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Perna's Perspective

by Nicholas S. Perna, PhD

Glasnost at the FOMC

I was so excited that I had trouble sleeping the night before the end of the latest Federal Open Market Committee (FOMC) meeting. And I wasn't disappointed: on January 25, Ben Bernanke revealed a lot more about the thinking of the nation's monetary policy body. As promised, the FOMC gave projections of the fed funds rate for the first time. Quite unexpected was a pledge to keep short-term interest rates low for almost three more years. I was also surprised when the FOMC officially adopted 2 percent as the monetary inflation target.

Glasnost. So what's the big deal? Maybe these disclosures don't sound all that earth-shaking but until the mid-1990s, the FOMC didn't reveal anything. The former Soviet Union had become much more open almost a decade earlier under Mikhail Gorbachev's *glasnost* policy.

Until 1994, financial markets had to figure out what the FOMC had decided. The FOMC would simply adjourn and go home. Usually markets got it right, but I remember one time in the late 1980s when a large bank mistakenly thought the Fed had increased the fed funds rate. Accordingly, the bank raised its prime rate but nobody else followed, so they rather sheepishly had to rescind the increase a few days later.

Over the past two decades, the Fed has become increasingly transparent. By 2000, it was releasing a statement at the conclusion of the meeting which gave the decision as well as a few tidbits that might give some clues to future decisions.

Chronology of Changes in the Fed Transparency

1994	Announce rate changes
2000	Release a statement after each meeting
2003	Says rates to stay low for a considerable period of time
2004-5	Says rates to rise at a "measured" pace
2005	Speeds up release of FOMC minutes to three weeks after meeting
2009	Releases long-term forecasts of GDP, inflation and unemployment
2011	Says rates to remain low until at least mid-2013
2012	Releases forecasts of fed funds

Three more years. The January 25 FOMC statement extended the period during which "exceptionally low levels for the federal funds rate" are "warranted" from mid-2013 to "at least" the end of 2014. This rather remarkable pledge is justified by an economy operating well below its potential and a "subdued outlook for inflation." Of course, this is a conditional promise that the Fed would have to renege on if economic growth and/or inflation turn out significantly higher.

Forecasts of GDP growth, unemployment and inflation for the next several years have been published for quite a while. The latest are similar to what private forecasters are predicting. PCE inflation is the change in the price index for personal consumption expenditures. It is very similar to the Consumer Price Index (CPI) and I am convinced that it was introduced by Alan Greenspan as a way of obfuscating. Unlike Ben Bernanke, Greenspan seemed to delight in confusing his audiences. He once quipped, "If you understood what I said, then I must have misspoke."

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FOMC U.S. Economic Forecast

	2012	2013	2014	LR
REAL GDP % CHANGE	2.5	3.0	3.7	2.5
UNEMPLOYMENT %	8.4	7.8	7.2	5.6
PCE INFLATION % CHANGE	1.6	1.7	1.8	2.0
CORE PCE "	1.7	1.8	1.8	NA
FED FUNDS %	.25	.25+	.25+	4.25

Note: data are midpoints of ranges. Unemployment and fed funds are year-end. GDP and inflation are the percent change from four quarters ago.

Material released at the same time, gave the projections of fed funds for the 17 members of the FOMC (fed governors and reserve bank presidents) without naming them. I have put 0.25 percent in the table through 2014. However, some FOMC members think fed funds should start rising sooner. By 2014, 11 of the 17 see fed funds at or below one percent while several others place it at 2 ½ percent. Even the upper end of this range might be considered "exceptionally low." Hence, it is probably incorrect to interpret the pledge as keeping fed funds perfectly flat at present levels through the end of 2014.

The long rage (LR) forecasts are rather important. The long range is not so much a time period as a state where the economy is behaving normally. (You may recall that Keynes said, "In the long run we are all dead." I don't think Bernanke had this in mind at all.) Hence, these numbers really aren't forecasts. Rather, they are largely statements of the Fed's goals or targets. In the long run, the Fed is striving to have the economy operate at full employment. As the table notes, the FOMC puts this in the vicinity of 5 ½ percent. Consistent with this, real GDP is growing at its long run potential of about 2 ½ percent.

The FOMC specifically selected 2 percent as its inflation target after hinting very strongly at this for the past few years. Bernanke pointed out at the press conference following the meeting that it is appropriate for the Fed to disclose its inflation target, since monetary policy is what determines the inflation rate in the long run. On the other hand, while the Fed is also supposed to aim for maximum sustainable employment, it is not practical to set a numerical target since the unemployment rate consistent with full employment is set by demographics, labor mobility, etc. and not the Fed.

Finally, I found the long run forecast of 4 ½ percent for fed funds (with a fairly narrow range of opinion) most interesting. I don't know when the long run is, but it could be as close as four to five years from now based on how many years it takes to get back to 5 ½ percent unemployment. That means a major Fed tightening may have to follow years of "exceptionally low rates."

The FOMC did not disclose its predictions for long-term interest rates. That's because the Fed can tightly control the fed funds rate, increasing or reducing the amount of reserves in the banking system by buying or selling securities though "open market operations." While bond yields are influenced by what the Fed does, they are also determined by the supply and demand for long-term funds from both home and abroad. Based on past relationships, a 10-year Treasury bill rate in the vicinity of 5 percent is consistent with fed funds of around 4 ¼ percent. Today's 10-year note yields around 2 percent. The *Wall Street Journal's* monthly survey of eminent economists (I'm a member of the panel…) has the 10-year note at under 3 percent by December 2012 and around 4 percent a year later.

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Some Implications

The cost of funds for credit unions is very likely to stay low for at least several more years, although not necessarily at today's rates.

Low returns on bank deposits and credit union shares will continue to be an issue for customers and members. Since I suspect that bond yields will start rising somewhat during the coming year, intermediate and longer term CDs will become even more attractive, relative to very short-term deposits which are held very low by the fed funds rate. Most very short-term rates move rather closely with fed funds.

Rising long term yields are a mixed blessing. They raise the return on new investments but reduce the market value on securities held in your portfolio. As we've been saying for awhile, pay close attention to what measures of interest rate sensitivity are saying about your institution's exposure to rising short-term and higher bond rates down the road.

Happy New Year!

Nick Perna is Resident Economist, Alloya Corporate. He specializes in economic analysis, forecasting and strategy. Dr. Perna has served as an economist for the Federal Reserve Bank of New York, General Electric and a number of major banking institutions. The *Wall Street Journal* and *BusinessWeek* have each twice cited Dr. Perna as one of the top economic forecasters in the United States. He has served as an economics professor at Williams College and New York University, and currently teaches an economics course at Yale University. In addition, he has also appeared on *The NewsHour with Jim Lehrer*, CNN, CNBC, the NBC *Nightly News*, ABC Radio and NPR's *All Things Considered*.