The release of the Fed’s interest rate forecasts was interesting. The main item that people focused on was when the round of tightening would begin in the forecasts, which appears to be late-2014. But there was a wide range of opinion among FOMC participants, with some believing that the Fed will tighten later this year, and others thinking that interest rates would not begin rising until 2016.

An important point to note is that these forecasts are highly dependent on economic conditions. These are only good forecasts if the economy actually grows as slowly as the Fed thinks it will over the next two years. If economic growth is faster, then monetary policy will tighten more quickly.

I have studied historical forecasts of short-term interest rates and in almost every historical tightening episode, private-sector forecasters have made substantial forecast errors. Interest rates usually rise faster and by more than the forecasters expect. You can see this in M&B in Chapter 5 in the Data Bank: How Accurate Are Expectations of Short-Term Interest Rates? (pages 89-90). You can see that the interest rate forecasts are always lagging behind the actual interest rate movements. You might think that the Fed could forecast interest rates better than private-sector forecasters, but for other variables, the Fed and private-sector forecasters forecast about the same, with a slight edge to the Fed. So perhaps the Fed will do slightly better, but don’t count on it.

Interest rates may have to rise more than normal this time. In a typical tightening episode, the Fed raises the fed funds rate by 3 to 5 percentage points (see Figure 5.4 on page 85, which shows the closely related short-term interest rate on three-month Treasury bills). But now the volume of excess reserves in banks is likely to cause the Fed to have to tighten policy much more aggressively than ever before to keep those funds from flowing into the economy and causing inflation. So, interest rates may have to rise much more than has historically been the case, once the economy’s pace begins to quicken. Or else inflation will rise, which will also lead to higher interest rates.

Perhaps the best news in the Fed’s statements was that the Fed declared that its long-run target for inflation would be 2 percent as measured by the personal consumption expenditures price index. This declaration moves the Fed a bit closer to inflation targeting (see M&B Chapter 18, pp. 403-405), but as Fed Chairman Bernanke pointed out in his press conference, the Fed has a dual mandate (see M&B Chapter 17, pp. 361-362) and not only must it keep inflation low but it must also keep output high.