Ghosts of Forecasts Past and Future

James Bullard

President and CEO, FRB-St. Louis

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Fed Forecasts and the Policy Assumption

Fed forecasts

- I plan to talk about Fed forecasts over the last several years and for 2014.
- These forecasts focus on three key areas: real GDP growth, the unemployment rate, and inflation.
- The forecasts are made by the Federal Open Market Committee (FOMC) each quarter, without attribution to individual members.
- I will point out my own forecasts as we consider the range of forecasts of the Committee.

The policy assumption

- When FOMC participants are asked to submit forecasts, it is under an "appropriate monetary policy" assumption.
- This aspect of the exercise greatly clouds the meaning of these Committee forecasts.
- What is an individual participant saying?
  - Is it that the forecast outcomes are possible but only under the policy assumption of that particular participant?
  - Or is it that the forecast outcomes are likely given the path of policy forecast by that particular participant, even if that participant views a different policy as appropriate?
- This is a long-standing problem with FOMC forecasts.

The policy assumption and Charles Dickens

- One is tempted to paraphrase Scrooge's plaint to the ominous ghost of Christmas future:

  Good spirit … assure me that I may yet change these shadows you have shown me, by an altered monetary policy!
- The ghost of Christmas future has shown Scrooge a vision of events to come, but only under Scrooge's present-day policy of cold-heartedness.
- In the Dickens short story, Scrooge does change behavior and the shadows foretold by the ghost of Christmas future do not come to pass.
  - Is the ghost of Christmas future therefore a poor forecaster?

