# A Hat Trick for the FOMC

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

# Introduction

# Macroeconomic forecasting on the FOMC

- Federal Open Market Committee (FOMC) participants regularly make forecasts.
  - This time of year provides a good window to evaluate previous forecasts to see what can be learned from them.
- On which dimensions was the Committee right, and on which dimensions wrong, in its forecasts for 2015?
- What are the implications for forecasts and monetary policy in 2016?

# Fed forecasts

- The Fed releases forecasts on real GDP growth, the unemployment rate, inflation and the policy rate.
- The forecasts are made by FOMC participants each quarter, without attribution to individuals.
- I will point out the St. Louis Fed's forecasts as we consider the range of forecasts of Committee participants in recent years.

# Main themes for today's talk

- The FOMC forecasts are "special" because the Committee also decides on monetary policy for the U.S.
- The FOMC forecast range looks set to miss on all three key variables in 2015.
  - A hat trick!
- However, these misses are such that they continue to pull the Committee in different directions on monetary policy.
  - Unexpectedly low inflation and real GDP growth suggest pushing policy in a somewhat easier direction.
  - Robust labor markets suggest pushing policy in a somewhat tighter direction.

# The Monetary Policy Assumption

# The policy assumption clouds FOMC forecasts

- When FOMC participants are asked to submit forecasts, it is under an "appropriate monetary policy" assumption.
  - How should this be interpreted?
- This aspect of the exercise clouds the meaning of these Committee forecasts.
- This is a long-standing problem.

# The problem as explained by Dickens

- Consider "A Christmas Carol" by Charles Dickens.
- The Ghost of Christmas Future shows Scrooge a scary vision of events to come, but only under Scrooge's present-day policy of cold-heartedness.
- If Scrooge changes his policy today, then perhaps the vision shown to him by the Ghost of Christmas Future will not materialize.
- In the story, Scrooge does change policy and his future unfolds in a very different way.
- Did the Ghost of Christmas Future make a "bad forecast"?

# The Ghost of Christmas Future

# The Dickens problem for the FOMC

- FOMC participants are like the Ghost of Christmas Future.
- They must produce a vision of what is to come for the economy, but under a monetary policy assumption.
  - Should participants project possible outcomes under a policy path likely to be chosen by the Committee, even if they view a different policy path as appropriate? The prediction may then be for less satisfactory outcomes.
  - Or, should participants project possible outcomes under their own policy assumption? If so, these participants might then predict good outcomes.
- Participants in fact use very different policy assumptions.
  - There is currently no resolution to this problem.

# The forecast assessment for today

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

# FOMC Forecast Assessment 2015

# The data

- We will consider the FOMC forecast ranges for three variables: Real GDP growth, unemployment and inflation.
- There is a "central tendency," which omits the three highest and three lowest projections.
- The forecasts are the ones made in June for the following January-December calendar year.
- Full data for 2015 are not yet available, and we fill in using private sector estimates.

