FOMC Guidance Shifts to Forecasts and the Neutral Rate

Looking past the soft economic data from the harsh winter months, FOMC members lowered their forecasts for unemployment and voted to continue to wind down purchases of US Treasuries and mortgages. Not surprisingly, the Board revamped its forward guidance, as Chair Yellen suggested she might at her Congressional hearings, by dropping the 6.5% threshold for unemployment as a precondition for the first rate hike and embracing a more qualitative approach including comments on the ultimate level of the policy rate at full employment. In truth, the economic forecasts – as opposed to the forecasts of rates themselves - are telltale enough to provide guidance as to the timing of the initial move to normalize rates, which still appears to be around mid-2015. And, for the first time, the FOMC is beginning to address the issue of the so-called 'neutral policy rate', that is the ultimate level of the fed funds rate when the economy finally reaches full employment.

The table below summarizes the forecasts of FOMC participants, which did not include those of two new governors, Stanley Fisher and Lael Brainard. On the surface, it appears that the range of forecasts for real GDP has narrowed but more likely the more aggressive outlooks belonged to the departing members. Only the unemployment forecasts have been revised downward reflecting incoming data showing the jobless rate had fallen to 6.7% by February. Otherwise participants seems to be remarkably undaunted by the spate of soft statistics this winter. Indeed, the policy directive and Yellen's comments were quite clear that the Board believes that economic activity was hampered "in part" by the harsh winter weather. These

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents, March 2014

Percent

Variable	Central tendency[1]				Range[2]			
	2014	2015	2016	Longer run	2014	2015	2016	Longer run
Change in real GDP	2.8 to 3.0	3.0 to 3.2	2.5 to 3.0	2.2 to 2.3	2.1 to 3.0	2.2 to 3.5	2.2 to 3.4	1.8 to 2.4
December projection	2.8 to 3.2	3.0 to 3.4	2.5 to 3.2	2.2 to 2.4	2.2 to 3.3	2.2 to 3.6	2.1 to 3.5	1.8 to 2.5
Unemployment rate...........	6.1 to 6.3	5.6 to 5.9	5.2 to 5.6	5.2 to 5.6	6.0 to 6.5	5.4 to 5.9	5.1 to 5.8	5.2 to 6.0
December projection	6.3 to 6.6	5.8 to 6.1	5.3 to 5.8	5.2 to 5.8	6.2 to 6.7	5.5 to 6.2	5.0 to 6.0	5.2 to 6.0
PCE inflation	1.5 to 1.6	1.5 to 2.0	1.7 to 2.0	2.0	1.3 to 1.8	1.5 to 2.4	1.6 to 2.0	2.0
December projection	1.4 to 1.6	1.5 to 2.0	1.7 to 2.0	2.0	1.3 to 1.8	1.4 to 2.3	1.6 to 2.2	2.0
Core PCE inflation[3]	1.4 to 1.6	1.7 to 2.0	1.8 to 2.0		1.3 to 1.8	1.5 to 2.4	1.6 to 2.0	
December projection	1.4 to 1.6	1.6 to 2.0	1.8 to 2.0		1.3 to 1.8	1.5 to 2.3	1.6 to 2.2	

Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The December projections were made in conjunction with the meeting of the Federal Open Market Committee on December 17–18, 2013.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.
2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
3. Longer-run projections for core PCE inflation are not collected.

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statements are not based on hunches. The staff can estimate the effect of extreme weather conditions from unpublished questions in the labor market surveys. Specifically, the BLS asks households whether they were out of work during the survey week due to bad weather, but you had to be absent the entire week. By contrast, the question in the establishment survey asks whether the respondent's work hours were affected by bad weather. Of course, the responses must be considerable greater than usual because some lost work time in built into the seasonal factors. A quick glance at the hours worked data suggests an unusual amount of work time was lost, although the more stringent household data does not. So when Chairwoman Yellen says economic activity was affected by bad weather, it means the staff actually has estimated the Q1 impact from the hours worked data. Moreover, the recent bounce back in manufacturing orders and shipments is consistent with that view.

In short, FOMC members had little reason to change their relatively rosy outlook, yet markets seemed to perceive the directive and further tapering of asset purchases to $55 billion/month as a more hawkish stance. One rationale was that the participants' forecasts for the funds rate itself inched up to around 1% by yearend 2015 and about 2.25% by yearend 2015. As Ms Yellen took pains to explain at the press briefing, scrutinizing the distribution of dots representing each participant's rate forecast is not a useful way to judge the collective leanings of the FOMC. Rather, the rate forecasts simply reflect the underlying individual economic forecasts that curiously show greater disparity than those of private sector analysts. So those participants who expect the US economy to grow close to its long term potential of 2% to 2-1/4% likely are the ones whose forecasts show little increase over the next two years, whereas those who envision much stronger growth in real GDP of 3.5% in 2014 and 2015 undoubtedly are associated with the high end of the policy rate forecasts. Note that consistent growth of 3-1/2% annually would eliminate entirely the current output gap by yearend 2016, at which time the FOMC presumably should have normalized its policy rate.

On this point, the Fed still is convening a confusing message. Chairwoman Yellen expressed the view that policy rates likely would remain well below 'normal' even after the economy reaches full employment because of the disinflationary tendencies of a deleveraging world economy. An equally plausible view is that the neutral fed funds rate itself is lower than the historical norm of 3-1/2% to 4% precisely because of the uncertainty and potential disinflationary tendencies of the deleveraging and de-globalizing world economy. At some point the Fed will need to clarify its views on the neutral funds rate if it hopes to contain the media from its proclivity to muddy the waters. In the interim, the Fed's clear message is that it will stay the course on exiting QE as gracefully and slowly as possible.

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19 March, 2014

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