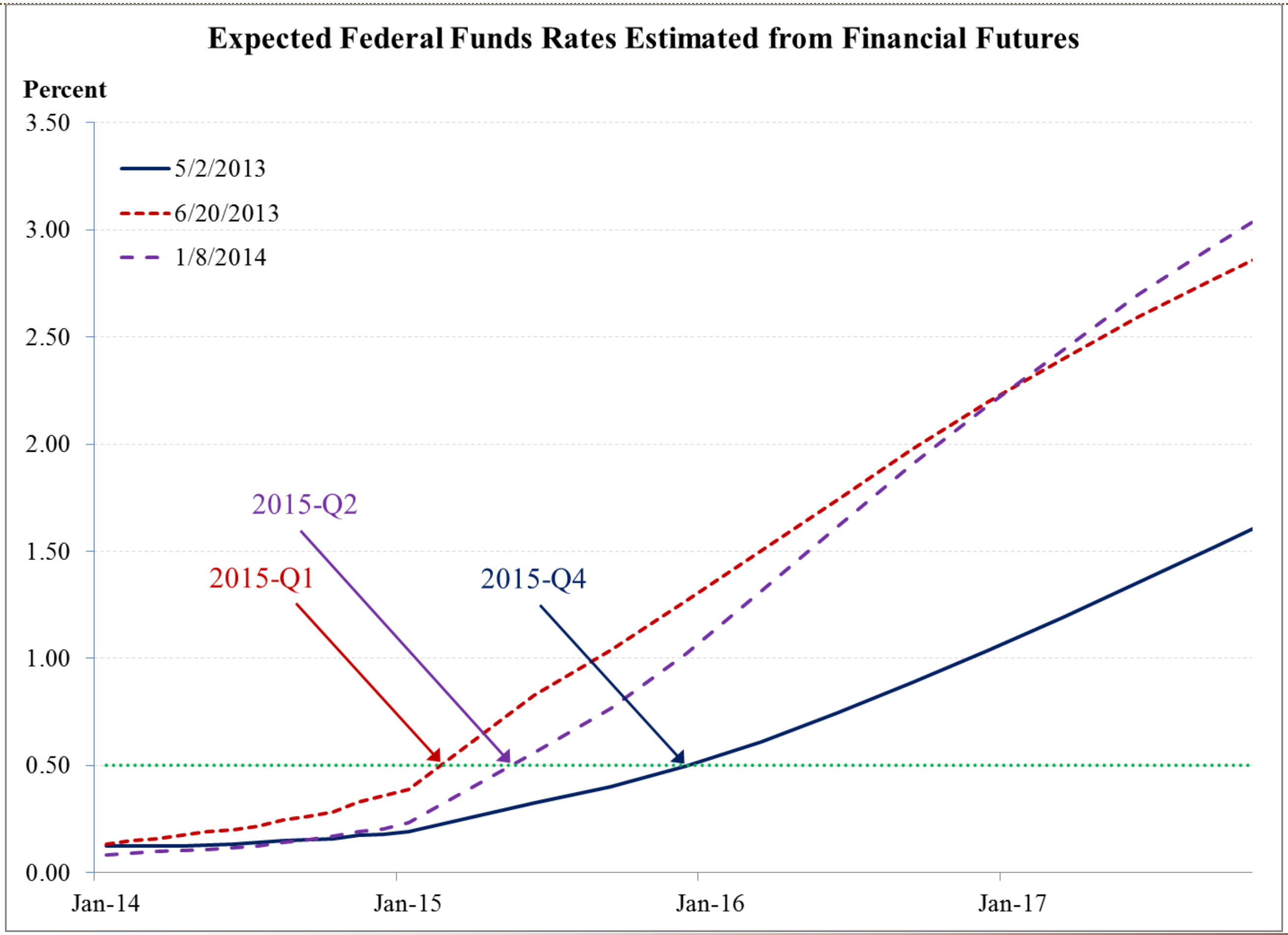
The forecasts for today

- When most outside observers look at FOMC forecasts, they simply ignore the policy assumption.
- Instead, outside observers treat the prognostications as forecasts of what will actually happen.
- That is how I will look at these forecasts today.
  - But, I will do so with your understanding that it is not completely fair.
- For a technical discussion on this and related issues, see Martin Ellison and Thomas J. Sargent, 2012, "A Defense of the FOMC," *International Economic Review*, and my related commentary, "Discussion of Ellison and Sargent," at the Workshop on Uncertainty Over the Business Cycle, Frankfurt, 2009.

The policy assumption for today

- FOMC policy currently consists of two parts.
  - The ongoing asset purchase program, currently set at $75 billion per month, about equally divided between Treasury securities and MBS.
  - Forward guidance, currently stated as a promise that the Committee will keep the policy rate near zero "well past" the point at which the unemployment rate hits 6.5 percent, provided inflation remains below 2.5 percent.
- This is a relatively complicated policy setting compared to normal times, and so it is hard to characterize current policy completely.
- We can look at a market expectation of rates instead.

Market expectations of rates



Source: author's calculations. Last observation: January 8, 2014.

