FRBNY BLACKBOOK UPDATE

RESEARCH AND STATISTICS GROUP

FOMC Background Material

October 2012

CONFIDENTIAL (FR) Class II FOMC

FRBNY BLACKBOOK UPDATE

October 2012

Contents

Exhibits

1. Policy Recommendation and Rationale

The more aggressive policy stance adopted by the FOMC at its September meeting includes several key elements of our long-standing recommendation for a more accommodative, integrated, and state-contingent policy strategy. However, we believe that the communication of this new strategy can be improved, especially with regard to the presentation of the asset purchases and the forward guidance on the path of the federal funds rate—including *after* lift-off—as a more integrated package.

We view three elements of the September statement as crucial contributors to the perception among market participants of a shift towards a "whatever it takes" approach to policy, which has led to an easing of financial conditions:

1. A greater focus on outcomes as determinants of the stance of policy ("The Committee is concerned that, without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions");
2. An open-ended flow approach to asset purchases, again conditioned on outcomes ("If the outlook for the labor market does not improve substantially, the Committee will continue its purchases…");
3. More explicit forward guidance indicating the policy rate will remain low for a longer time period than that prescribed by standard policy rules ("a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens").

These elements should be retained and strengthened.

We see two main dimensions in which the communication of the current policy stance could be improved. First, the Committee should further emphasize the integrated nature of the package of tools being deployed to achieve more accommodation, and their joint dependence on economic conditions. Second, the FOMC could specify this dependence quantitatively, rather than qualitatively.

With regard to the first dimension, the "substantial improvement" criterion for the labor market in the September statement applies primarily to asset purchases, whereas the clause discussing the appropriateness of a highly accommodative stance of policy after the economic recovery strengthens pertains primarily to the interest rate instrument. We think it would be desirable to integrate these two expressions of the state contingent nature of the policy stance more fully, so as to strengthen the message that the size and duration of the current asset purchase program, the evolution of the balance sheet after the program comes to an end, the lift-off date for the FFR, and its subsequent trajectory are all part of a coordinated set of tools being deployed and adjusted over time to achieve the mandated goals of the Federal Reserve. This integration is particularly desirable because the definition of a substantial improvement in the labor market has often been linked to the debate about the adoption of unemployment thresholds advocated by Presidents Evans and Kocherlakota, even though in their proposals these thresholds apply to the lift-off date for the FFR rather than to the cessation of asset purchases.

As for the second dimension, the Committee may specify quantitatively, rather than qualitatively, the conditions that might grant an adjustment of the current stance of policy. Although we believe that a more explicit description of the policy reaction function is generally desirable, we are reluctant to endorse the definition of quantitative thresholds that would narrowly apply to the lift-off date for the federal funds rate. The main reason for our reluctance is that this approach to thresholds would probably focus the policy discussion almost exclusively on the date of the rate lift-off, to the detriment of the other dimensions of the policy strategy. If that happens, this adjustment to the language would blunt, rather than strengthen, the integrated nature of the “do whatever it takes” tone that we think is the best feature of the current FOMC statement.

Of course, the more explicitly state-contingent nature of the thresholds for lift-off would have the advantage of making the date of the first hike endogenous, therefore reducing the communication burden on the Committee. However, adopting numerical thresholds would almost certainly require choosing a value for the unemployment rate, which we see as an inadequate indicator of the health of the labor market. As discussed on several occasions, we prefer a more nuanced characterization of labor market conditions that focuses on job flows rather than on unemployment, but this approach would probably be impractical to convey within the confines of the FOMC statement. As for inflation, the ability to garner sufficient consensus within the committee for a quantitative threshold level may result in setting a level that would lead to an early exit from the current policy stance, blunting some of the accommodative force of the current statement. More generally, forcing the Committee to agree on hard numbers on specific indicators could highlight differences in views on the economy and appropriate policy that might instead be more easily reconciled within a softer, more qualitative, and hence more nuanced notion of progress towards the objectives.

Although our recommendation is to avoid a more quantitative expression of the thresholds for lift-off at this stage, we recognize the strong momentum behind this proposal. If thresholds were to be adopted, we would advise placing greater emphasis on the inflation threshold rather than on the unemployment threshold, by selecting values so there is a higher ex-ante probability that the former, rather than the latter, will be crossed first. The rationale for this preference is threefold. First, there is greater agreement within the Committee about the inflation rate consistent with the price stability objective than there is about the unemployment rate consistent with the maximum employment goal. Differences in NAIRU estimates across participants are an additional source of potential disagreement on the specification of an unemployment threshold. Second, specifying a tolerance for deviations of inflation from the long-run objective seems significantly easier than defining an unemployment threshold. Although the extent of inflation tolerance requires specifying several parameters—assuming that the Committee continues to refer to inflation as measured by the change in the PCE deflator, it would still need to specify the threshold and a forecast horizon over which to measure it—this problem is significantly less complex than that of quantifying the attainment of substantial improvement in the labor market, since the latter would ideally include several indicators, most of which are not very familiar to the public. In this respect, one option might be to define a threshold for the unemployment rate as "first among equals" within a broader set of indicators to be monitored by the Committee. Last, more emphasis on the tolerance for an inflation rate temporarily above the long-run objective would presumably strengthen one of the channels through which we expect forward guidance to affect aggregate demand at the zero lower bound, namely through the effect of higher medium-term inflation expectations on real interest rates.

