed its accommodative policy stance. The outcome was not a surprise, although some committee members have been concerned about low interest rates leading people to “reach for yield”; trying to get a higher rate of return on their investments by taking on more risk. In a recent speech, Fed Chairman Bernanke argued that the Fed was monitoring those risks carefully and does not feel that the situation calls for the Fed to slow down its quantitative easing. So, the Fed will continue to purchase $45 billion of long-term securities and $40 billion of mortgage-backed securities each month, with the goal of keeping long-term interest rates at a low level, which in turn may help stimulate the economy.

At the FOMC meeting, the 19 participants (the 7 members of the Board of Governors and the 12 presidents of Federal Reserve Banks) made forecasts of real GDP growth, the unemployment rate, and the inflation rate. The forecasts did not change dramatically from the forecasts they had made last December (see Table). For 2013, the forecasts for each variable were slightly lower than they were in December, but otherwise the forecasts did not change very much in other years.

Table. Table 1 from the Fed’s March 2013 Projections. The FOMC changed its forecasts slightly for 2013, but not much in other years or in the long run.
The central tendency shown in the table (and in the following charts) is obtained by excluding the top 3 and bottom 3 forecasts for each variable for each year, and shows the range of the remaining 13 forecasts by the FOMC participants. Chart 1 from the Fed’s report shows that the FOMC expects real GDP growth to increase in each of the next three years, while the unemployment rate is expected to decline gradually. Inflation is expected to rise very gradually towards its long-run target of 2 percent.

Chart 1. Figure 1 from the Fed’s March 2013 Projections. The projections show a gradual increase in real GDP growth, a steady decline in the unemployment rate, and a small rise in inflation.
The longer run projections give you a sense of where the FOMC thinks the economy is heading when it returns to normal. Real GDP growth is expected to be 2.3 to 2.5 percent per year. The FOMC is very uncertain about what the unemployment rate will be in the long run, with a central tendency between 5.2 percent and 6.0 percent. This is not surprising, as macroeconomists know that the long-run, or natural, rate of unemployment changes over time and is hard to forecast. Of course, the long-run inflation forecast is exactly 2 percent, because that is the Fed’s stated target for inflation.

The last piece of the Fed’s projections show when the FOMC thinks that it will begin to raise its target for the federal funds interest rate (Chart 2). As you can see, only one FOMC participant thinks the Fed will raise short-term interest rates in 2013, 4 more think that will happen in 2014, 13 think it will happen in 2015, and one participant thinks the Fed will keep rates near zero until 2016. These projections are consistent with the Fed’s goal of convincing people that short-term interest rates will remain low for a long time. In that case, based on the theory of the term structure of interest rates in Chapter 5, long-term interest rates will stay low. On the other hand, if people began to believe that the Fed was going to raise short-term interest rates soon, then long-term interest rates would rise immediately, because of the expectations hypothesis that relates long-term interest rates to future short-term interest rates.

Chart 2. Lower Panel of Figure 2 from the Fed’s March 2013 Projections. The projections show what the individual FOMC participants think will happen to the target federal funds interest rate.