Forecasts Past

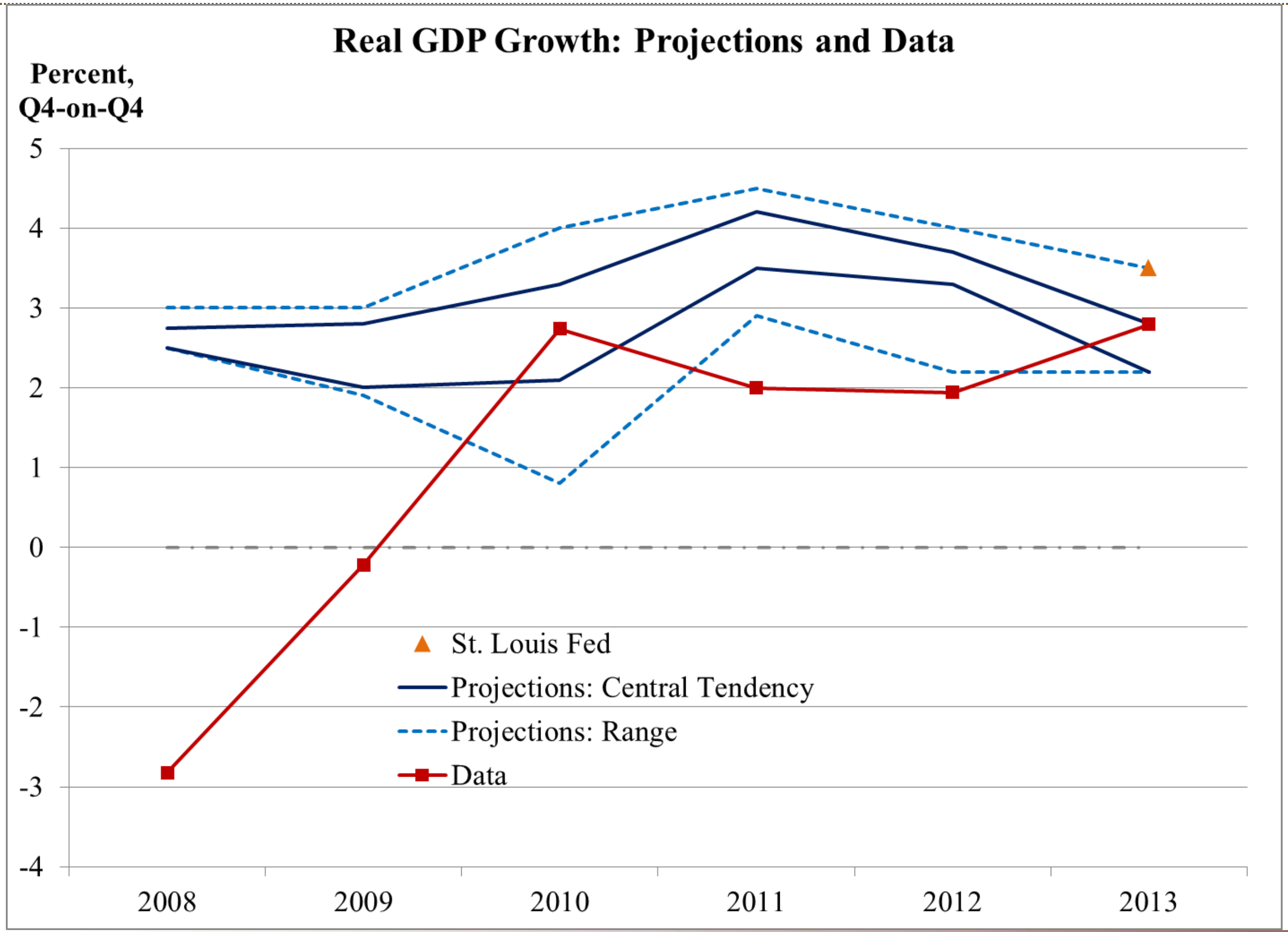
Forecasts past

- In the last several years, the FOMC has tended to be:
  - too optimistic on real GDP growth,
  - about right on unemployment and
  - mixed regarding its inflation forecast accuracy.

- In 2013, the FOMC was:
  - about right on GDP growth,
  - too pessimistic on unemployment and
  - too sanguine that inflation would remain near target.

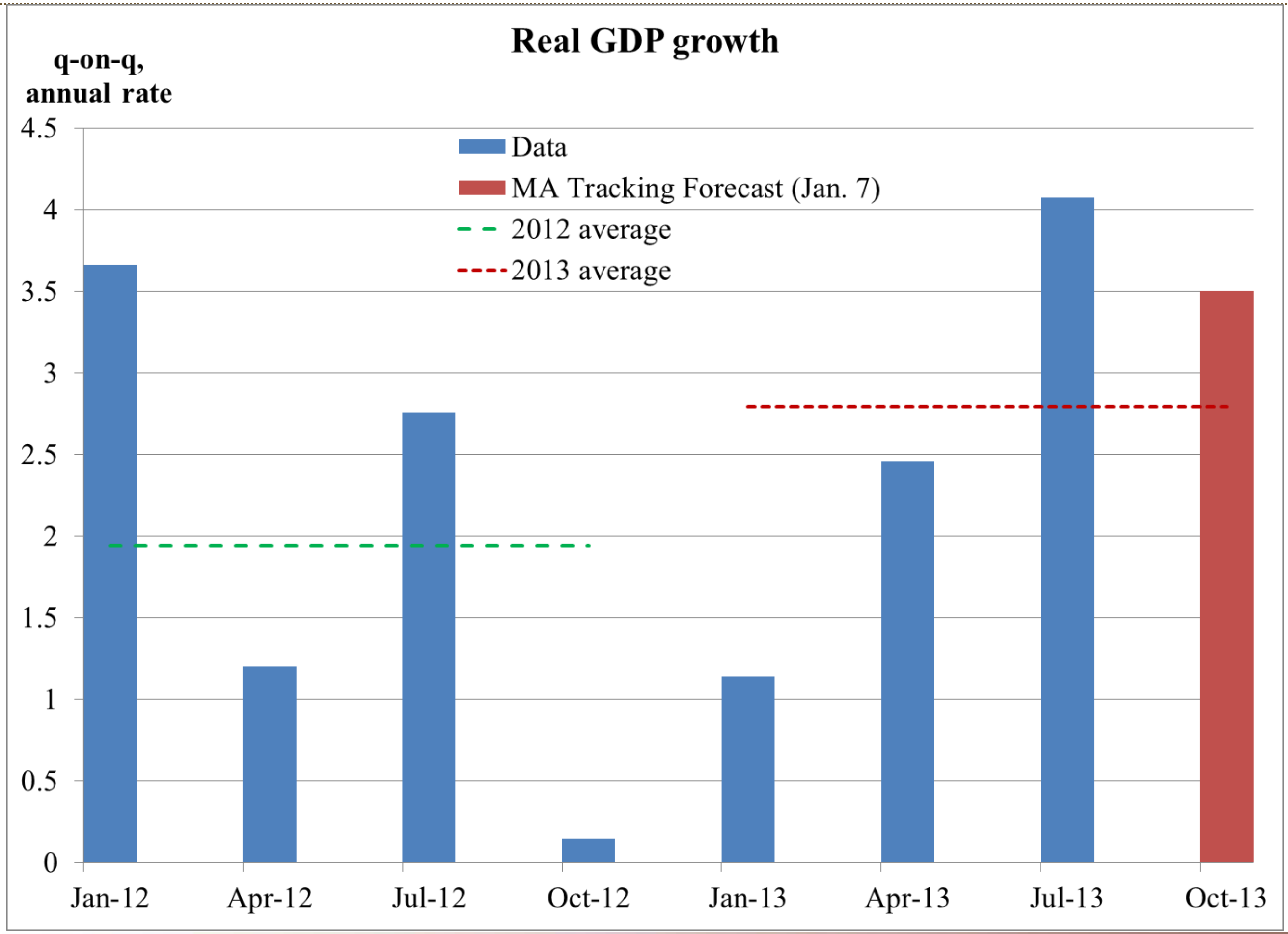
Forecasts Past: Real GDP Growth

Forecasts past



Source: FRB Economic Projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July. The 2013-Q4 figure is the MA tracking forecast.

