A Policymaker's Perspective on the Economic Outlook

Additional Information

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Introduction

This is a natural time to think about what may happen in the year ahead. As business leaders, you may have already adjusted your business plan and set your capital budgets to achieve the goals you have set for your companies. For Federal Reserve monetary policymakers, our "goals" are straightforward. We have a dual mandate from Congress - price stability and maximum employment - but Congress has given the Federal Reserve independence in choosing our so-called business plan on how to achieve these two objectives.

The data we get on the economy are backward-looking - meaning that they give us information about the economy at some point in the past. But monetary policy is forward-looking, meaning that whatever policy decision the Federal Reserve makes affects economic growth and inflation in the future. So effective policymaking requires that we make the most informed assessment possible about where the economy is heading over the next several months, quarters, and even years.

For some of you, establishing your business plan is an ongoing, rather than an annual, exercise. Certainly that is the case for the Federal Reserve. We make policy decisions based on continually updated economic projections. Perhaps new data reveal that the economic landscape was different than we saw it when we made a previous decision. Or perhaps we see that the economy is approaching hurdles we had not anticipated. Making economic projections is a difficult, but nevertheless an essential, part of the policymaking process.

This morning, I want to spend some time talking with you about the Federal Reserve's economic projections and my current views on the state of the economy. I will begin by describing the recent decision by the Federal Reserve to release our economic projections more frequently and the role that economic projections play as communication devices. Next, I will discuss the process I use to make my own economic projections, and I will conclude with my current views on the economy.

Please understand that the opinions I express today are my own. I do not presume to speak for any of my colleagues in the Federal Reserve System.

I. Economic Projections as Communication Devices

So let me begin my remarks by describing the changes the Federal Reserve has made in releasing our economic projections and the role they play as communication devices.

For most of our history, the Federal Reserve did not announce any policy moves, choosing instead to let the world guess at our policies by carefully reading the financial market indicators. But gone are the days when central banks find it advantageous to operate in secret. Over time, and especially since 1994, the Federal Open Market Committee (or FOMC), the Federal Reserve's policymaking group, has taken a series of steps to become more transparent. These days, the public can see a press statement on the Board of Governors' website soon after the FOMC meets, and can read the full minutes of that meeting within just three weeks.

This past November, Chairman Ben Bernanke announced that the Federal Reserve is taking another step forward. We are now releasing our economic projections more frequently, and we are expanding their content. We are releasing our economic projections four times a year instead of just twice a year, which will give you more timely updates on how we see the economic environment unfolding. These projections are a compilation of the individual forecasts made by Federal Reserve governors and Reserve Bank presidents based on their own assessments of the appropriate policy required to achieve our dual mandate.

We are providing projections for real GDP growth, the unemployment rate, and two measures of inflation--overall inflation and "core" inflation, which excludes the volatile food and energy components. We have also extended the forecast horizon from two years to three years so you can get a better sense of where we think the economy and inflation are headed in the medium term.

In addition to providing more information about the economic outlook, we are also including a detailed narrative of the major influences shaping our projections. The narrative discloses the range of opinion among Committee participants and provides some measures of how we assess the uncertainties in our projections. All of this information is intended to provide you with a better understanding of the path the Federal Reserve expects the economy to follow on our way to achieving our dual mandate of price stability and maximum employment.

I believe that these enhanced economic projections will bring a number of benefits. First, the Federal Reserve is accountable to the public, and the more effectively we explain our decisions - and the rationale behind them - the better we are able to maintain our democratic legitimacy. Second, clarity about our policy objectives and strategy may help anchor the public's long-term inflation expectations and improve overall economic performance. With inflation expectations anchored, I believe that we will actually gain added flexibility to address near-term problems, such as the recent turbulence in the financial markets, without risking our credibility. Third, greater public understanding of what we are trying to accomplish and how we plan to do it should lead to better decision-making by households, businesses, and financial market participants.

II. The Process of Making Economic Projections

Now I'd like to take a few moments to share with you the process I use to make my own economic projections. At the next FOMC meeting, at the end of this month, I will submit my economic projections for 2008, 2009, and 2010. Here is how I am approaching that task.

I begin with a data-driven model of the economy. This so-called "structural" model is a collection of mathematical equations that represent the major sectors of our economy and the most important forces that influence those sectors.

For example, when energy prices rise or fall significantly, I need to know how these changes are likely to affect consumer spending. And by extension, I would like to know how changes in consumer spending will affect business capital spending plans, industrial production, underlying price pressures, and so on. These models are an absolutely essential part of the projection because they bring a strict discipline to the process. They keep track of a huge number of interrelationships and ensure that, in the end, I have accounted for all of the major forces that are influencing the economy. In short, the model helps me ensure that everything adds up.

Data-driven models are a necessary starting point for my projection, but they are only a starting point. For all of their analytical sophistication, economic models are really just abstractions. Even the best of them is a simplification of a very complex world. Let me describe just three of their shortcomings that I need to keep in mind when making a projection.

First, economic models are usually based on backward-looking data that are subject to measurement error. For example, as I speak with you this morning, the most recent GDP estimate I have is for the third quarter of last year, and it has been revised higher and higher with each passing month. I have monthly data on certain sectors of the economy, of course, but each of these snapshots gives me only a limited and blurry view of the overall economic picture.

