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Fed 'Doves' Beat 'Hawks' In Economic Prognosticating

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AS THE U.S. EMERGED from recession in the summer of 2009, Janet Yellen, then president of the Federal Reserve Bank of San Francisco, took a grim view of the economy's prospects.

"I expect the pace of the recovery will be frustratingly slow," she said in a San Francisco speech. A month later, addressing fears that money flooding into the economy from the Federal Reserve would stoke inflation, Ms. Yellen said not to worry in a speech to Idaho bankers: High unemployment and the weak economy would tamp wages and prices.

Others at the Fed spoke forcefully in the other direction. Unless the central bank reversed the easy money course, Philadelphia Fed President Charles Plosser warned in December 2009, "the inflation rate is likely to rise to levels that most would consider unacceptable."

Ms. Yellen was proved right.

Predicting the direction of the U.S. economy with precision is impossible. But the Fed must forecast growth, inflation and unemployment to guide its decisions on interest rates. Central bank miscalculations—when the Fed pushed interest rates too low or too high—have historically turned problems into catastrophes, fueling the Great Depression, for example, and the wealth-eroding inflation of the 1970s.

The Wall Street Journal examined more than 700 predictions made between 2009 and 2012 in speeches and congressional testimony by 14 Fed policy makers—and scored the predictions on growth, jobs and inflation.

The most accurate forecasts overall came from Ms. Yellen, now the Fed's vice chair. She was joined in the high scores by other Fed "doves," policy makers who wanted aggressively easy money policies to confront a weak U.S. economy and low inflation. Collectively, they supported Fed Chairmen Ben

Bernanke's strategy to pump money into the U.S. economy.

The least accurate forecasts came from central bank "hawks," those who feared Fed policies would trigger rising inflation.

Examining such predictions is more than a parlor game. Fed forecasts are important now because the central bank is near a turning point that will have a substantial impact on the U.S. economy.

Fed officials are considering whether to scale back an $85 billion-a-month bond-buying program this year, a move that could pull stock prices down and send interest rates higher.

If the Fed believes growth and hiring will pick up—and inflation will rise to a more normal 2%—the central bank will start to pull back on the purchases.

But if forecasts are wrong—if the Fed overestimates the economy's strength and pulls back too soon, for example—then economic growth could falter, stalling an incipient housing recovery and fueling the jobless rate.

"We should be keeping track of these forecasts and having some accountability," said Mark Gertler, a New York University economist who reviewed the Journal analysis.

Of course, forecasting ability doesn't always translate into wise central bank leadership. Arthur Burns, who led the Fed during the high inflation of the 1970s, was known for his forecasting prowess.

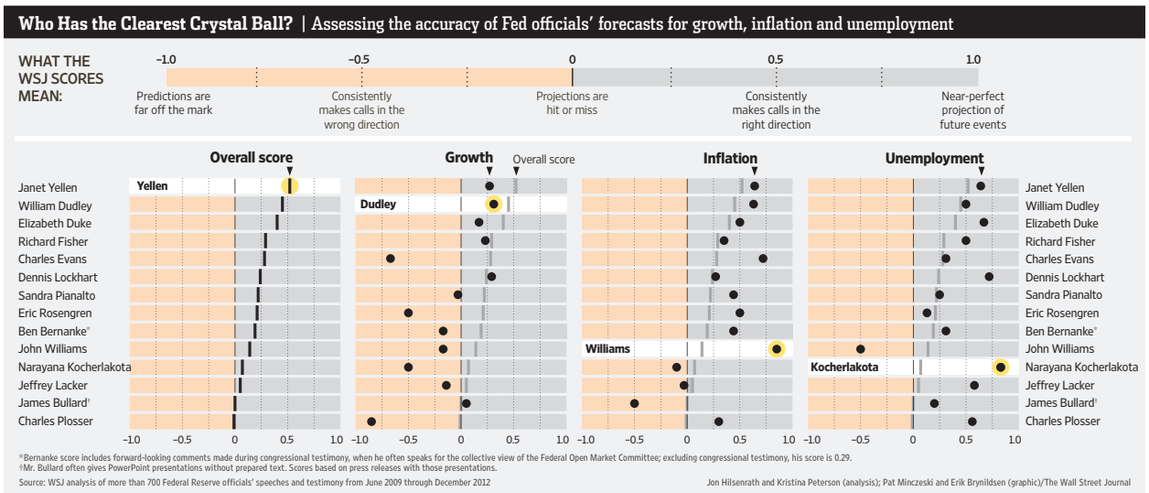
But New York Fed President William Dudley said forecasting errors have had serious consequences. "We were consistently too optimistic about growth over the 2009-2012 period," he said in a May speech. "As a result, with the benefit of hindsight, we did not provide enough stimulus."