# The forecast record

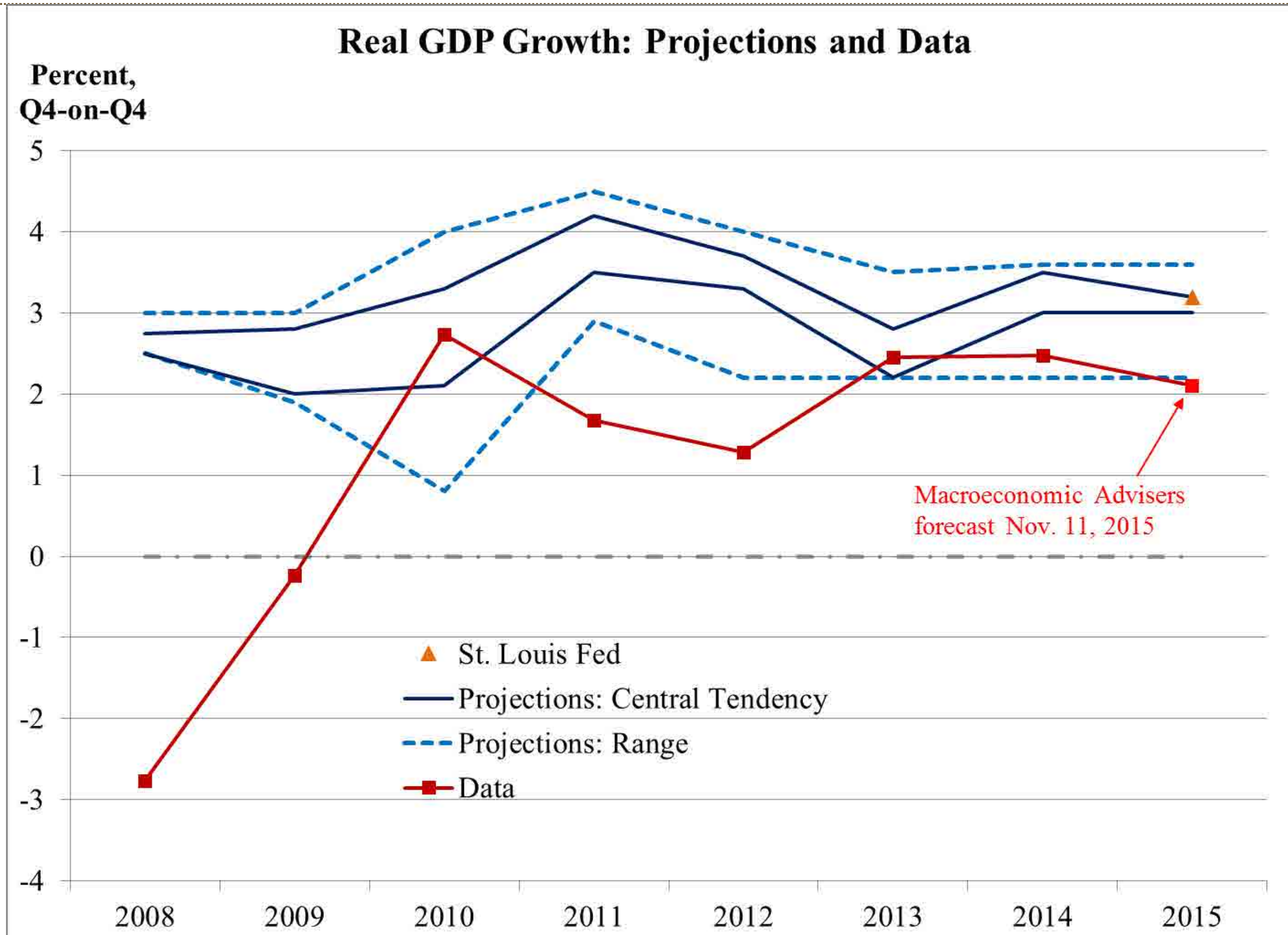
- *The Committee often misses in the sense that the entire range of forecasts across FOMC participants is too high or too low.*

- In 2015, the FOMC was:
  - too optimistic on real GDP growth,
  - too pessimistic on unemployment, and
  - too sanguine that inflation would remain near target.

- This is the "hat trick" in the title of this talk.

