



Reconciling FOMC Forecasts and Forward Guidance

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Prepared for
Shadow Open Market Committee
September 20, 2013

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Forward guidance plays a big role in the Fed's monetary policy, but trying to manage market expectations and aggregate demand through forward guidance may generate as many inconsistencies, misinterpretations and adjustment problems as the benefits it is presumed to provide. This is particularly true when the Fed constantly qualifies and changes its guidance. This note focuses on the confusing messages provided by the Fed's economic forecasts and assessment of the future appropriate path of the Federal funds rate, which earlier this week were updated and extended out through year-end 2016.

The Fed has augmented its unconventional quantitative easing with forward guidance on when it may taper its asset purchases and the timing of rate hikes in an attempt to suppress interest rates until economic growth strengthens. But the longer the economy recovers from financial crisis and recession, and the closer the unemployment rate gets to the Fed's longer-run objective, tensions and potential inconsistencies arise.

The longer that the Fed anchors its policy rate to zero and signals artificially low rates into the future even as economic performance improves, the more monetary policy deviates from the Fed's long-run objectives, and the larger monetary policy adjustments that eventually will be required. Markets recognize these deviations, making the Fed's task of managing expectations more difficult and risking abrupt financial market adjustments that may jar economic performance. Despite the Fed's guidance and massive purchases of bonds, yields have risen above pre-QEIII levels.

As the unemployment continues to fall modestly faster than the Fed forecasts, a tension and potential inconsistency has emerged between the Fed's unemployment rate projections and its assessment of the appropriate future Federal funds rate path. The appropriateness and sustainability of a persistently negative real Fed funds rate through year-end 2016 and a bloated Fed balance sheet are increasingly questionable as economic growth pushes the unemployment rate to its natural rate.

Despite efforts to be transparent, the Fed has not clarified key issues. Instead, it has generated questions about the merits and risks of its policies. If the Fed's longer-run inflation target is 2% and its appropriate long-run Fed funds target is 4 percent, does a 1.75% Fed funds rate at year-end 2016 make sense when the Fed's unemployment rate projection is 5.4%-5.9% and core inflation is 1.7%-2.0%? Is the Fed's long-run inflation objective really 2%, even though the Fed has indicated that temporarily higher inflation would be accepted—even welcomed—and argues a near-zero real funds rate would be appropriate at virtually full employment? How reliable are the Fed's projections as forward guidance, when the Fed downplays the unemployment rate in favor of a broader assessment of "overall labor market conditions" and how should markets respond when the Fed's forward guidance becomes a "moving target"? Left unanswered, these questions add to the market's confusion, jeopardize the Fed's credibility and establish a bad precedent for future monetary policy.

The Fed's economic and inflation projections, which the Fed provides as required by the Full Employment Act of 1978, have gained significant attention, particularly since the Fed now puts so much focus on its dual mandate of low inflation and low unemployment and augments its quarterly forecasts with the Fed's assessment of "the appropriate timing of policy firming" (the year in which FOMC members see as the appropriate timing of the first

hike in the Federal funds rate) and the “appropriate pace of policy firming” (the assessment of the year-end funds rate target).

It’s uncertain how closely these assessments of the appropriate funds rate relate to the Federal funds rates assumptions the FOMC members use as a basis for their economic and inflation forecasts. In those quarterly projections, the FOMC members are instructed to assume “appropriate monetary policy”, although no set guidelines or rules are established for what is “appropriate” (Many FOMC members likely assume the funds rate generated by senior Fed staffers and provided to them in the Green Book.)

Providing economic projections and future appropriate future funds rates while also giving guidance that links tapering of its asset purchases and future policy rate hikes to the unemployment rate (and overall labor market conditions as Bernanke emphasized in his September 18 post-FOMC conference call) is a tricky business. Add all of this to the LSAPs, and the Fed’s monetary policy is just too complex: its toolbox is over-used and full of confusion.

The Fed’s latest central tendency forecasts project stronger real growth in 2014-2016 and a gradual rise in inflation to 2.0%. In its June forecasts, the Fed reduced its 2013 real GDP projection to reflect year-to-date softness, but it continued to project above potential growth in 2014 and 2015 (3.0%-3.5% and 2.9%-3.6%, respectively). Consistent with this healthy growth outlook, the Fed edged down its projected unemployment rate for 2015Q4 to 5.8%-6.2%, acknowledging that the unemployment rate had been receding faster than the Fed’s earlier projections. The Fed maintained its prior inflation projection of a drift up in the core PCE deflator to 1.7%-2.0%.

