

Economic SYNOPSES

short essays and reports on the economic issues of the day

2009 ■ Number 29



Uncertainty About When the Fed Will Raise Interest Rates

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In response to the current economic crisis, the Federal Reserve has reduced its federal funds rate (FFR) target to zero. With the FFR at zero and a negative rate practically infeasible, the Fed is now in largely uncharted territory when conducting monetary policy. Other types of policies are now the focus of attention.

However, changes in the FFR eventually could again be the primary policy tool. But when might this happen? The answer depends on how the future of the U.S. economy is viewed and how that view maps into monetary policy. Here, I use the most recent forecasts from each member of the Survey of Professional Forecasters (SPF)¹ to show that the current lack of consensus about future economic growth and inflation makes it hard to predict when the Fed will raise interest rates.

To demonstrate this uncertainty, I translate the forecasts into a policy prescription using a [Taylor rule](#). The Taylor rule is a formula that implies a change in the FFR (from its equilibrium value) when there is a change in either the output gap (the difference in log-gross domestic product [GDP] and log-potential GDP) or the inflation gap (the difference in actual inflation and the target rate of inflation) where these two measurements reflect the Fed's dual mandate of price stability and long-term economic growth.

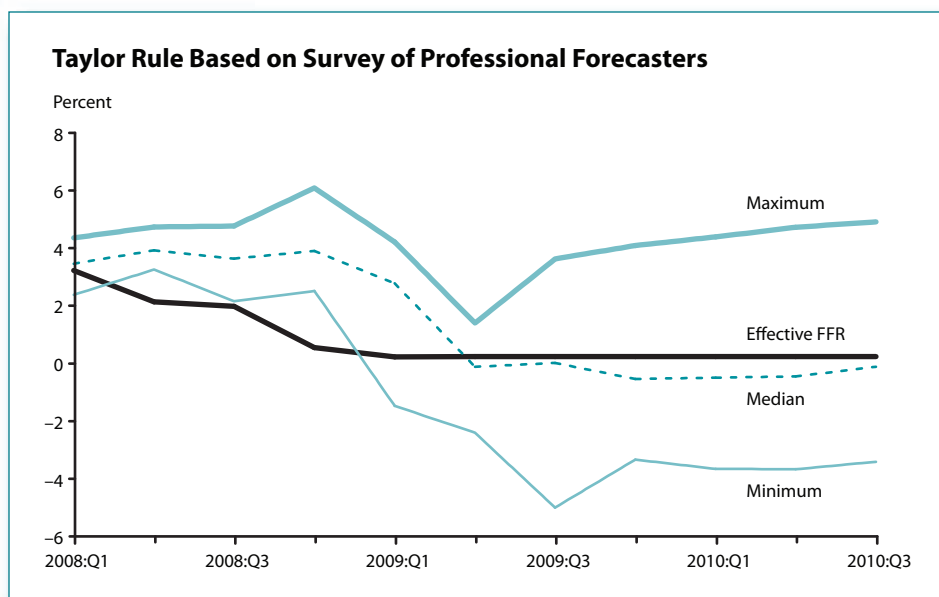
In accordance with recent comments from Federal Open Market Committee (FOMC) members,² I set the target inflation rate at 2 percent and the equilibrium FFR target at 2.5 percent. Quarterly forecasts of potential GDP are from the [Congressional Budget Office](#), and forecasts of both log-GDP and log-core personal consumption expenditure inflation are from the SPF. Substituting these values into the Taylor

rule provides a predicted path of the FFR for each forecaster starting in 2009:Q2 and ending in 2010:Q3.

It's hard to make a firm prediction as to when the Fed will raise interest rates.

The median, maximum, and minimum values of these predictions are plotted in the chart. The median path implies an FFR that stays near zero through 2010:Q3. Even so, there is considerable disagreement among the survey participants. Some forecasts imply that the FFR should be a bit above ½ percent already and rise to nearly 5 percent by mid-2010. And if a negative FFR were feasible, other forecasts imply that the FFR should be as low as -5 percent in mid-2009 before rising to nearly -3 percent by mid-2010.

It's easy to speculate about the reasons for such a wide range of FFR predictions. For some forecasts, a large and



persistent output gap requires low interest rates to stimulate growth. For others, the huge expansion of the Fed's balance sheet requires higher interest rates to moderate future inflation. Not surprisingly, the high degree of uncertainty about the overall economy implies a similar degree of uncertainty about when the FFR will again be a primary tool of monetary policy. ■

¹ The SPF is available at www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/data-files/.

² Bernanke, Ben S. Semiannual Monetary Policy Report to the Congress before the Committee on Banking, Housing and Urban Affairs, U.S. Senate. February 24, 2009; www.federalreserve.gov/newsevents/testimony/bernanke20090224a.htm.