Mixed Signals?

There are times when the Fed’s policy actions are relatively easy to predict, and other times when it is far more difficult. A neutral policy stance is a situation where the federal funds rate target is consistent with expectations that inflation will be on target and output will return to its long-run potential. Starting from such a neutral position, policymakers monitor incoming information to see whether adjustments are needed in the policy stance. Because forecasts reflect information available at the time forecasts are made, forecast errors reflect new information that arrives after the policy stance is chosen.

The figure below shows forecast errors for inflation and real GDP growth. The forecast errors are constructed by subtracting the latest Blue Chip consensus forecast from the relevant quarter’s advance report on actual GDP growth for the year-to-date. These advance data, the first estimates published by the Bureau of Economic Analysis, contain most of the information about GDP and are hardest to forecast. Therefore, when advance data for the second quarter are released in July, the available GDP growth estimate for the calendar year includes the final estimate for the first quarter and the advance estimate for the second quarter. A positive forecast error in July indicates—at that point in time—the available GDP growth estimate is above the Blue Chip forecast for the year.

In the case of real GDP growth, if the forecast errors are positive, by implication, GDP may be growing above the path that was expected to take it back to its potential. Because there is no explicit policy objective for inflation, positive forecast errors for inflation suggest that inflation is above the path that it was expected to take in order to reach the objective at the time policy was set.

If both forecast errors are positive—that is, if inflation and growth are both unexpectedly high—then the points will lie in the upper right-hand region of the figure, indicating the need for a tighter policy. If both forecast errors are negative, which indicates surprisingly slow growth and low inflation, then the points will lie in the lower left-hand sector. This suggests the need for a looser policy. If the points lie in the other, shaded, quadrants where one forecast error is positive and the other is negative, there is no clear indication for policy action.

Since the beginning of 1994, GDP growth forecast errors (measured on the vertical axis) have tended to be positive, mainly lying above the horizontal axis. Generally, the inflation errors have been negative, with the points lying to the left of the vertical axis. In the majority of these cases, then, the forecast errors have been in the shaded area where growth is surprisingly high and inflation is surprisingly low. Therefore, since 1994, the signals about what, if anything, should be done with monetary policy have often been mixed. In fact, since 1994, the first quarter of 2000 was the only instance in which forecast errors for both inflation and GDP growth were positive. Therefore, we should not be surprised that the Fed would see the need to tighten monetary policy.

—William T. Gavin
—Rachel J. Mandal