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Economic Research Note

US: 2017? No problem

- **The September FOMC interest rate forecasts will likely feature a funds rate in 2017 close to neutral**
- **The 2015 and 2016 forecasts should be little changed, projecting a slow rate normalization process**
- **The rhetoric justifying this slow pace may shift gradually from headwinds toward risk management**
- **One problem with the forecasts: less forecast dispersion in 2017 could get mistaken for less uncertainty**

A year ago we discussed how the roll-out of the Fed's 2016 interest rate forecasts would create some communication dilemmas for the Fed (See "The 2016 problem," GDW, Aug. 16, 2013). Indeed, for much of the last year Fed leadership has found itself trying to explain why its interest rate outlook was apparently at odds with its economic forecast. As we look ahead to this September's FOMC meeting, the Fed will once again be rolling forward its forecasts another year. Unlike last year, we expect little disconnect between the Fed's interest rate and economic forecasts: we believe it will forecast the funds rate in 2017 at a level close to neutral – around 3.75% – with the economy at full employment and price stability.

Even so, the interest rate forecasts for 2015 and 2016 will still be somewhat lower than what would be implied by standard policy rules such as the Taylor rule. The gap will be somewhat less than it was last year – because the FOMC's interest rate forecasts rose, and its estimate of the level of the neutral funds rate declined – but nonetheless there will still be a gap. We see an evolution in how the Fed describes that gap. Heretofore it has relied on the "headwinds" argument. More recently it introduced broader notions of labor market slack. Going forward, we see a greater emphasis on risk management. This framework, usually associated with Greenspan, aligns well with the thinking of the current leadership, which sees the costs of hiking too soon as greater than the costs of hiking too late.

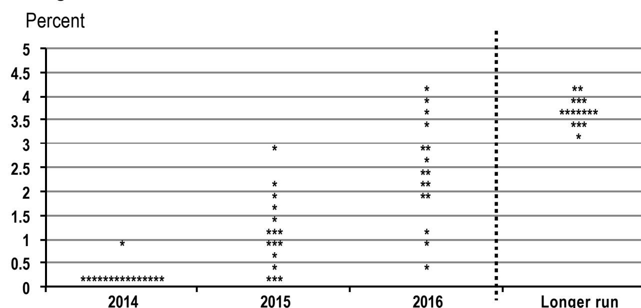
Finally, while the introduction of the 2017 forecasts will not present tactical problems for the Fed, it will highlight more fundamental, longer-term, problems with the way the FOMC communicates policy intentions. The Fed's interest rate outlook conveys the *dispersion* of the differing point forecasts among the Committee participants, but not a sense of *uncertainty* that each participant may feel about his/her own forecast. This distinction will come into focus with the upcoming forecasts. The 2017 interest rate projections will likely show less dispersion than the 2016 projections, even though uncertainty naturally increases the farther out one projects into the future. This could present some nettlesome communication issues at a time when the Fed is trying to remind the markets of the inherent uncertainty in the policy outlook.

FOMC central tendency

	Meeting date	2014	2015	2016	Longer run
Real GDP	Sep '13	2.9 to 3.1	3.0 to 3.5	2.5 to 3.3	2.2 to 2.5
	Dec '13	2.8 to 3.2	3.0 to 3.4	2.5 to 3.2	2.2 to 2.4
	Mar '14	2.8 to 3.0	3.0 to 3.2	2.5 to 3.0	2.2 to 2.3
	Jun '14	2.1 to 2.3	3.0 to 3.2	2.5 to 3.0	2.1 to 2.3
Unemployment rate	Sep '13	6.4 to 6.8	5.9 to 6.2	5.4 to 5.9	5.2 to 5.8
	Dec '13	6.3 to 6.6	5.8 to 6.1	5.3 to 5.8	5.2 to 5.8
	Mar '14	6.1 to 6.3	5.6 to 5.9	5.2 to 5.6	5.2 to 5.6
	Jun '14	6.0 to 6.1	5.4 to 5.7	5.1 to 5.5	5.2 to 5.5
Core PCE inflation	Sep '13	1.5 to 1.7	1.7 to 2.0	1.9 to 2.0	2.0
	Dec '13	1.4 to 1.6	1.6 to 2.0	1.8 to 2.0	2.0
	Mar '14	1.4 to 1.6	1.7 to 2.0	1.8 to 2.0	2.0
	Jun '14	1.5 to 1.6	1.6 to 2.0	1.7 to 2.0	2.0

Source: Federal Reserve Board

Target Federal Funds Rate at Year-End



Source: Federal Reserve Board

Meet the new forecasts

Since the last Summary of Economic Projections (SEP) was released on June 18th, the data have, broadly speaking, evolved in line with Fed expectations. The unemployment rate is down a tenth, core PCE inflation is tracking their 1.6% year-ago forecast for 4Q14, and GDP growth may have come in a touch firmer than they were looking for. All in all, though, the economic forecasts for 2014 to 2016 will likely look quite similar to what they were in June, subject to the caveat that we still have a decent amount of data to be released between now and the September meeting. A relatively unchanged economic forecast therefore implies a relatively unchanged interest rate forecast for 2015 and 2016.