2. Outlook and Risks Update

2.1 Central Forecast

Intermeeting developments.

On balance, data released over the intermeeting period have led to no meaningful change in our forecast for growth of real GDP over the second half of 2012. At this writing, we expect growth of real GDP of 1 ¾% (annual rate) over the second half, essentially the same as over the first half of the year.

Data on consumer spending and housing have been somewhat better than expected. Sales of light-weight motor vehicles rose to 15 million (seasonally adjusted annual rate) in September, the highest since March of 2008. Retail sales excluding autos and gasoline rose at a healthy pace in the third quarter after declining in the second quarter. We expect growth of real PCE of around 2 ¼% (annual rate) in 2012Q3, a bit stronger than over the first half of the year despite the rebound of energy prices and the slowing of the rate of growth of nominal disposable income. Total housing starts rose sharply in September, increasing 15.0% to the highest since July of 2008. This report suggests that the recovery of housing construction, which up until now has been quite gradual, may be moving into a higher gear. Our own analysis suggests that most if not all of the excess production of the boom years has been worked off through roughly five years of levels of starts well below underlying demographic demand. Indeed, the CoreLogic national home price index rose for the ninth consecutive month in August and was up 4.5% from August 2011.

However, the somewhat stronger pace of consumer spending and residential investment has been offset by weaker business fixed investment. Available data suggest that both business investment in equipment and software and in nonresidential structures declined in the third quarter. Our forecast assumes some modest rebound in these categories in the fourth quarter, but that is based largely on hope rather than any hard information. Moreover, growth of exports appears to have slowed markedly during the third quarter, with the net export growth contribution falling to essentially zero. Again, in the modal forecast this slowing of exports is expected to be temporary.

Manufacturing output rose 0.2% in September, and the ISM manufacturing index rose to 51.5 from 49.6 in August. This may signal the beginning of an upturn following four to five months of generally sluggish activity in the manufacturing sector. Inventory-sales ratios in the retail and wholesale sectors rose over the past several months, particularly for motor vehicles. With the firmer tone of auto and other retail sales of late, this inventory cycle may be coming to a close.

As has been widely followed in the press, the unemployment rate fell sharply in September, to 7.8% from 8.1% in August. There was a quite large (873,000) increase in household employment in September, more than double the estimated increase in the labor force. However, for the third quarter as a whole the average monthly gain in household employment was 186,000. By comparison, the establishment report depicted a more modest improvement in labor market conditions in September. Payroll employment rose by 114,000 (146,000 average for the entire third quarter). Hours worked rose sharply in September, but were up at just a 0.8% annual rate for the third quarter as a whole. The one-month diffusion index of employment gains rose slightly to 52.8, but remained well below the recent peak of 70.3 reached in January of this year. Initial claims for unemployment insurance, which fell notably in the second half of September, rebounded to 388,000 over the second week of October.

Recent price data have been pretty much as we expected. The total CPI rose 0.6% in September for the second consecutive month, led by a 4.5% increase in energy prices on the heels of a 5.6% increase in August. The 12-month change in the total CPI was up to 2.0% from a recent low of 1.4% in July. Weekly data suggest that any increase in gasoline prices in October will be relatively modest. Prices for food at home fell slightly in September, led by declines in meat prices. Experts in agricultural prices report that this is the first phase of the impact of the drought, when meat producers increase sales in anticipation of higher future prices for feed. The core CPI rose 0.15% in September following gains of just 0.1% in the preceding two months. The 12-month change rose slightly to 2.0% from 1.9% in August, but both three-month and six-month changes are slowing sharply, suggesting that a slowing in the 12-month change is in the pipeline.

Conditioning assumptions.

Our estimate of potential GDP growth is around 2 ¼%, reflecting trend productivity growth of 1 ¼% and trend growth of hours worked of 1%. The Board staff estimates of potential for 2012, 2013, and 2014 are 1.8%, 2.0%, and 2.1%, respectively, all unchanged from the previous Tealbook. However, the Board staff has significantly lowered their estimate of the output gap over the forecast horizon due to reductions of their estimate of potential GDP for 2011 and earlier.

We expect the lower degree of inflation persistence evident since the early 1990s to continue. This assumption is in contrast to the greater degree of inflation persistence assumed in recent Board staff forecasts. In our central scenario, inflation expectations remain well anchored. This assumption is central to our projection that core PCE inflation will gradually move up over the forecast horizon to the FOMC's objective of 2.0%. In contrast, the Tealbook forecast expects core PCE inflation to remain closer to 1.5% over the forecast horizon.