Another view of real GDP growth



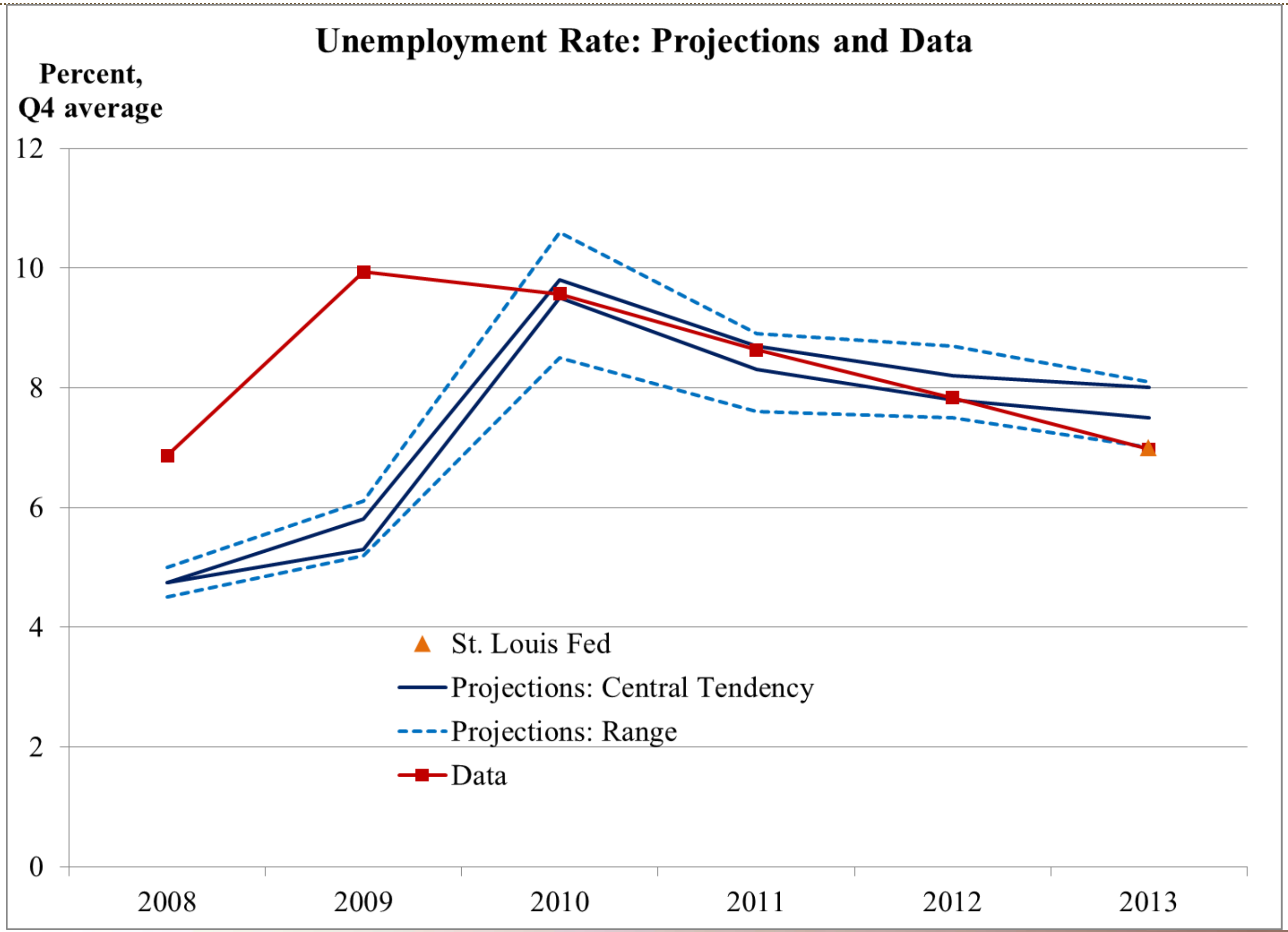
Source: Bureau of Economic Analysis and Macroeconomic Advisers.

Remarks on GDP growth forecasts for 2013

- It now appears that the FOMC got the GDP growth forecast for 2013 about right.
- Much of this success is because third- and fourth-quarter GDP growth estimates have been revised up considerably over the last several weeks.
- The confidence expressed by Chairman Bernanke at the June post-FOMC press conference, that growth was likely to accelerate in the second half of 2013, now looks prescient.
- The general theme that I championed early in 2013, that 2013 would be better than 2012, also appears to have been correct.
  - The failure to hit 3 percent growth is due mainly to 2013 Q1.