# Real GDP Growth Forecasts

# Real GDP growth



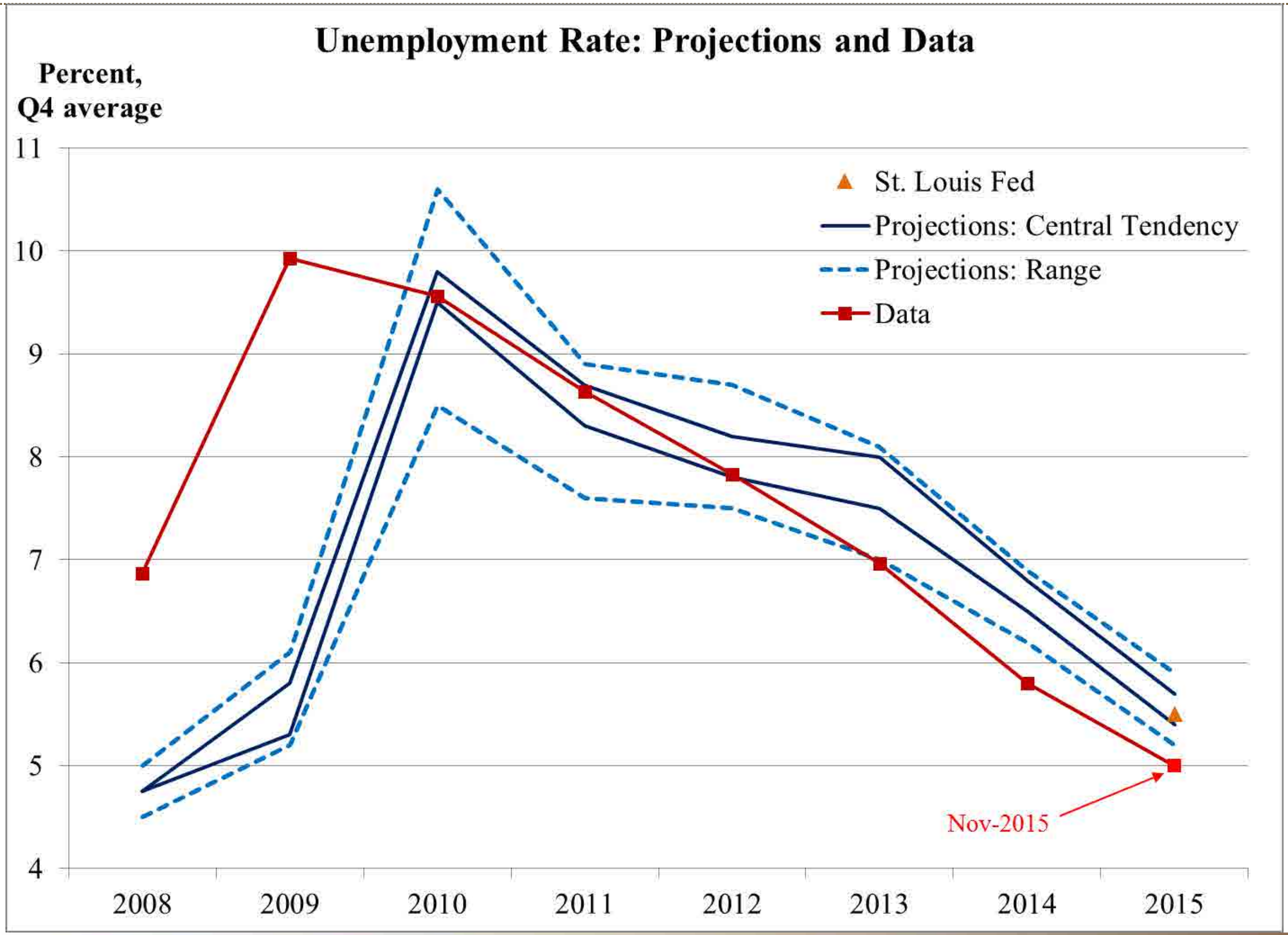

*Source: FRB Economic Projections of Federal Reserve Governors and Reserve Bank Presidents in the Monetary Policy Report to the Congress from the previous July. The 2015 data figure is the MA November 11, 2015, forecast.*

# Remarks on real GDP growth

- The central tendency of the Committee overestimated real GDP growth for 2015.
  - The Committee was better on this variable in 2013 and 2014.
- The big misses for this variable were 2011 and 2012, as well as during the recession years 2008 and 2009.
- Bottom line: The growth forecast looks too high for 2015.
  - The St. Louis Fed was also too high.