Second, economic models require a host of assumptions that are obviously imperfect. For instance, I know my economic projection depends on the behavior of things like the cost of energy and the wealth of households. But while I must make certain informed guesses about the outlook for oil prices and the performance of the stock market, I really can't know these important influences with much certainty when I plug them into my economic model.

Third, every model is tied to historical events that may not perfectly reflect our current economic situation. This weakness is especially a problem when I think about the important role that expectations play in the economy and how people form their expectations. For example, how is the public, especially financial market participants, interpreting the incoming information today compared to the last time we faced a similar set of economic circumstances? Is confidence about the future affecting household spending and saving decisions differently this time? And what is the public expecting in terms of economic policy adjustments versus some previous period?

Because of these shortcomings, I choose to temper the economic projection from my model with a good dose of judgment. I use the economic insights of economists - and we have many very good ones at the Bank - but I also take full advantage of a broad collection of business contacts. Each business leader has a unique perspective on the economy, and together their perspectives paint a vivid picture. Business leaders know what is happening right now and, equally important, they can describe the plans they are making for the future.

I have been asking the business community a lot of questions lately - questions about issues like consumer spending patterns, the strength of their order books and inventories, and any plans they have made to add to their payrolls.

I am also considering some pivotal assumptions underlying the outlook. One question is whether the recent rise in oil prices is likely to continue. Another is how the dollar's performance is affecting pricing power. Yet another question is whether the stresses in the financial sector are disrupting the normal saving and lending channels.

Finally, there are all kinds of "expectations" issues that I need to sort through. I need a sense of how households are incorporating lower housing values into their spending and saving decisions. I need a sense of how the prospect for slower consumer spending, and perhaps slower economic growth, is likely to change the business appetite for investment. And I need a sense of how financial markets are reappraising risk and how that is affecting the cost and availability of credit.

As you can imagine, I make a lot of phone calls before I make my economic projection. Then I go back to my economic model and adjust it based on what I have learned. Of course, conditioning economic models to incorporate the judgment of experts without violating the integrity of the model is often more art than science. But it is important to try to strike a proper balance between the best of statistical science and the best of expert opinion to get as clear an economic roadmap as possible.

That said, there is obviously much room for improvement in the process. Even the very best of economic forecasts is not particularly reliable. To be specific, the confidence interval around a one-year-ahead real GDP forecast is about 2.4 percentage points. That can span the difference between an economy that is marching forward and one that is teetering on a precipice. And it's the "teetering on a precipice" that I'd really like to have some forewarning about!

The experience of forecasting around the time of the last recession illustrates my point. In December 2000, the predominant view among forecasters was that real GDP would expand at a 3 percent pace in 2001. The actual growth rate turned out to be only ¾ of a percent. The economy actually began to contract in March 2001, but we did not have confirmation that the economy was contracting until November 2001 - just as the economy was climbing out of recession. As I said earlier, economic statistics are released with a lag and are often revised substantially over time. Obviously, having such an imperfect understanding of how the economy is unfolding greatly complicates our ability to make accurate near-term projections.

At the Federal Reserve Bank of Cleveland, we are always working to improve our modeling process. We are researching how to better understand business and household expectations for the economy, inflation, and the likely path of monetary policy. We are rethinking the way we interpret survey data of households, and we are improving the ways we pull market sentiment from the financial data.

Our economists are studying the sources and shifts in productivity that pin down our economic potential. And we are working on the development of new models that account for how economic interactions change over time on the basis of expectations.[1] In recent years, economists have been able to make these very complicated models more relevant to the policy process, and the models may soon find their way into my economic projections. But I don't think I'll be pitching my Rolodex of business contacts anytime soon.

III. My Views on the Economy

So that's the process of making projections. With all of that as background, how am I thinking about the economy this morning? Of course, I know that our economy is confronting a number of challenges as the new year begins. The residential real estate market still appears to be in freefall. In addition, oil prices have risen, and housing and equity prices have fallen. These factors are restraining the economy beyond the housing sector.

Directly and indirectly, the negative influence of housing on overall economic performance could affect the outlook for some time. We are also seeing a related slowing in consumer spending, perhaps in response to reduced household wealth. Tightened credit market conditions could also hinder economic growth this year for both businesses and consumers. A weak December employment report, combined with a falloff in retail spending and flat industrial production, supports my view that the economy has shifted to a lower growth track. Although I expect that the restraining influences to growth will diminish over time, and that the economy will gain firmer traction later this year and into 2009, I am concerned about the downside risks to that outlook.

Even as economic growth was slowing, inflation at year-end was clearly elevated. Rising energy prices were a big part of the increase in overall inflation, and some of those costs were passing through to the core inflation measures as well. So, too, the falling dollar seems to have boosted import prices. But I continue to believe that the economy's inflation trend will move lower over the forecast horizon as the growth rate of the economy slows and the influence of energy and import prices diminishes.

Risks remain to my inflation outlook, including the risk of losing the public's confidence in the Federal Reserve's commitment to price stability. I will continue to closely monitor the inflation situation, including the behavior of inflation expectations.

My FOMC colleagues and I will be discussing the outlook for the economy in less than two weeks. Needless to say, the economic and financial environment has been very fluid lately, creating the need to be highly flexible in responding to changes to the outlook and associated risks.

I would like to thank Michael Bryan, vice president and economist at the Federal Reserve Bank of Cleveland, for his insights in the development of these remarks.

[1] These models are called Dynamic Stochastic General Equilibrium Models.