FOMC Economic and Inflation Projections for September, June and March 2013

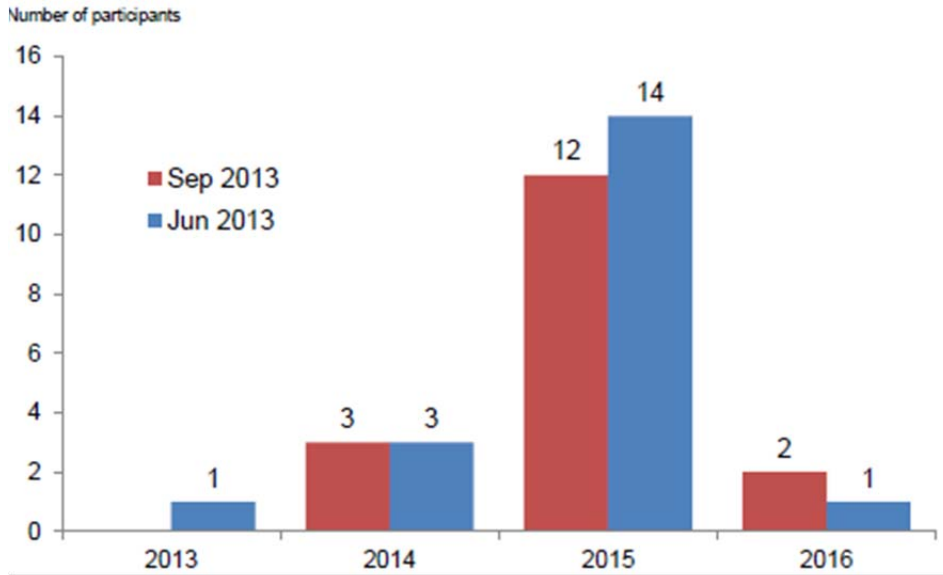
GDP and PCE price indexes (Q4/Q4%), unemployment rate (Q4 average)

Variable	FOMC's central tendency				
	2013	2014	2015	2016	Longer run
Change in real GDP	2.0 to 2.3	2.9 to 3.1	3.0 to 3.5	2.5 to 3.3	2.2 to 2.5
Jun'13 projection	2.3 to 2.6	3.0 to 3.5	2.9 to 3.6	--	2.3 to 2.5
Mar'13 projection	2.3 to 2.8	2.9 to 3.4	2.9 to 3.7	--	2.3 to 2.5
Unemployment rate	7.1 to 7.3	6.4 to 6.8	5.9 to 6.2	5.4 to 5.9	5.2 to 5.8
Jun'13 projection	7.2 to 7.3	6.5 to 6.8	5.8 to 6.2	--	5.2 to 6.0
Mar'13 projection	7.3 to 7.5	6.7 to 7.0	6.0 to 6.5	--	5.2 to 6.0
PCE inflation	1.1 to 1.2	1.3 to 1.8	1.6 to 2.0	1.7 to 2.0	2.0
Jun'13 projection	0.8 to 1.2	1.4 to 2.0	1.6 to 2.0	--	2.0
Mar'13 projection	1.3 to 1.7	1.5 to 2.0	1.7 to 2.0	--	2.0
Core PCE inflation	1.2 to 1.3	1.5 to 1.7	1.7 to 2.0	1.9 to 2.0	--
Jun'13 projection	1.2 to 1.3	1.5 to 1.8	1.7 to 2.0	--	--
Mar'13 projection	1.5 to 1.6	1.7 to 2.0	1.8 to 2.1	--	--

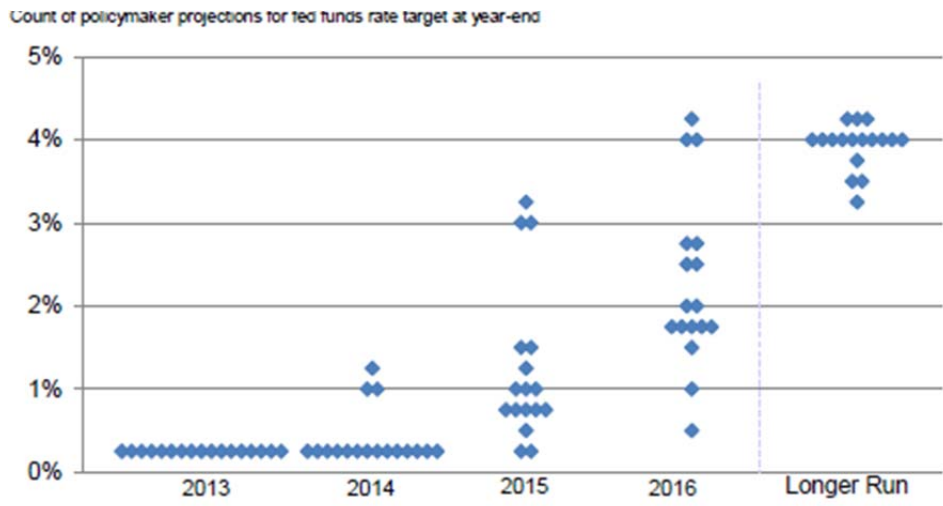
In September, the Fed lowered its real GDP growth projections for 2014, despite the Fed’s assessment of lessening drag from the government’s sequestration. This reflects the Fed’s disappointment in the soft economic data in recent months—like most forecasters the Fed is influenced by the most recent trends. For 2016, the Fed projected growth of 2.5%-3.3% and an unemployment rate of 5.4%-5.9%, virtually the same as its longer-run projection of 5.2%-6.0%. The Fed maintained its forecast that inflation would rise gradually to 2% over the projection period. The Fed’s assessments of the appropriate path of the Fed funds rate are strikingly low relative to the Fed’s economic and inflation forecasts. In June and September the vast majority of FOMC members believe that it would be appropriate for the first rate hike to occur in 2015 or 2016, and that the Fed maintain a negative funds rate through year-end 2016. In June, the median assessment for the year-end 2015 was 1.0%. In September, the mode