# Unemployment Forecasts

# 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; Bureau of Labor Statistics.*

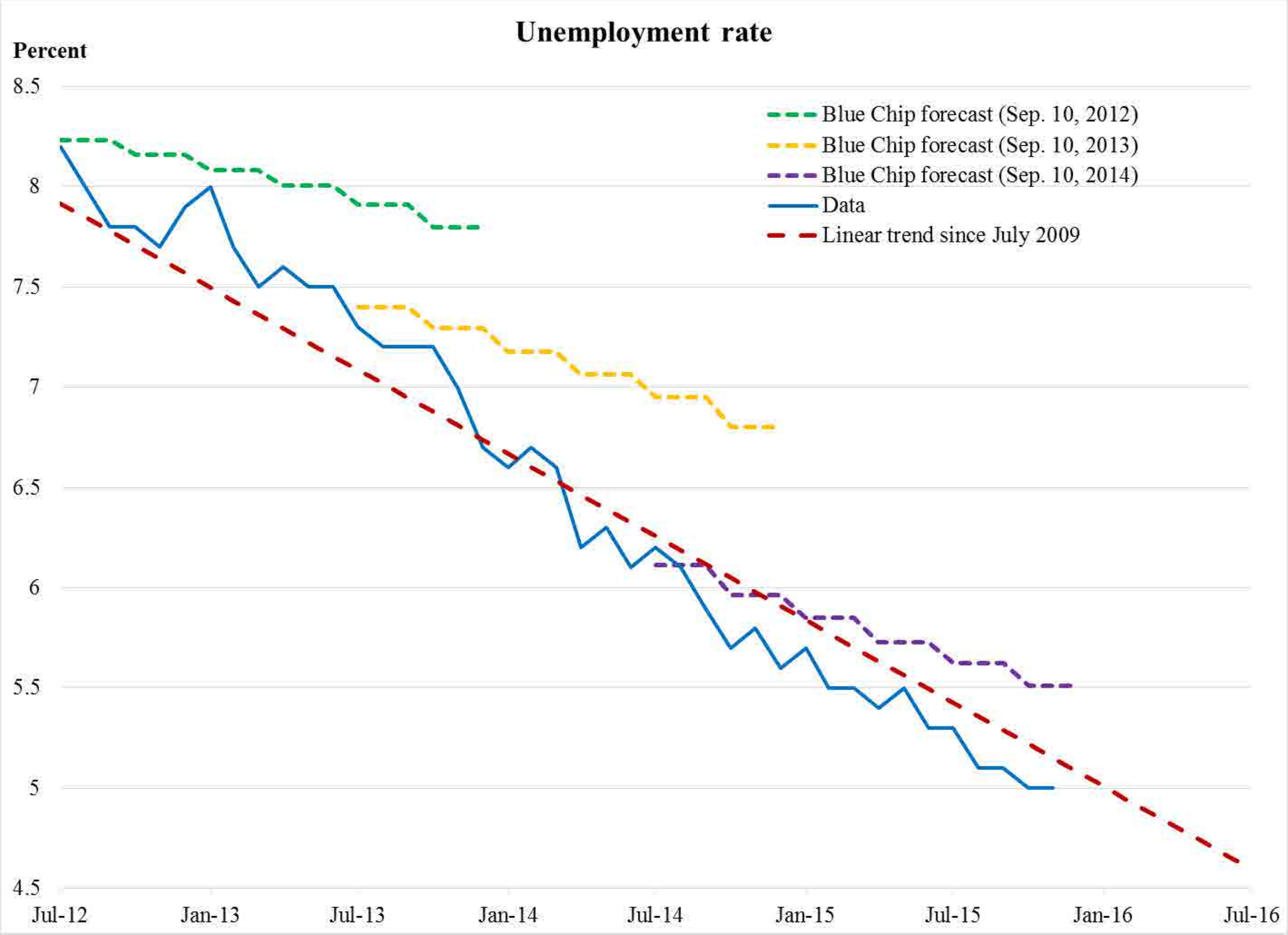
# Remarks on unemployment

- The Committee missed the extent of the decline in unemployment in 2015, expecting less labor market improvement than was observed.
- For 2015, the St. Louis Fed had the one of the lower forecasts for the end-of-year unemployment rate.
  - Despite being optimistic for this variable, we were still too high for 2015.
- Bottom line: The FOMC was too pessimistic on labor market improvement.
  - This is the third year in a row this has happened.

# Private sector forecasts for unemployment

- The private sector forecasting community has also been far too pessimistic on unemployment.
- The following chart shows forecasts for unemployment made at the launch of QE3 in September 2012, and in the following years, for the end-of-year unemployment rate in 2013, 2014 and 2015.
- These forecasts were all too high.
- Fed and private sector forecasters may want to change their thinking on unemployment, having been wrong three years in a row.

