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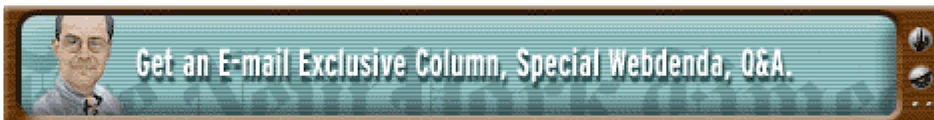




ECONOMIC VIEW

# When the Fed Shifts Rates, Is It Telling Its Secrets?

By DANIEL ALTMAN

Does the Federal Reserve Board know things about the economy that the rest of us don't? When the Fed's path for short-term interest rates switches direction, as some pundits thought it might last week, many investors see a signal as well as a change in the cost of credit. And when the Fed revises its view of the risks in the economy, investors may think they've learned something useful. But have they?

The two questions have different answers. The Fed may know things that investors don't, but its policy changes generally don't convey much of that information.

From a look at its staff, one might expect the Fed to have an advantage in taking the pulse of the economy. The Fed employs 210 professional economists at its headquarters in Washington, and an additional 275 at its 12 regional banks. On the boards of those 12 banks and 25 additional branches are 281 more people whose part-time job is to think about the shifting fortunes of businesses and consumers. Many more people outside the Fed also follow the economy, of course, but it's unclear whether they exchange information as easily through the market as the Fed can within its own organization.

Christina D. Romer and David H. Romer, a husband-and-wife team of economists at the University of California at Berkeley, tried to measure whether the Fed's internal forecasts for gross national product and inflation were more accurate than those of private-sector prognosticators. Their results, published two years ago, suggest that "commercial forecasters would find it nearly optimal to discard their forecasts and adopt the Federal Reserve's." That is, the private-sector forecasts offer almost no useful information once one has access to the Fed's internal forecasts.

This summer, a new study has surfaced that suggests the Fed's policy moves do not necessarily reflect its advantage in forecasting.

In that study, three of the Fed's own economists — Jon Faust, Eric T. Swanson and Jonathan H. Wright — made this observation: The Fed

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often sets interest rates before a report on some aspect of the economy becomes public, but after the period covered by that report has elapsed. The three researchers asked whether knowing the Fed's action in advance could add any predictive power to commercial forecasts of what the report would say.

For example, the Fed left interest rates unchanged last Tuesday. On Friday, the Labor Department released its report on consumer price inflation for July. Could commercial forecasts of July inflation have been improved by knowing that the Fed would stand pat?

After looking at data from 1989 to 2001, the researchers answered "no" for two kinds of consumer price inflation. The answer was also "no" for three other inflation measures, as well as for nonfarm payrolls, real gross domestic product and retail sales. The only forecasts that the Fed's interest-rate moves could have helped were for industrial production. And guess what? Industrial production is the only one of those nine indicators that is calculated by the Fed.

Mr. Faust pointed out that the Fed had many other ways to convey information — through its regular publications, for example, or speeches by its governors. Yet professionals still take notice when the Fed's actions surprise the markets. A significant share of investors expected the Fed to cut interest rates on Tuesday. Their disappointment probably made them more likely to sell stocks, and the markets declined.

So a few questions remain. First, were all those disappointed folks just worried about industrial production? Perhaps, but it's more likely they were thinking more about the long-term health of the economy than just the next set of numbers to come over the transom. The study by the three Fed economists looked only at short-term forecasting — not the long-term implications of the Fed's actions and its statements on the economic outlook. On Tuesday, the Fed decided the economy was more likely to weaken than to gain strength.

Next, is the Fed failing to incorporate all the useful information in its internal forecasts when it fiddles with short-term interest rates? Again, probably not. The Romers found that the Fed's superior information about inflation pertained less to the current quarter than to the next four quarters. So it's not too surprising that the Fed's monetary policy moves reveal little about soon-to-be released statistics on inflation in the recent past.

And where does the Fed's advantage come from? For one thing, the Fed has proprietary information about banks. In addition, the reserve banks' research teams keep tabs on all sorts of businesses, said David Skidmore, a Fed spokesman. Besides the tracking of statistics, he added, "there are other things that are more akin to a reporter working a beat." What a strange idea!

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