for year-end 2015 was lowered to 0.75% and for year-end 2016 was set at 1.75%, below the Fed's inflation projection.

FOMC: Appropriate Timing of Policy Firming



Appropriate Pace of Policy Firming as of September 18, 2013

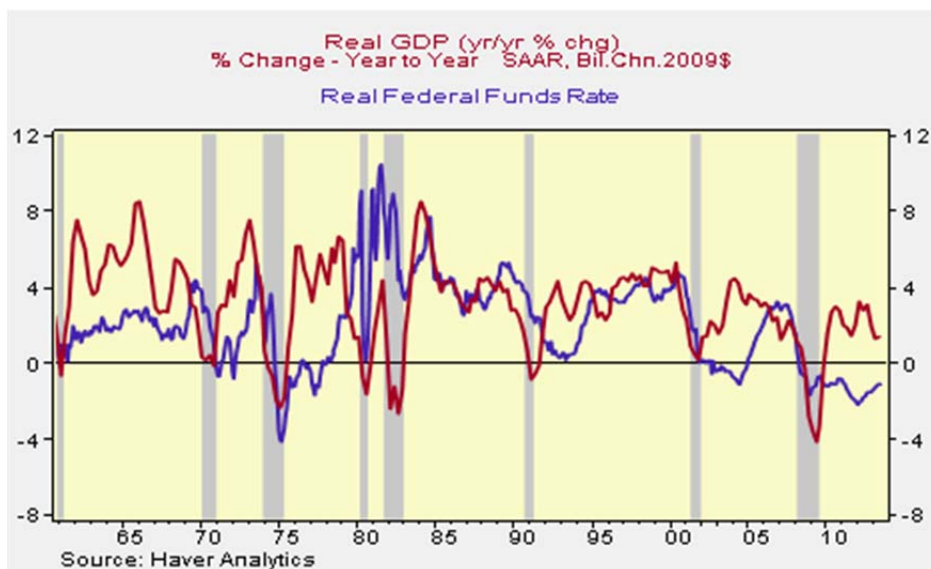


In both June and September, the FOMC members' assessment of the appropriate longer run target rate was bunched closely around 4.0%. This assessment of a 2% real Fed funds rate is in line with prior economic expansions and suggests full normalization of monetary policy consistent with longer-run forecasts of 2.3% real GDP growth and a 5.2%-6.0% unemployment rate. However, a negative real funds rate when unemployment is at its long-run

natural rate, as the Fed projects for 2016, is inconsistent with its historic pattern and suggests excessive and risky monetary ease.

The Fed has kept the funds rate below inflation since 2008, the longest period in recent history. The last period of such a long sustained negative real funds rate was in 1974-1977, and it resulted in double digit inflation. Historically, following recession and early recovery when the Fed's monetary stimulus has kept the target rate at or below inflation, the Fed has hiked rates above inflation as economic conditions improved, as shown in the chart.

Although economic growth has been slower than prior cyclical episodes when the Fed hiked the funds rate above inflation, the Fed's projections of stronger real GDP and a lower unemployment rate are in a range consistent with Fed rate hikes and a positive real funds rate in past cycles. Moreover, rising inflation, as the Fed projects, pushes down the real funds rate and increases the eventual rate hikes required to normalize monetary policy. Based on ultra-accommodative monetary stimulus and improving economic and labor market conditions, the Fed will be very lucky if inflation does not rise above 2%.