Forecasts Past: Unemployment

Unemployment

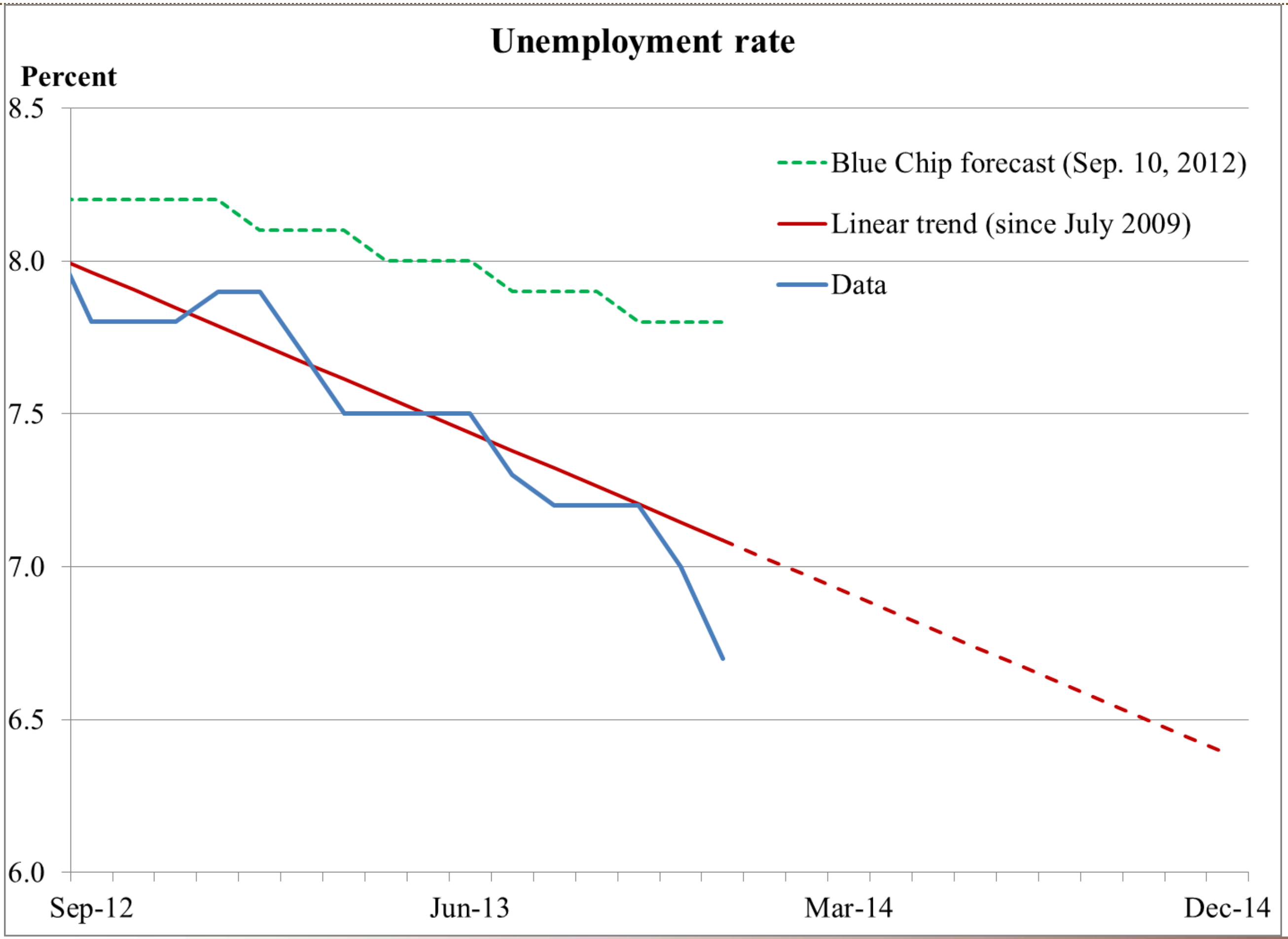


Source: FRB Economic Projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July.

Remarks on unemployment forecasts

- The FOMC was generally too pessimistic on unemployment during 2013.
- Actual fourth-quarter average unemployment for 2013 came in at the lower edge of FOMC point forecasts, that is to say, about at the St. Louis Fed's forecast.
  - Success in forecasting is a rarity, so we plan to take full credit for this!
- The previous graph probably understates the degree of surprise on unemployment over the last 18 months.
- The current unemployment rate is well below the private sector forecasts at the time QE3 was launched.

Unemployment rate



Source: Bureau of Labor Statistics and Blue Chip Economic Indicators. Last observation: December 2013.

