Looking Forward

In this issue of *Region Focus*, we take a look at the business of economic forecasting. Some call it a science, others an art. Clearly, forecasting contains elements of both. And while no single forecast is always going to be 100 percent accurate, it's also clear that forecasts provide value to those who read them, from Wall Street to Main Street.

Forecasting is an input into our everyday decisionmaking process. Your decision about whether to buy a car, for example, is based on a personal forecast that you will have the income to pay for it, and perhaps on a forecast that the car will maintain value over the years should you decide to sell it. Such a forecast may be based on a detailed analysis or on a simple gut feeling.

The Federal Reserve System produces some of the most detailed economic forecasts in the world. Recently, Chairman Ben Bernanke announced that some of the Fed's forecasts would be released to the public on a more frequent basis. Instead of semiannual projections with horizons of two years, now there will be quarterly forecasts with three-year horizons. Federal Open Market Committee (FOMC) participants will also add overall (or "headline") inflation to their forecasts, which already encompass changes in real gross domestic product, unemployment, and core inflation (which excludes prices of food and energy). Summary narratives will now accompany the numerical projections, giving a richer account of the Fed's outlook.

These are important changes. The Federal Reserve Bank of Richmond will continue preparing its own economic forecast and submit it as usual to the Board of Governors. The addition of the third year to the forecast horizon, along with the new narrative, will give an indication of individual members' preferences for inflation and perspectives on other longer-term trends. This should shed more light on the diversity of opinion around the FOMC table. The perspective in, say, San Francisco may be quite different than in Philadelphia, both geographically and philosophically.

Increasing the frequency and the depth of Fed communications with the public is part of a broader strategy that should help improve the effectiveness of monetary policy. In part, this is because forecasts are crucial to the process of conducting monetary policy in the first place. Changes in the target federal funds rate do not affect the economy immediately; there is a lag. Monetary policy is thus necessarily forward-looking, aiming to anticipate how policy actions will mesh with ever-moving economic conditions.

Externally, forecasts can help guide public expectations about future monetary policy. If the public uses the forecasts to gain a better understanding of where the Fed believes the economy is headed, then it is more likely to respond accordingly. Asset prices in financial markets, for example, may be more likely to move in directions favorable to the Fed achieving its objectives of price stability and sustainable growth.

Meanwhile, a public that is able to compare economic forecasts with central bank behavior can better discern patterns in monetary policy. If the pattern is consistent, policymaking becomes more credible, and inflation expectations become anchored. This is particularly useful to the Fed during times of economic shocks. The central bank can take policy actions in response to shocks — such as a spike in oil prices, for example — without shaking the public's confidence that the long-term inflation objective remains the same. Moreover, expectations are crucial to the behavior of inflation, and an informed public can better learn to form inflation expectations that are consistent with monetary policy.

A forecast of future economic conditions is just one piece of information that the Fed shares with the public. It also conveys objectives, its current policy stance, and, to some extent, its decisionmaking process. Together these messages form the core of the Fed's overarching strategy for explaining its policy actions to the public.

Chairman Bernanke called the Fed's communications strategy "a work in progress." Indeed, the past two decades have witnessed an evolution in Fed communications. It was only 14 years ago that the Fed first started announcing policy changes at the time they were made. More recently, FOMC minutes have been released three weeks after a meeting, instead of five to seven weeks later. Each step builds on past advances.

It's important to keep in mind that the way the Fed conducts monetary policy is not changing. For now, we are just trying to explain it better.

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