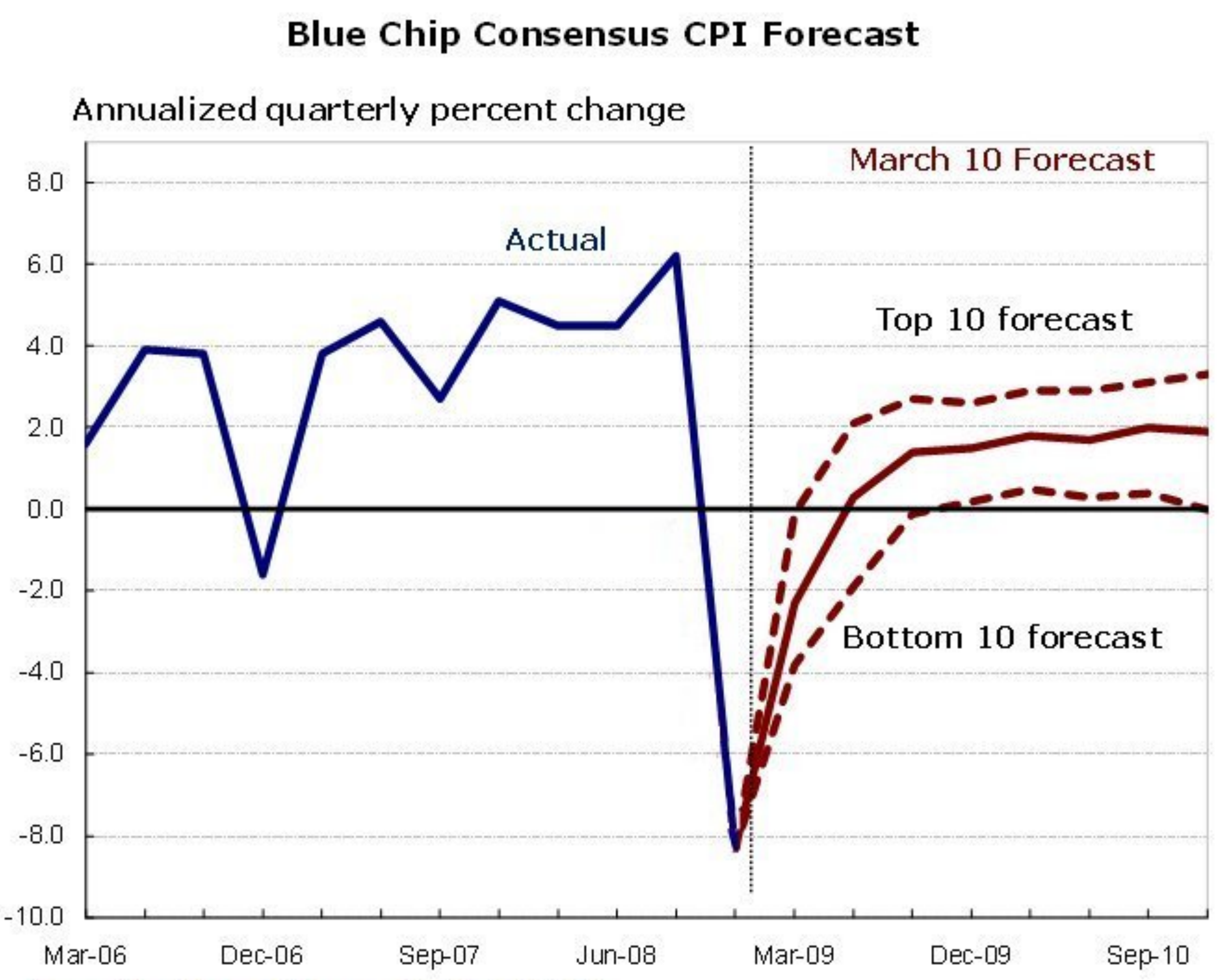
**April 6, 2009**

## The mean and the variance of the longer-term inflation outlook

Ever hear the one about the statistician who had his head in the oven, his feet in the freezer, but who said he felt fine—on average? We kind of feel that way when we look at the recent distribution of inflation forecasts. Not only does the Federal Reserve Bank of Atlanta produce its own economic forecasts, but we're also eager consumers of others' forecasts. That's because we believe there is useful information to be learned from varying views. For one thing, it helps to reveal the risks. The current inflation forecast is a good case-in-point.

Figure 1 shows the consensus CPI forecast for the Blue Chip panel of economic forecasters from March 10:



Sources: Blue Chip panel of economists, March 10, 2009

The "average" forecast shows CPI-measured inflation falling at a 2.25 percent (annualized) pace in the current quarter, followed by a modest .25 percent rise in the second quarter and then gradually climbing to a 2 percent growth trend in the second half of next year.