# Unemployment

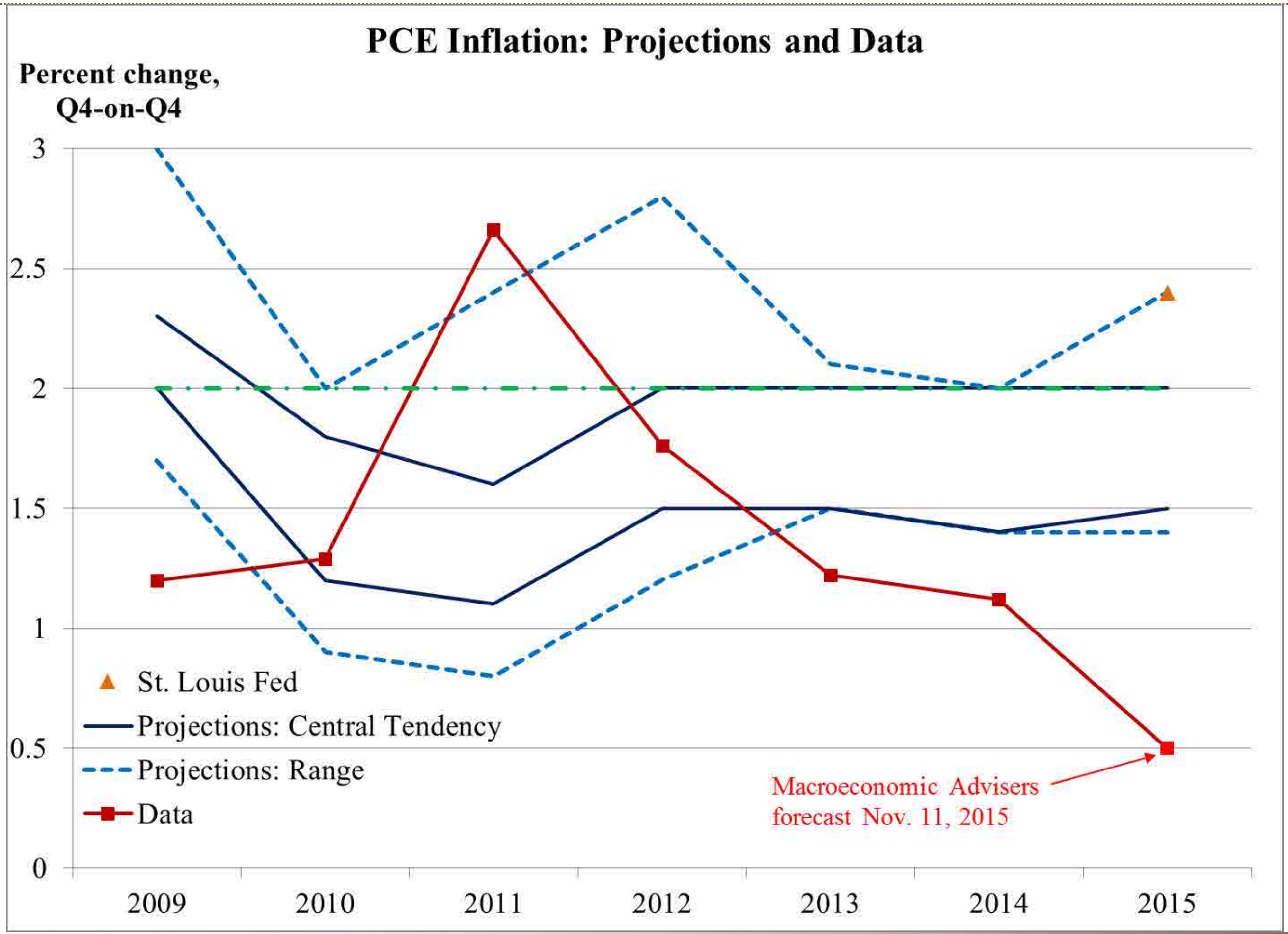





*Source: Bureau of Labor Statistics and Blue Chip Economic Indicators. Last observation: November 2015.*