Somewhat ironically, after the funds rate hit the zero nominal bound and the Fed implemented its LSAP programs in 2009-2010, the Fed acknowledged that LSAPs were unconventional, but argued that effectively they were an extension of the Fed's conventional monetary policy of adjusting its policy rate to manage aggregate demand. The Fed conducted research and reported on empirical studies that related the magnitude of asset purchases to changes in its (negative) "effective" funds rate target. Presumably, the dramatic rise in the Fed's balance sheet since then would be consistent with an increasingly negative effective real funds rate as the economy improves and the unemployment rates.

The Fed has veered away from this line of analysis, instead arguing that the timing of the tapering of QEIII has **no** bearing on the timing of future Fed rate hikes. The market has not bought that line of argument. When Bernanke announced the Fed was considering tapering in May, the Fed funds futures market sold off sharply, as markets moved up their assessment of when the Fed would hike rates, leading bond yields higher. This week the Fed funds futures rallied when the Fed surprised markets by delayed tapering.

Earlier this year, the Fed sought to clarify its forward guidance by linking the timing of its initial rate hike and (more loosely) tapering of LSAPs to the unemployment rate, but subsequently qualified and changed the guidance. The Fed's Policy Statements following every FOMC meeting in 2013 have established a 6 ½% unemployment rate as a hurdle for its initial rate hike. However, Fed members have added unofficial qualifications suggesting that it may be a moving threshold, and Bernanke stated at this week's post-FOMC meeting press conference that the 6 ½% is not a threshold or a target, and that the first rate hike may not occur until the unemployment rate is "significantly below 6 ½%". Moreover, Bernanke emphasized that the Fed is focusing on "overall labor market improvements" as much as the unemployment rate. Bernanke has also changed his earlier statement that he would like asset purchases to be concluded by the time the unemployment rate reaches 7 percent, which based on the Fed's projections would occur in Spring 2014. Setting guidelines and then changing them dilutes the lasting effectiveness of forward guidance.

Ironically, the constant stream of statements by Fed members about the prospects for tapering led the markets to expect the Fed would take action at its September 17-18 meeting. Consistent with these market expectations, the Fed funds futures market had priced in a 1.15% fund funds rate in December 2015 and 2.25% in December 2016, up dramatically from May, before Bernanke initiated the prospects of tapering.

But the Fed was clearly influenced by the soft economic data in recent months, concerns about fiscal policy and the potentially negative economic impact of higher interest rates. Bernanke's press conference following the September 17-18 FOMC meeting "clarified" (changed) the Fed's interpretation of its earlier forward guidance and highlighted the totally discretionary nature of monetary policy: as long as inflation remains below 2%, the Fed expects to maintain its extremely accommodative monetary policy; the Fed is responding to the high frequency data (and not considering the normal lagged impacts of its policies) and has no broader exit strategy; and the Fed is responding to "overall labor market conditions" much as the unemployment rate, suggesting implicitly that the Fed is responding to the labor force participation rate and factors that affect it as well as other factors and government policies that affect labor demand and supply. Bernanke noted the Fed's policies are also being influenced by fiscal policies and any potential disruptions that may unfold.

How forward looking is forward guidance that bases monetary policy on high frequency data releases?

Lost in the public debate about when the Fed tapers and eventually hike rates has been any rigorous discussion about whether its asset purchases and forward guidance have actually helped stimulate the economy. Nominal and real GDP growth have not accelerated, despite the Fed's massive quantitative easing and very low real costs of capital. Excess reserves at banks have grown nearly in line with the dramatic growth in the Fed's balance sheet, as the Fed's LSAPs have not materially stimulated bank lending. Interest rates are now higher than they were before QEIII.

The Fed argues that without the QEIII (and forward guidance) the economy would have grown much more slowly, and unemployment would be much higher. But is this assessment correct? It is based on the Fed's macro model whose longer-run track record has been underwhelming and unreliable. It is clear that the economy's slow recovery has stemmed from a host of non-monetary factors that have temporarily constrained demand, production and employment, including: lengthy adjustments in the housing sector, adjustments in household balance sheets, and government fiscal and regulatory policies and the uncertainties they create. These economic drags are real and have been beyond the scope of the Fed's monetary policies. Providing guidance of a sustained negative real funds rate is not helping private sector confidence.

The Fed's asset purchases have influenced and distorted prices of financial markets—boosting the stock and bond markets and the prices of other assets—but they have had little impact on the real economy. And while the Fed's forward guidance has had a measurable short-run announcement effects, its lasting impact is highly uncertain.

The current problem facing the Fed is monetary policy is still geared toward economic and crisis management long after the economy has achieved sound footing and financial markets are functioning efficiently. Forward guidance is increasingly less convincing and effective when it is used to support a monetary policy that is seen as strategically unsound.

The Fed should establish the proper scope of monetary policy, be more circumspect about the efficacy of its policies and their limited ability to affect real problems facing the economy, and establish an exit policy and stick to it.