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 what dimensions was the Committee right, and on what dimensions wrong, in its forecasts for 2014?

- What are the implications for forecasts and monetary policy in 2015?
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.
  - We will treat FOMC forecasts as unconditional statements of what will actually happen, but only after acknowledging this difficulty.
- The FOMC has been surprised in the same way two years in a row.
- The nature of this surprise pulls the Committee in two different directions on monetary policy.
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.
  - What does this mean?

- This aspect of the exercise clouds the meaning of these Committee forecasts.

- This is a long-standing problem with FOMC forecasts.
The Ghost of Christmas Future
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 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 their own policy assumption? If so, these participants might then predict good outcomes.
  - Or, should participants project possible outcomes under a policy path likely to be chosen by the Committee, even if these participants view a different policy as appropriate? These participants might then predict less satisfactory 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.
FOMC Forecast Assessment 2014
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 2014 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 is too high or too low.

In 2014, the FOMC was:

- about right on real GDP growth,
- too pessimistic on unemployment, and
- too sanguine that inflation would remain near target.

This is the same set of misses as in 2013.
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 2014-Q4 figure is the MA January 2015 forecast.
Remarks on real GDP growth

- The central tendency of the Committee underestimated real GDP growth slightly in 2013 and overestimated real GDP growth in 2014.
  - This leaves the level of real GDP approximately correct over the two-year period.
  - In this sense, the Committee has been about right recently.
- 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 was about right for 2014.
Unemployment Rate: Projections and Data

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

- The Committee missed the large decline in unemployment in 2014, expecting less labor market improvement than was observed.

- For 2014, the St. Louis Fed had the second lowest estimate for the end-of-year unemployment rate—we were at the low end of the Committee range.
  - Despite being optimistic for this variable, we were still too high for 2014.

- Bottom line: The FOMC was too pessimistic on labor market improvement.
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 one year after that, for the end-of-year unemployment rate in 2013 and 2014.
- Both of these forecasts were too high by a full percentage point or more.
- Unemployment is one of two workhorse measures of labor market performance (along with nonfarm payroll employment).
Unemployment

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 2014-Q4 figure is the MA January 2015 forecast.
Remarks on inflation

- The Committee overestimated inflation again in 2014, similar to 2013.
- The St. Louis Fed was, along with the entire Committee, too high.
- The pattern for core inflation (which excludes food and energy) forecasts is similar.
Implications for Current Monetary Policy
Implications

- The Committee has been surprised in the same direction for two years in a row.
- The surprise has the following form:
  - Real GDP growth not too different from expectations.
  - Labor markets stronger than expectations.
  - Inflation lower than expectations.
- This constellation of surprises pulls the Committee in different directions with respect to monetary policy choices.
Better-than-expected real variables

- In traditional central banking, when real macroeconomic performance exceeds expectations, policymakers chart a more aggressive course for interest rates.
- The generally good real GDP growth, coupled with the sharp and surprising improvement in labor markets, suggests somewhat earlier and faster policy rate increases than would otherwise be the case.
- Has the Committee shifted market expectations toward an earlier and higher path for the policy rate in response to this surprise?
  - Answer: No.
Market expectations of the policy rate path

Inconsistency?

The Committee received better-than-expected news on the real economy over the last two years, and yet adjusted policy in the direction of maintaining low interest rates for a longer time.

By itself, this suggests some inconsistency in recent monetary policy decisions.

- In particular, an adjustment like this makes it hard for the private sector to infer the Committee’s reaction function to incoming data.
- Why didn’t the Committee adjust in the normal way to better-than-expected news on the real economy?
Lower-than-expected inflation outcomes

- However, there is another variable: Inflation.
- The improvement in the real economy has not been accompanied with upward movements in inflation so far.
  - The level of inflation is not so low that it can alone justify a policy rate of zero.*
- Still, low inflation readings and declining inflation expectations may indicate a loss of credibility for the Committee’s 2 percent inflation target.
- An important tenet of modern central banking is that a central bank must protect its credibility with respect to its inflation goal.

*See J. Bullard, November 2014, *Does Low Inflation Justify a Zero Policy Rate?*, remarks delivered at the St. Louis Regional Chamber Financial Forum, St. Louis, Mo.
Bottom line

- The bottom line is that there have been positive surprises relative to forecasts during 2013 and 2014 concerning the labor market.

- This normally would have led to a more aggressive plan for the policy rate compared to expectations as of the summer of 2012.

- Instead, market expectations for the policy rate have moved in the opposite direction, raising questions about the nature of the Committee’s reaction function to incoming data.

- Surprisingly low inflation readings provide one possible explanation for this development.
Summary
Summary

In a forecasting sense, the FOMC has been surprised in the same way two years in a row. The surprise has been that real GDP growth has been about as expected, but labor markets have improved more rapidly than expected, while inflation has remained low.

This type of surprise pulls the Committee in different directions.

- Better real performance suggests a more aggressive rate policy.
- Lower-than-expected inflation outcomes weigh on the credibility of the Committee’s inflation target, and suggest a less aggressive rate policy.