Our interpretation of the Blue Chip consensus inflation forecast (if such a thing is really possible, since it's merely an average of many forecasts) is that falling energy and other commodity prices combined with a large amount of economic slack is likely to exert considerable downward pressure on inflation over the next few quarters. But as the economy gradually recovers, we should begin to see a gradual return of inflation to something closer to what the Federal Reserve sees as consistent with price stability.

OK, that's the combined wisdom of the 50-some members of the consensus forecast panel. But there's a bit more to the story than just the average forecast. Consider the 10 highest inflation forecasts relative to the 10 lowest. The inflation "optimists" see the CPI tracking at, or a shade under, 0.5 percent over the forecast horizon, while the pessimists see inflation continuing to move higher and topping 3 percent (annualized) in the second half of 2010. Now, some discrepancy in economic forecasts is to be expected, but the range of disagreement in the Blue Chip forecast about the longer-term inflation trend—at a little over 3 percentage points—is an exceptionally large spread. (By our calculations, it's about twice the spread of the group's longer-term average inflation prediction.)

However, we've got a pretty good idea of what's causing such a large discrepancy. There likely are two competing and seemingly large risks within the consensus. First, some of these forecasters may believe the economy will not rebound in the way that is implied by the forecast average, which is to say that the economic slack (see Friday's jobs report) putting downward pressure on inflation may be with us for some time. These forces could be exacerbated and prolonged if the public were to incorporate the lower near-term price behavior into their longer-term inflation expectations. We're going to speculate that this is the inflation scenario the Blue Chip inflation "optimists" have in mind.

On the other side, some of these Blue Chip forecasters may believe the economy will do an abrupt about-face and climb out of the recession more adeptly than the consensus now predicts. In their view, if it does, and the Federal Reserve is not adept at shrinking the size of its balance sheet, there would be the proverbial inflationary scenario of "too much money chasing too few goods." And, again, if the public incorporates *this* scenario into their expectations, the prediction of the inflationary pessimists comes to pass.

These competing inflation scenarios were a topic of conversation at the January Federal Open Market Committee (FOMC) meeting (below is a quote from the minutes of that meeting):

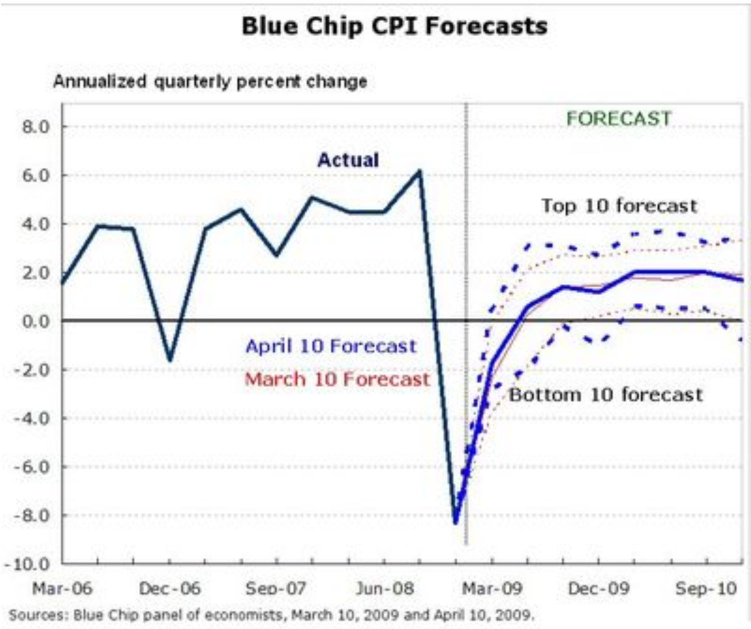
"Many [FOMC meeting] participants noted some risk of a protracted period of excessively low inflation, especially if inflation expectations were to move down in response to lower actual inflation and increasing economic slack, and a few even saw some risk of deflation.

"Several others, however, anticipated that longer-run inflation expectations would remain well anchored, supported in part by the Federal Reserve's aggressive expansion of its balance sheet and the resulting growth of the monetary base…some noted a risk that expected inflation might actually increase to an undesirably high level if the public does not understand that the Federal Reserve's liquidity facilities will be wound down and its balance sheet will shrink as economic and financial conditions improve."

One risk has feet in the fire—the other in the freezer. Here's hoping that the consensus is right.

Update from April 6, 2009:

The April 10 Blue Chip report came out today, showing a further widening of the spread between the forecasts for CPI inflation. While the mean forecast was revised only slightly, the difference between the top and bottom 10 forecasts for Q4 2010 increased by a full percentage point, from 3.3 to 4.3.

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