On February 2, the Federal Open Market Committee (FOMC) raised the intended federal funds rate 25 basis points (bp) to 2.5%, the sixth such increase since the current round of tightening began in late June 2004. The FOMC’s press release stated that “even after this action, the stance of monetary policy remains accommodative.” It noted that “labor market conditions continue to improve gradually” and pointed to a containment of longer-term inflation expectations. The FOMC has said that accommodation can continue to be removed at a “measured pace.”

Market participants seem to agree. Implied yields are consistent with 25 bp increases in the funds rate at the March, May, and June meetings. Since the FOMC’s February 1–2 meeting, participants in the options market have placed higher probabilities on a 25 bp increase at the March meeting. The implied probability of a 25 bp hike now exceeds 92%.

On February 16, the Fed released its semiannual Monetary Policy Report to the Congress, which presents economic projections by the Board of Governors and Reserve Bank presidents. The central tendency of the projections for real GDP growth for 2005 is 3.75%–4.00%. The core PCE Chain-Type Price Index is expected to grow at an annual rate of 1.50–1.75%, and the fourth quarter unemployment rate is projected at 5.25%.

How reliable might these projections be, in themselves and relative to private forecasters? A scatter plot of perfect projections versus actual

(continued on next page)
values would lie along a 45-degree line. Here, we compare the Monetary Policy Report’s accuracy in projecting unemployment with that of private forecasters and with a naïve forecast that simply predicts a future value equal to the current one. At times, these values miss the actual unemployment rate by one or more percentage points. We can gauge their overall performance by calculating mean absolute errors. Over a 12-month horizon, the mean absolute error of professional forecasts of the unemployment rate is 0.52% versus the Federal Reserve’s 0.38%. Both are more accurate than the naïve forecast’s mean absolute error of 0.69%.

In recent years, Fed projections of real GDP growth (fourth quarter to fourth quarter) have tracked actual real GDP growth quite well, but the timing of its upturns and downturns has always been difficult to project. And for prolonged periods, the projections over- or understate real GDP growth considerably. The inflation projections, (0.85% mean absolute error) fared better than projections of real GDP growth.

Since the FOMC began tightening in June 2004, the yield curve has flattened significantly. In returning policy to a more neutral stance since then, the FOMC has increased the target federal funds rate by a cumulative 150 bp. Yields on three-month Treasury bills have essentially followed suit. At the curve’s long end, however, the yield on 10-year Treasury bonds has fallen nearly 50 bp.