Remarks on unemployment surprises

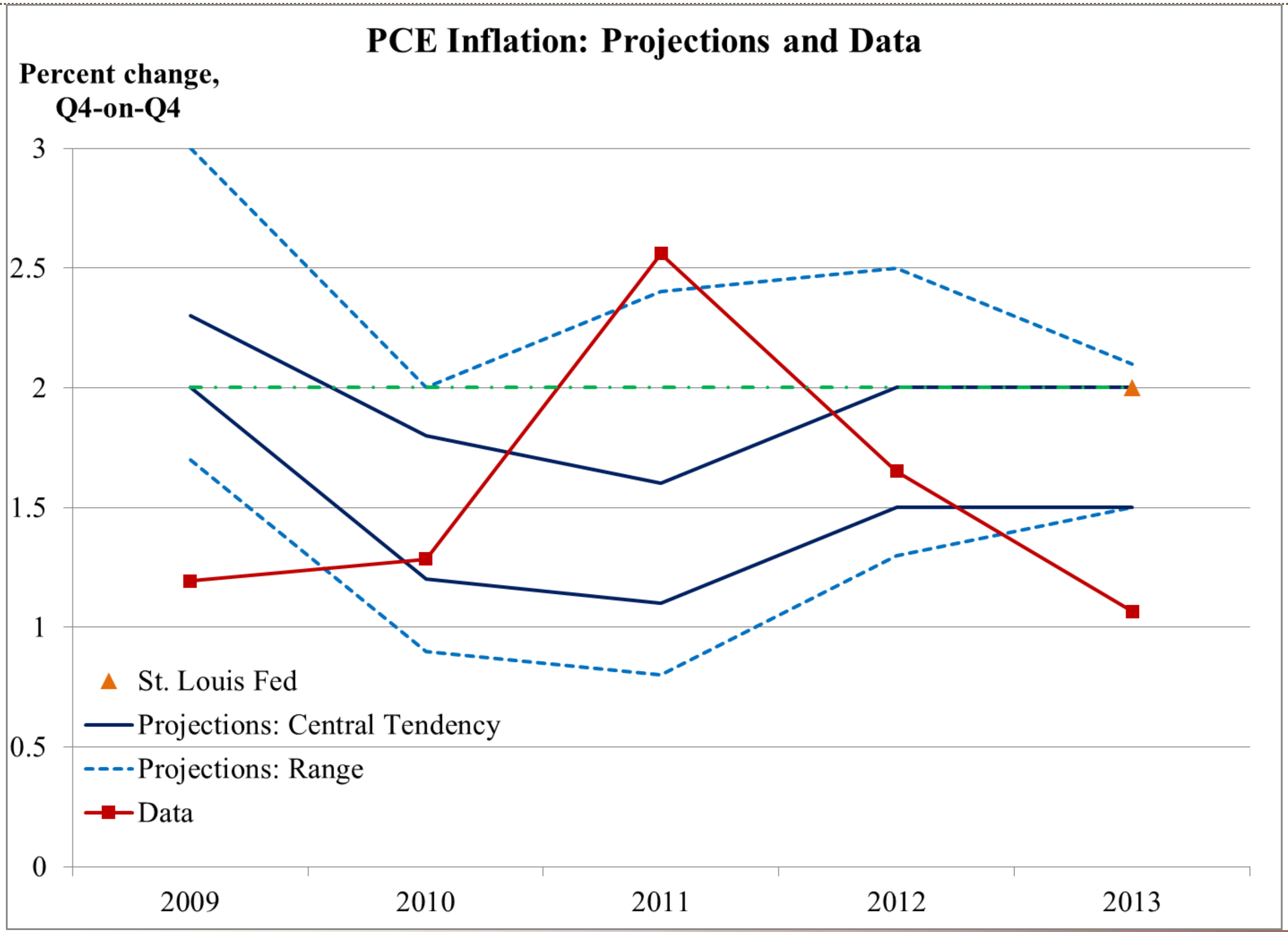
- The current unemployment rate is substantially below the expectations at the time of the September 2012 decision to begin the current open-ended asset purchase program.
- This is certainly one important aspect of the substantial labor market improvement the Committee was seeking in pursuing the program.
- The Committee cited improved labor market conditions in its tapering decision in December 2013.

Labor force participation

- Labor force participation has been relatively low.
- However, labor force participation has been declining in the U.S. since it peaked in 2000.
- The most likely explanation for this decline is longer-term demographic effects.