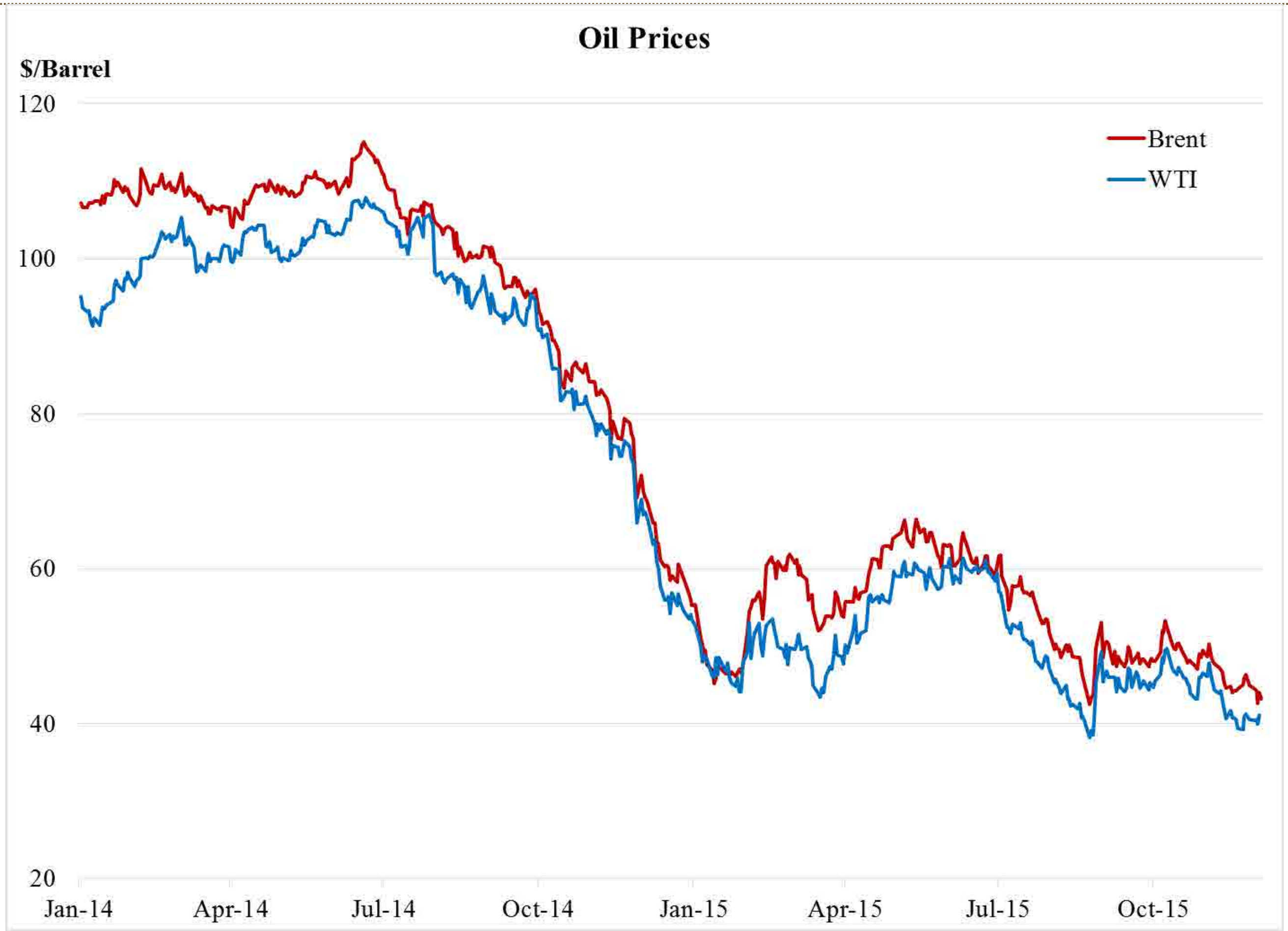
# Inflation Forecasts

# 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 2015 data figure is the MA November 11, 2015, forecast.*

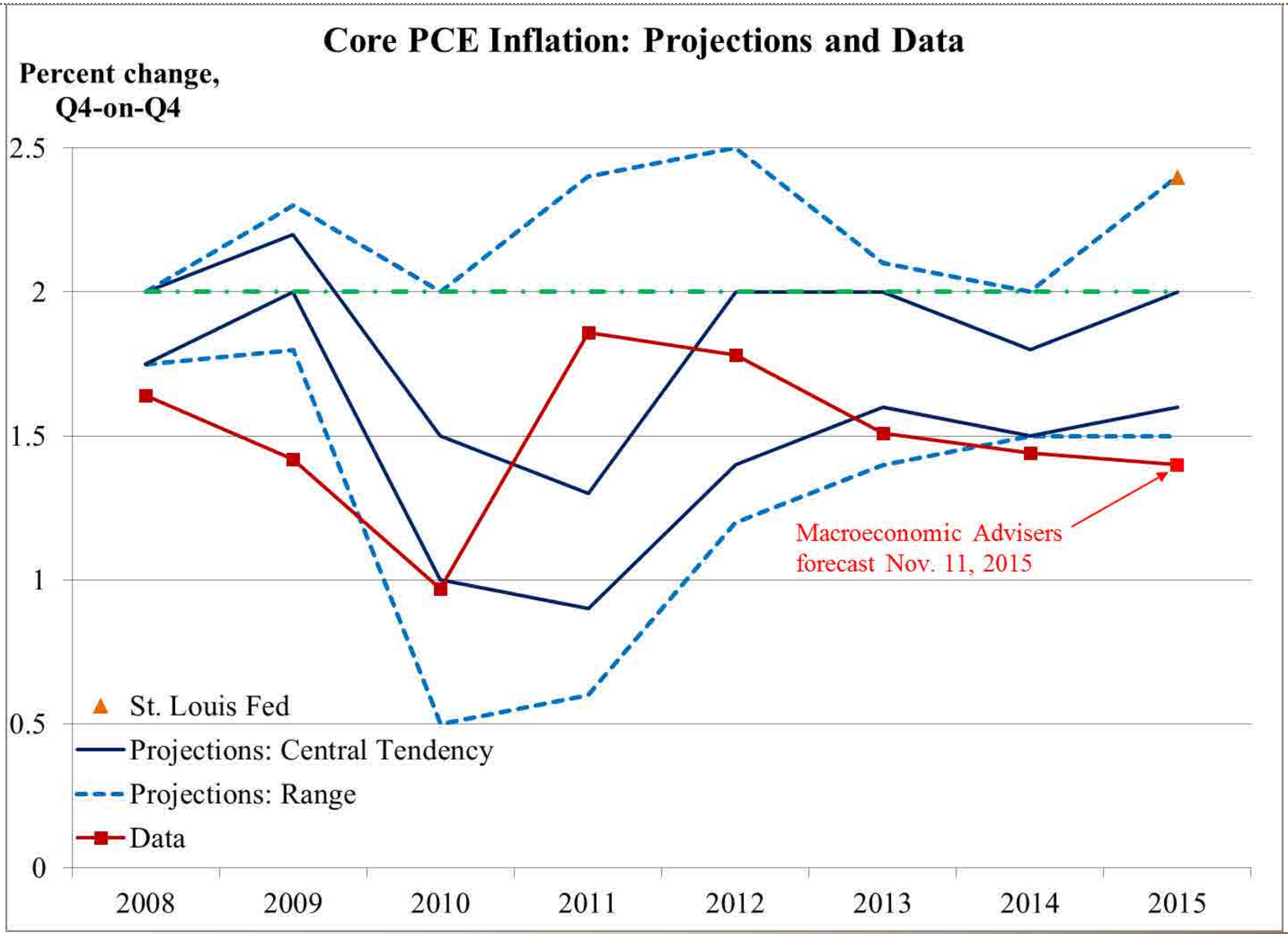
# Oil prices






*Source: Energy Information Administration and Financial Times. Last observation: December 3, 2015.*

# 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 2015 data figure is the MA November 11, 2015, forecast.*

# Remarks on inflation

- The Committee overestimated inflation for 2015.
- However, a large oil price shock is still influencing the inflation numbers.
- The Committee was closer on core inflation, but still too high.
  - The St. Louis Fed was too high.
  - We expected inflation to rebound as the economy improved.