Richard Fisher, the Dallas Fed president and another high scorer, took a different view. He has said slow growth was evidence the Fed's easy money medicine wasn't working and the economy needed less of it.

The Fed issues a quarterly forecast based on the views of its 12 regional Fed bank presidents and seven Fed governors. Over the past four years, these forecasts included errors, mostly from overestimating the economy's strength. None of the Fed forecast reports indicate who said what.

To evaluate the performance of individual Fed officials, the Journal looked at texts of speeches and congressional testimony. Forward-looking comments about the economy were rated for accuracy.

The Journal gave a mark ranging from -1.0—far off the mark—to 1.0—nearly perfectly correct—for each comment



and averaged the total. A final score of zero showed someone was wrong as often as correct.

The analysis was shared with the Fed policy makers. Five of the 19 policy makers weren't ranked because they hadn't been at the Fed long enough or hadn't spoken publicly enough about the economy.

Ms. Yellen and Mr. Dudley—both in Mr. Bernanke's inner circle—ranked first and second in the Journal analysis. Both predicted slow growth and low inflation over the past four years. Ms. Yellen had the highest overall score in the Journal's ranking, 0.52. Mr. Dudley scored 0.45.

The lowest scores were tallied by Mr. Plosser, -0.01; St. Louis Fed President James Bullard, 0.00; Richmond Fed President Jeffrey Lacker, 0.05, and Minneapolis Fed President Narayana Kocherlakota, 0.07.

Investors who closely follow every comment by Fed officials don't appear to distinguish policy makers by the accuracy of their economic forecasts.

Macroeconomic Advisers LLC, a research firm, determined Mr. Plosser, Mr. Bullard and Mr. Lacker consistently moved markets more than Ms. Yellen. Messrs. Plosser, Lacker and Bullard and Ms. Yellen declined to comment for this article.

Forecasts by Fed officials depend on their view of how the economy works. Ms. Yellen, for instance, places great weight on the role of economic slack—high unemployment or idle factories—in driving inflation. Lots of slack, she has argued, holds down inflation. On the other hand, prices are more likely to rise when there are few available workers and factories are operating near capacity in this view.

"With slack likely to persist for years, it seems likely that core inflation will move even lower," Ms. Yellen said in September 2009. Her views warrant scrutiny because she is a

candidate to succeed Mr. Bernanke when his term ends in January.

Mr. Dudley did especially well forecasting growth. Some Fed officials believed the current recovery would behave like past recoveries and the economy would, for a while, grow faster than its long-term trend of 3.2%.

But in May 2010, Mr. Dudley returned to his alma mater, New College of Florida, with a grim counter argument during a commencement address.

"The recovery is not likely to be as robust as we would like for several reasons," he said, pointing to the fragile banking system and the debt weighing down many households. He declined to comment for this article.

Other Fed officials, including Mr. Bernanke consistently predicted that faster growth was just around the corner.

"Although the pace of recovery has slowed in recent

How the Journal Scored Forecasts by Fed Policy Makers

To rank the accuracy of forecasts by Federal Reserve officials, The Wall Street Journal examined more than 700 passages in speeches and testimonies since the end of the recession in June 2009.

The statements included specific forecasts—"I expect the unemployment rate will fall to around 8% to 8.5% by the end of the year"—as well as general ones—"The recovery is likely to be painfully slow," for example.

Each statement was scored on a scale from -1, far from what actually happened, to +1, very accurate; 0.5, consistently in the right direction; -0.5, consistently in the wrong direction.

To calibrate scores, the Journal used a statistical tool known as standard deviation, which is a measure of the normal variability in a collection of data. If a forecast was within one standard deviation of what is considered normal variation, it was counted as correct and awarded one point. If it was more than one standard deviation away, it was considered incorrect and lost a point.

Officials were awarded half credit for forecasts that were in the right direction but lacked precision. The benchmarks used were gross domestic product for growth, the unemployment rate and the change in the Commerce Department's personal consumption expenditure price index for inflation.

For example, in January 2011, Boston Fed President Eric Rosengren said, "My own forecast is for growth of 3.5% to 4.0% over 2011." He received a mark of -1 because growth was 2% that year and the annual standard deviation of growth over the past two decades was 0.68 percentage point, making him more than one standard deviation off.

In October 2011, Cleveland Fed President Sandra Pianalto said, "I don't expect the pace of growth to pick up very soon; my outlook for real GDP growth in 2012 is about 2%." She got a full point for that forecast because growth was 1.7%, within one standard deviation of her projection.