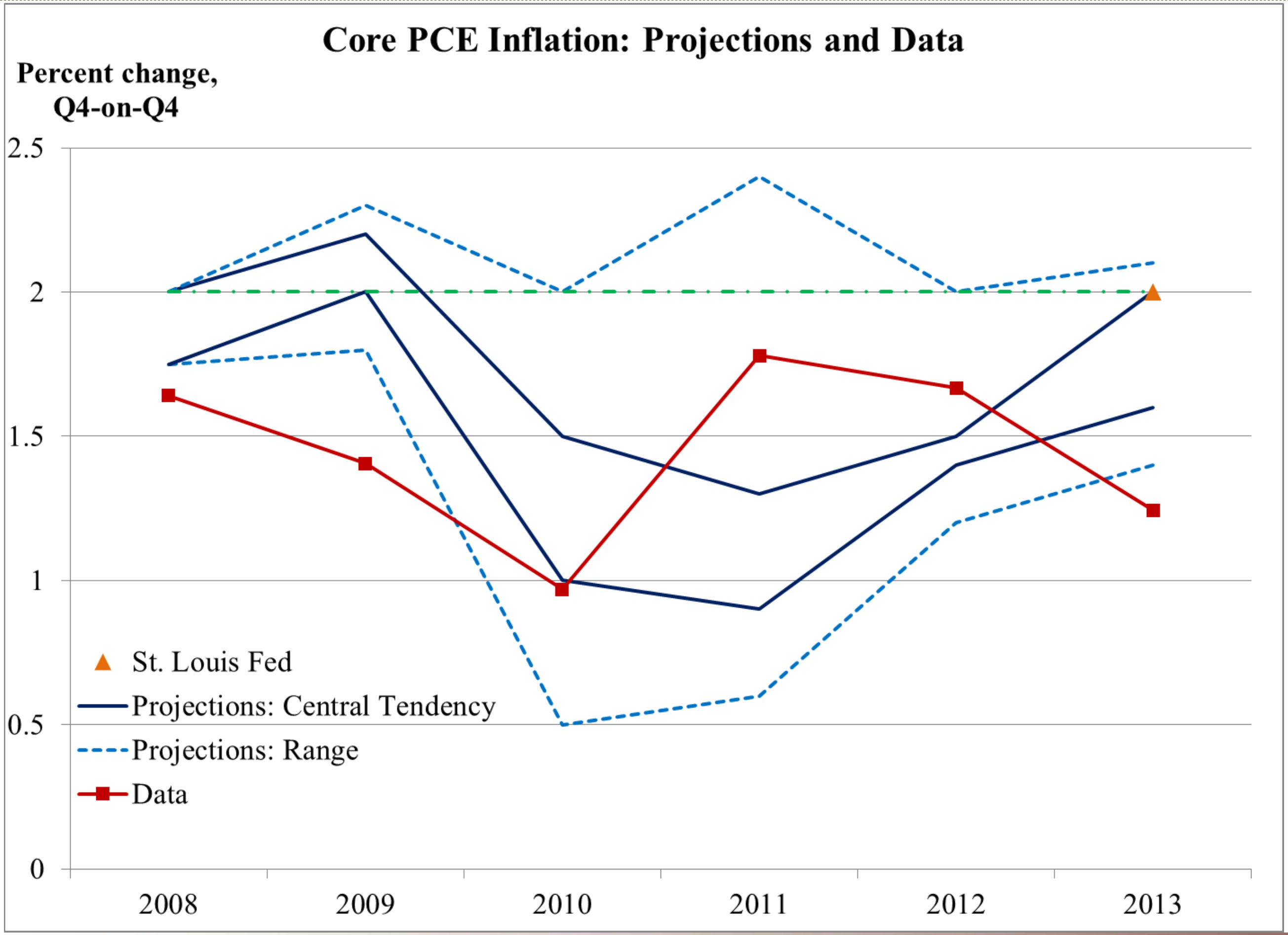
Forecasts Past: Inflation

Headline inflation



Source: FRB Economic Projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July. The 2013-Q4 figure is the MA December 2013 forecast.