# Implications for Current Monetary Policy

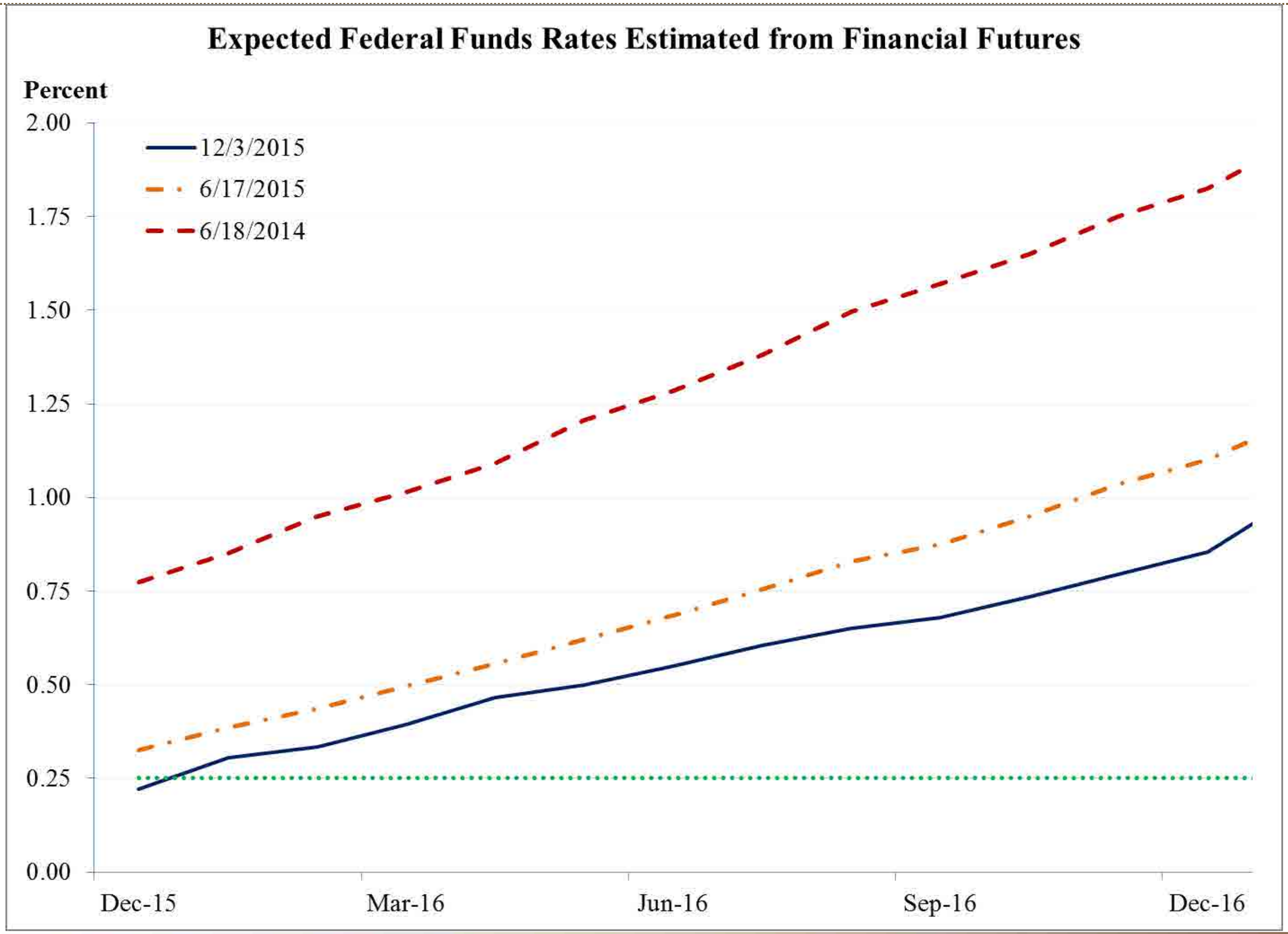
# Implications

- The Committee ranges look to have missed on all three variables in 2015.
- The surprise has the following form:
  - Real GDP growth has surprised the Committee to the low side.
  - Labor markets have surprised the Committee to the upside.
  - Inflation has surprised the Committee to the low side.
- This constellation of surprises continues to pull the Committee in different directions with respect to monetary policy choices.

# How did the Committee adjust policy?

- In traditional central banking, when macroeconomic performance deviates from expectations, policymakers chart a different course for interest rates.
- The surprisingly strong improvement in labor markets suggests somewhat earlier and faster policy rate increases than would otherwise be the case.
- But the slower-than-expected real GDP growth and lower-than-expected inflation suggest somewhat later and slower policy rate increases than otherwise.
- Which of these effects won out?

# Expected policy rate paths






*Source: Bloomberg and author's calculations. Last observation: December 3, 2015.*

# Result: A more dovish policy than otherwise

- The Committee did adjust the policy rate path in response to the news embodied in forecast errors between the summer of 2014 and today.
- That adjustment was toward a later liftoff.
- This can be interpreted as showing that the Committee does react to news on the economy that deviates from expectations.
- It also suggests that negative surprises with respect to real GDP growth and inflation carried more weight during this period than the positive surprises on labor market performance.

# Summary

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- In a forecasting sense, the FOMC has been surprised on all three key variables in the last 18 months, a sort of "hat trick."
- The surprise has been that:
  - real GDP growth has been slower than expected,
  - inflation has been lower than expected, and
  - labor markets have improved more rapidly than expected.
- This type of surprise pulls the Committee in different directions with respect to policy.
- The Committee's adjustment to policy was to move toward a later normalization in response to these surprises.

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