US Weekly Economic Briefing

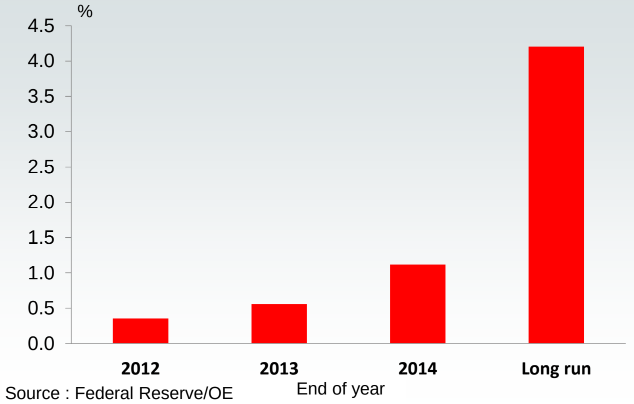
Highlights

- The Federal Reserve has taken additional actions to make its monetary policy more transparent to markets. The latest moves include the release of FOMC members' expectatins for the federal funds rate at the end of each of the next few years and in the longer term.
- Another is an statement of strategy for meeting its dual mandates of price stability and full employment. Although the statement included an explicit target for inflation but not for unemployment, the equal weights given to each goal afford the Fed more discretion in setting monetary policy.

The Fed moves to provide more transparency

At the end of the Federal Open Market Committee meeting on January 25th, the Federal Reserve unveiled new features of its on-going efforts to provide transparency to the markets on monetary policy. In addition to the Chairman's press conference following the meeting and the release of the Committee members' forecasts of economic growth, unemployment and inflation, which have been in effect for some time, the Fed released the Committee members' expectations of the future path of the federal funds target rate. This data shows when each of the Committee members expects policy 'firming' to begin and how quickly they expect the target to rise, in the absence of some additional shock to the economy. However, as in the case of the forecasts of growth, unemployment and inflation, the projections of the federal funds target are not identified with the individual members who made them.

FOMC projections of federal funds target rate



Source : Federal Reserve/OE

Eleven members of the Committee expect the first change in policy to take place in 2014 or later, but three expect it to begin this year and another three look for it in 2013. By the end of 2014, there is considerable divergence of opinion, with six members still holding to the current 0-0.25% range but others spread out across the scale to the highest at 2.75%. Even with that divergency, the expectations for the target level remain low. The weighted averages of members' views for the end of 2012, 2013, and 2014 and for the long term are shown in the chart nearby. It was calculated by assigning a value of 0.125% to the current extremely low range. There is a very slow increase, from 0.35% at the end of 2012 to 1.12% at the end of 2014, on the way to the eventual long run rate of 4.21%. These expectations form the basis for the comment in the Fed's policy statement that the Committee expects conditions to warrant the extension of the current very low range for the target to at least late in 2014.

The Fed also issued a separate press release in which it announced an agreement among the FOMC members on the the strategy it will employ in meeting its dual mandates of price stability and full employment. The two goals will be considered to have equal importance, though a specific numerical value was provided for inflation but not for the unemployment rate. This difference in treatment was also explained in the statement: since inflation is primarily determined by monetary policy, it is possible for the FOMC to set a target, but since the level of employment is determined by nonmonetary factors that may be difficult to measure, it is not appropriate for the Fed to set a fixed goal. However, the the long run rate of unemployment is one of the variables published regularly in the FOMC's Summary of Economic Projections and right now those estimates have a central tendence of 5.2% to 6.0%, well below the current unemployment rate, which suggests continued expansionary policy.

The inflation target is specified as 2% in the year-on-year growth of the personal consumption deflator. In 2011Q4, that annual growth rate in the overall deflator was 2.6%, moderately above the target range, which would suggest a nearer-term tightening. But presumably for the near term, the Fed would consider the core deflator, stripping out more volatile food and energy prices, rather than the overall index (though the release did not indicate that). The core deflator showed inflation of 1.7% in Q4, modestly below the target.

Unemployment above target and inflation below target both require expansionary policy to move them toward desired levels. But it is not difficult to see that circumstances could easily develop in which the policy requirements of the two goals will be in opposite directions – the present gap on inflation is much narrower than that for unemployment, so a moderate pickup in growth could easily produce above target inflation while the unemployment rate still has a long way to fall to reach its goal. The Fed would then have to weigh the circumstances – the relative size of the gaps, the likely speed with which the gaps will close – to form a balanced approach to policy. The equal weights on the two goals in effect gives the Fed more lattitude to set monetary policy as it sees fit.