Core inflation

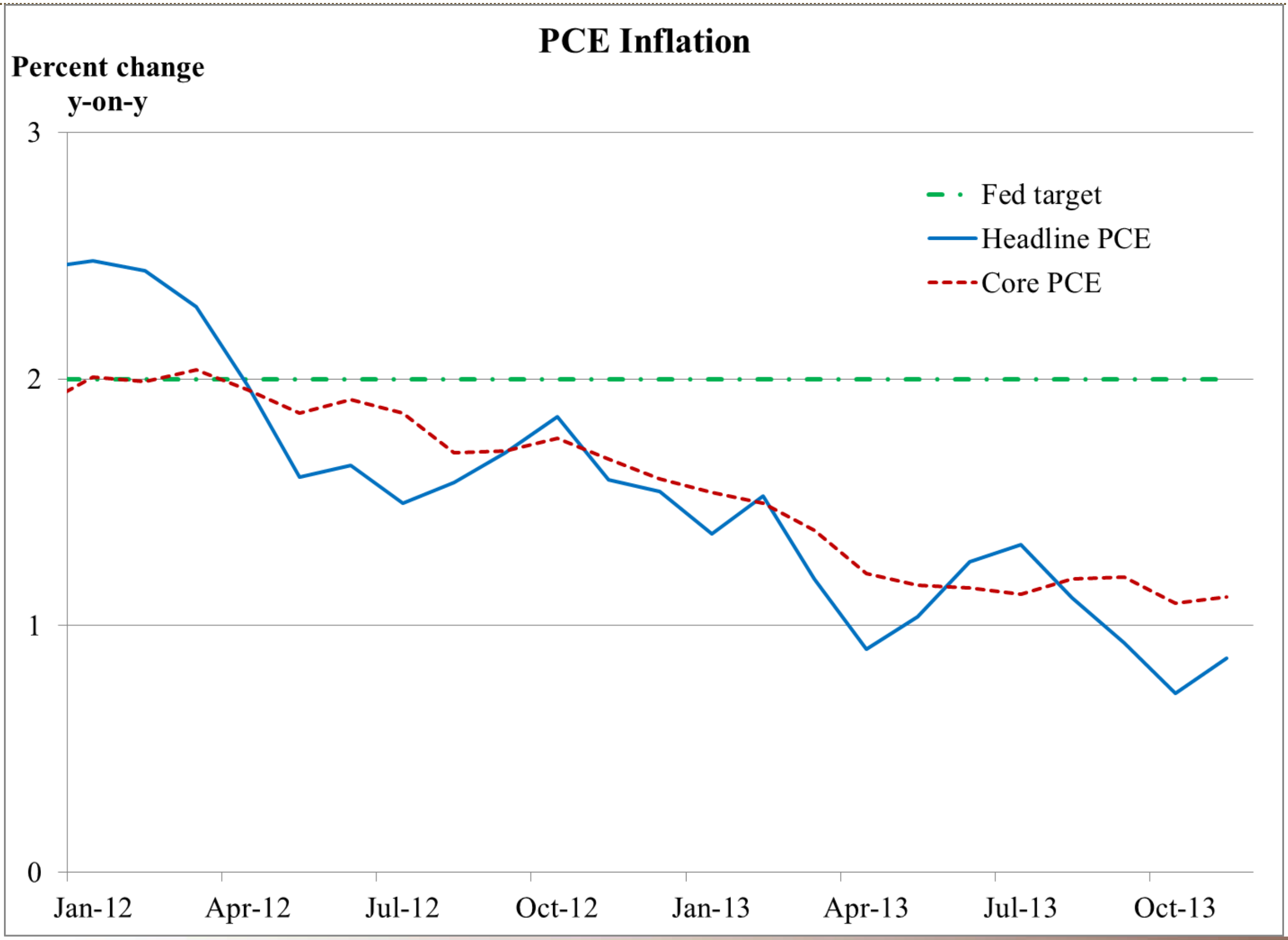


Source: FRB Economic Projections of Federal Reserve Governors and Reserve Bank presidents in the Monetary Policy Report to the Congress from the previous July. The 2013-Q4 figure is the MA December 2013 forecast.

Remarks on inflation forecasts

- Inflation surprised to the downside in 2013.
- The St. Louis Fed projected that inflation would be at about 2 percent as of the end of 2013. Instead, it is running closer to 1 percent.
- All of the FOMC point forecasts were too sanguine about inflation moving back toward the Committee's target of 2 percent.
- There is no generally accepted explanation for the low inflation readings.
- Inflation has generally been declining since early 2012.

Inflation remains low



Source: Bureau of Economic Analysis. Last observation: November 2013.

Ghost of the Economy Future

Real GDP 2014 forecasts

- The St. Louis Fed's forecast for 2014 on real GDP growth is 3.2 percent.*
- This is on the high side of FOMC point forecasts.
- The empirical models we use continue to suggest that with today's very low interest rates, more rapid economic growth is likely going forward.
- We think that many of the obstacles to faster growth have been dissipating.

**Forecast as of December 2013 prepared for the December 18, 2013* Summary of Economic Projections.

Unemployment

- The St. Louis Fed's forecast for 2014 for the fourth quarter average unemployment rate is 6.2 percent.*
- This is the most optimistic of the forecasts on the FOMC.
- Our forecast is based on three factors:
  - We have done very well extrapolating the trend rate of decline over the last several years.
  - We expect more rapid growth, which should put additional downward pressure on unemployment.
  - We think that today's labor force participation rate is about right given observed demographic trends.

**Forecast as of December 2013 prepared for the December 18, 2013* Summary of Economic Projections.

Inflation

- The St. Louis Fed's forecast for 2014 for both core and headline inflation is 1.6 percent.*
- This means that inflation will be higher in 2014 than it is currently and closer to the Committee's target of 2 percent.
- We are in the central tendency of the FOMC forecasts for this variable.
- Because inflation surprised to the downside in 2013, it remains a wildcard for the Committee in 2014.

Forecast as of December 2013 prepared for the December 18, 2013 Summary of Economic Projections.

Conclusion

Summary for 2013

- I reviewed the ghosts of FOMC forecasts past and future.
- FOMC forecasts have to be viewed with a jaundiced eye, because they are made under the "appropriate monetary policy" assumption of each FOMC participant.
- Nevertheless, interpreted as straight forecasts of what will happen, the FOMC was about right on real GDP growth in 2013, too pessimistic on unemployment, and surprised by low inflation.
- The St. Louis Fed's 2013 forecast had the same character, but was more accurate on the unemployment dimension.

Summary for 2014

- For 2014, the St. Louis Fed continues to project improved growth prospects for the U.S. economy, with real GDP growth expected to exceed 3 percent.
- We continue to expect unemployment to fall, reaching 6.2 percent on average during the fourth quarter of 2014.
- And, despite being surprised by low inflation during 2013, we continue to project higher inflation going forward, with both core and headline inflation reaching 1.6 percent by the fourth quarter of 2014.

Federal Reserve Bank of St. Louis
stlouisfed.org

Federal Reserve Economic Data (FRED)
research.stlouisfed.org/fred2/

James Bullard
research.stlouisfed.org/econ/bullard/