Over the past few forecast rounds we have seen a gradual marking down in the Committee's estimate of trend GDP growth, the natural unemployment rate, and the neutral funds rate. We continue to see the estimates for all three of these long-run variables as biased lower. As in the past, we expect

the magnitude of the revisions to be relatively small, as these estimates tend to be revised gradually.

The June forecasts foresaw an economy in 2016 that had an economy growing above trend, close to full employment, and getting close to the Fed's 2% inflation goal. Since these forecasts assume "appropriate monetary policy" it is reasonable to project an economy in 2017 that is growing at trend, is at full employment and at the Fed's 2% inflation goal. Even with the headwinds argument, the June interest rate forecasts – looking at either the median or the mean – projected the funds rate increasing about 135 basis points between the end of 2015 and the end of 2016.

With the funds rate "dots" at the end of 2016 likely still to be clustered around 2.5%, a continuation of that pace of policy normalization would place the midpoint of the funds rate at 3.85% at the end of 2017. Moreover, such a continuation of policy normalization at the pace projected for 2016 seems a reasonable conjecture: on the one hand headwinds are likely to be less, so there is little need for a slower pace, on the other hand, 3.85% would already put it slightly above its latest estimate of the neutral funds rate, so there is probably only limited reason to project a faster pace than was seen in 2016. (A catch-up need to overshoot neutral may appear to be one reason for a faster pace in 2017, but with 2016 inflation still somewhat below target the Fed's own forecast does not seem to call for such overshooting).

The preceding discussion relates to measures of central tendency within the dots – the median or the mean. It may be instructive to think about how the differing wings of the Committee forecast policy evolving in 2017. In June, four participants saw the 2016 funds rate at 3.5% or higher. These hawks and center-hawks presumably anticipate a fairly normal rate hike cycle aimed at heading off inflation risk. Because they have already moved quite close to neutral by 2016, they will likely project only modest further rate hikes in 2017.

On the other side there are five participants who see the funds rate at the end of 2016 at 2% or lower, and two who see it at 1% or lower. The strategy motivating these forecasts would seem to be a desire to be deliberately behind the curve in order to nurse the economy back to health. That goal having largely been achieved by the end of 2016 (at least in the SEP forecasts) implies that there is more catch-up policy normalization to occur in 2017. The differing strategies the hawks and doves adopt for 2014-2016 imply, paradoxically, that the hawks tighten less in 2017 and the doves tighten more. Another implication is that measures of dot central tendency which trim out the hawks may show a steeper path of rate hikes in 2017 than in 2016.

Still explaining 2015 and 2016

If we are right, 2017 will be self-explanatory: the economy is in equilibrium, and the funds rate is at its equilibrium rate. Even so, the Fed will still need to explain why the path to get there – 2015 and 2016 – has a funds rate that is well below what would be implied by most pre-crisis policy rules. According to Chair Yellen, "FOMC participants provide a number of explanations" for this apparent disconnect

Among these explanations "headwinds" remains a favored story, though we believe evidence is building that the headwinds the Fed has identified are fast fading. The "optimal control" explanation may be preferred by a few doves, but we see little appetite in the broader Committee for this strategy; even Chair Yellen has stressed no intention to overshoot the inflation target – a view at odds with optimal control. The "shadow slack" explanation – which emphasizes measures of labor market slack beyond the unemployment rate – may be gaining traction, as evidenced by the discussion of "underutilization of labor" in the last FOMC statement. This explanation is closely related to the idea that stimulating aggregate demand can generate better aggregate supply. Going forward, we see increased emphasis on the risk management explanation. We saw hints of this in Yellen's recent Senate testimony when she offered that "when short-term overnight interest rates are at zero we have no ability to lower them further; we need to be careful the economy is on a solid trajectory before we consider raising interest rates."

Dispersion is not uncertainty

The standard deviation of the Fed's latest 2015 interest rate forecast was 0.8%-point; 2016 was 1.1%-points; the longer-run was 0.3%-point. In 2017, as the economy is projected to be one year more entrenched in expansion, we can expect more Committee participants seeing the funds rate getting closer to neutral, As this occurs the dispersion of the 2017 rate forecasts may be less than the 2016 forecasts. This is a natural consequence of the Fed's forecasting approach whereby each participant assumes appropriate monetary policy: at very long horizons the dispersion in funds rate forecasts should converge to the dispersion in the neutral rate forecast. (In the near term this phenomenon may be artificially masked by the zero lower bound).

Of course, the further out one forecasts the more uncertain that forecast becomes. This could mistakenly be interpreted as the Fed being less uncertain about the outlook. Such a mistake could come at an inopportune time for the Fed. Fears about market complacency have led Fed leadership to underscore that uncertainty is always pervasive. Just as Fed rhetoric had to hammer home that "tapering is not tightening" so too will it have to emphasize that "dispersion is not uncertainty."

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