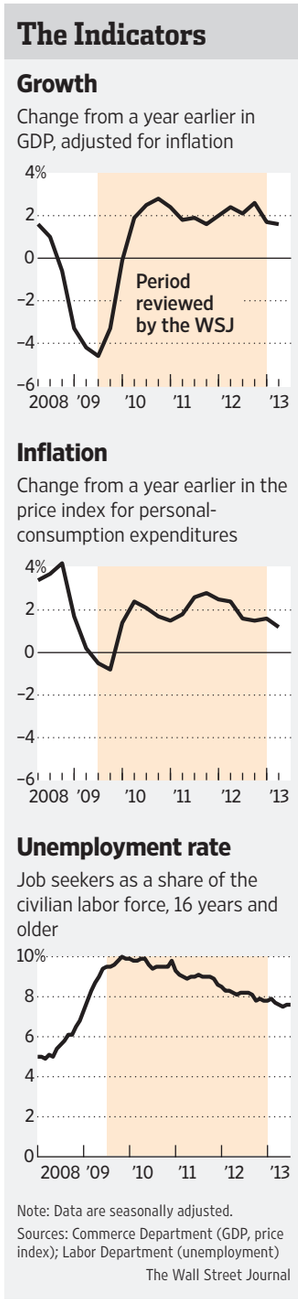
The Journal calculated the average—using total points and the number of predictions—to produce scores. Comments that contained a mix of correct and incorrect predictions received a score of zero. Forecasts repeated between meetings of the Federal Open Market Committee meetings were counted only once.

Moody's Economy.com, a private forecasting firm, checked the Journal's scoring. The final results by the Journal reflect so`me suggestions by Moody's.

—Jon Hilsenrath and Kristina Peterson

months and is likely to continue to be fairly modest in the near term, the preconditions for a pickup in growth next year remain in place," Mr. Bernanke said in October 2010, just before launching a bond-buying program. Growth slowed the following year.

Mr. Bernanke finished in the middle of the pack in the Journal's analysis, in part because he often relayed the consensus of Fed officials. He declined to comment for this article.



Luck also played a role in forecasts. In 2011, for instance, the economy looked like it was moving to faster growth when a tsunami struck Japan, disrupting the global economy.

The Fed's hawks had some of the worst forecasters. Mr. Plosser overestimated growth, while Mr. Bullard, Mr. Lacker and Mr. Kocherlakota warned of looming inflation. Their forecasts were wrong almost as often as they were correct.

While Ms. Yellen focused on the impact of slack on inflation, some hawks focused on money. The late Milton Friedman, the Nobel Prize-winning University of Chicago economist, said inflation was always and everywhere a byproduct of monetary policy: Prices only shoot higher when a central bank pumps too much money into the economy.

Hawks worried the Fed's decision to pump trillions of dollars into the U.S. financial system after the crisis would result in fast-rising prices. They sometimes couched their worries as risks, rather than predictions. In 2009, for instance, Mr. Bullard warned that the Fed's bond-buying programs had created a "medium-term inflation risk."

"The hawks have been issuing warnings, but there has been no sign of the things they've been warning against," said Martin Eichenbaum, an economist at Northwestern University and a Fed dove.

Mr. Kocherlakota of the Minneapolis Fed changed his

hawkish views in 2012. "Inflation is not coming in as hot as I expected," he said in an interview last year. "You have to learn from the data." He declined to comment for this article.

Mr. Bullard changed his focus at times. In 2010, and again more recently, he signaled concern about inflation getting too low. A St. Louis Fed spokeswoman said the Journal analysis failed to account for the role Mr. Bullard's warnings played in formulating policies that helped to prevent inflation from getting too high or too low.

Some of the Fed's best forecasts came from noneconomists, including Fed governor Elizabeth Duke and Atlanta Fed President Dennis Lockhart—former bankers—and Mr. Fisher, a former investment manager. Some of the Fed's most brilliant Ph.D.s, including Mr. Kocherlakota, generated the most subpar scores.

Economists generally rely on economic models based on past behavior. These models are used heavily by the staff at the Federal Reserve Board in Washington and at regional Fed banks. But the recession and the current recovery were unlike most past cycles.

"The models have been wrong," Mr. Bullard, one of the Fed's many Ph.D. economists, said in an interview with the Journal in November.

James Hamilton, an economist at the University of California at San Diego who also reviewed the Journal's analysis, warned against betting that the doves' recent winning streak would continue.

"This was a period of subpar GDP growth and low inflation," he said. "Whether these same individuals would also prove to be better forecasters during a period of strong GDP growth and rising inflation is difficult to determine on the basis of the last four years."

One reason the hawks have been wrong about inflation is that the money the Fed has pumped into the financial system has tended to sit at banks without being lent to customers.

Economists say it is possible inflation can still catch fire if banks lend more aggressively and money starts circulating more widely.

If that happens, Mr. Eichenbaum said, the hawks would be proven right and "everybody else is going to look real bad."

—Michael R. Crittenden contributed to this article.