There have been only modest changes in both the Tealbook and Blackbook projections of global real GDP growth in 2012—to 1.7% (Q4/Q4) from 1.8% (Q4/Q4) in the case of the Tealbook and to 1.9% from 2.1% in the case of the Blackbook. Projected growth rates for the euro area and much of Asia have been lowered. For 2013, our forecast for global growth is unchanged at 2.8% as is the Board's at 2.4%. In both cases there is broad based firming of growth except in the case of Japan. In 2014 we anticipate global growth to remain near the 2013 pace, while the Board staff anticipates a strengthening to 3.0%.

The exchange value of the dollar is projected to decline more in 2012 than previously expected. The Board expects the nominal exchange value of the dollar to fall 0.7% (Q4/Q4) versus a rise of 1.2% in the last Tealbook. Similarly, we expect the dollar to fall 0.8% versus a rise of 0.2%. For 2013 and 2014, we anticipate a depreciation of 1.5% and 1.8%, respectively, versus 2.5% in both years in the last Blackbook. The Tealbook assumption is a depreciation of 1.4% in 2013 and 1.9% in 2014, in both cases quite close to the September projections. On balance, the level of the exchange value of the dollar is lower over the entire forecast horizon.

Reflecting intermeeting developments, our assumed path of WTI oil prices, based on recent futures quotes, has moved down. We now expect a price of $91 for 2012Q4, down from $96.50, and a price of $92.50 for 2013Q4, down from $96. The WTI price per barrel is then expected to ease to $90.50 by 2014Q4. The Board's projected path is quite similar to ours.

As is our standard practice, we adopt the same federal fiscal assumptions as in the Tealbook, which are unchanged from September. For 2013, those assumptions include the expiration of the payroll tax cut and Emergency Unemployment Compensation (EUC) as well as the spending restraint resulting from the discretionary spending caps enacted last August. In contrast, the 2001-2003 tax cuts that are set to expire at the end of 2012 are assumed to be extended. In addition, the further cuts in spending mandated by the automatic sequestration provisions of the Budget Control Act are assumed to be replaced with a much more gradual spending reduction program. These changes in policy exert a fiscal drag of 1.2 percentage points on GDP in 2013, declining to 0.5 percentage points in 2014.

We also adopt the Tealbook assumptions regarding equity and home prices. Equity prices are expected to rise at a 10% annual rate in 2013 and 2014, a bit faster than assumed in September, reflecting a modest easing of investor concerns about economic conditions in the euro area and about the US fiscal situation. In addition, the starting point for this growth is higher due to the roughly 3% increase in equity prices over the intermeeting period. As a result, the path of equity prices over the forecast horizon is higher. As of August, the CoreLogic national home price index has increased for nine consecutive months and is now up 4.5% from year ago levels. For all of 2012, this index is now expected to increase 6 ½%, a bit more than previously thought. However, the rate of increase of this index is still expected to slow to around 2 ¼% (annual rate) in 2013 and 2014 due to an increased supply of distressed properties coming onto the market. On balance, however, the path of home prices over the forecast horizon is somewhat higher than in September.

The Outlook.

Our forecast for some firming of both growth and inflation in 2013 and 2014 is essentially unchanged. Our expectation is that factors such as deleveraging and restricted access to credit will gradually subside as forces restraining growth. The improvement in home prices that we have seen this year, and which we expect to continue, will certainly help on this front. In addition, uncertainty about the US fiscal path is likely to diminish somewhat after the election when the government begins to set forth its agenda. World growth is expected to pick up in 2013 as the euro area emerges from recession and growth in the developing world responds to fresh policy stimulus. Finally, the monetary policy actions undertaken in September will begin to have a more substantial impact on the US economy. However, growth in 2013 is likely to be held back to just around 2 ½%, with only a relatively modest decline of the unemployment rate, due to our fiscal policy assumptions outline above. In fact, the negative effect on growth could be larger than that generally expected as research suggests the impacts of fiscal policy changes are magnified when monetary policy is constrained by the zero lower bound. Thus, risks to projected growth next year are skewed to the downside. But as we enter 2014, fiscal drag is expected to be greatly diminished, allowing the full force of monetary accommodation and the natural healing of the economy to be realized. In 2014, we expect growth of around 3 ¾%, with the unemployment rate declining more substantially even though the participation rate begins to move gradually higher.

The increase of the total PCE deflator in 2012 has been nudged up to 1.9% from 1.8% in September due to somewhat stronger increases in energy prices than previously expected. The projected increase of the core PCE deflator is unchanged at 1.7%. In 2013 and 2014, as the economy begins to establish greater forward momentum, we expect both total and core inflation to move gradually higher, with total PCE deflator inflation moving to around 2% in 2013 and 2 ¼% in 2014. The gradual decline of slack in the economy along with the expected decline of the exchange value of the dollar and resulting more rapid increase of nonpetroleum import prices contribute to this increase.

2.2 Alternative Scenarios and Risks

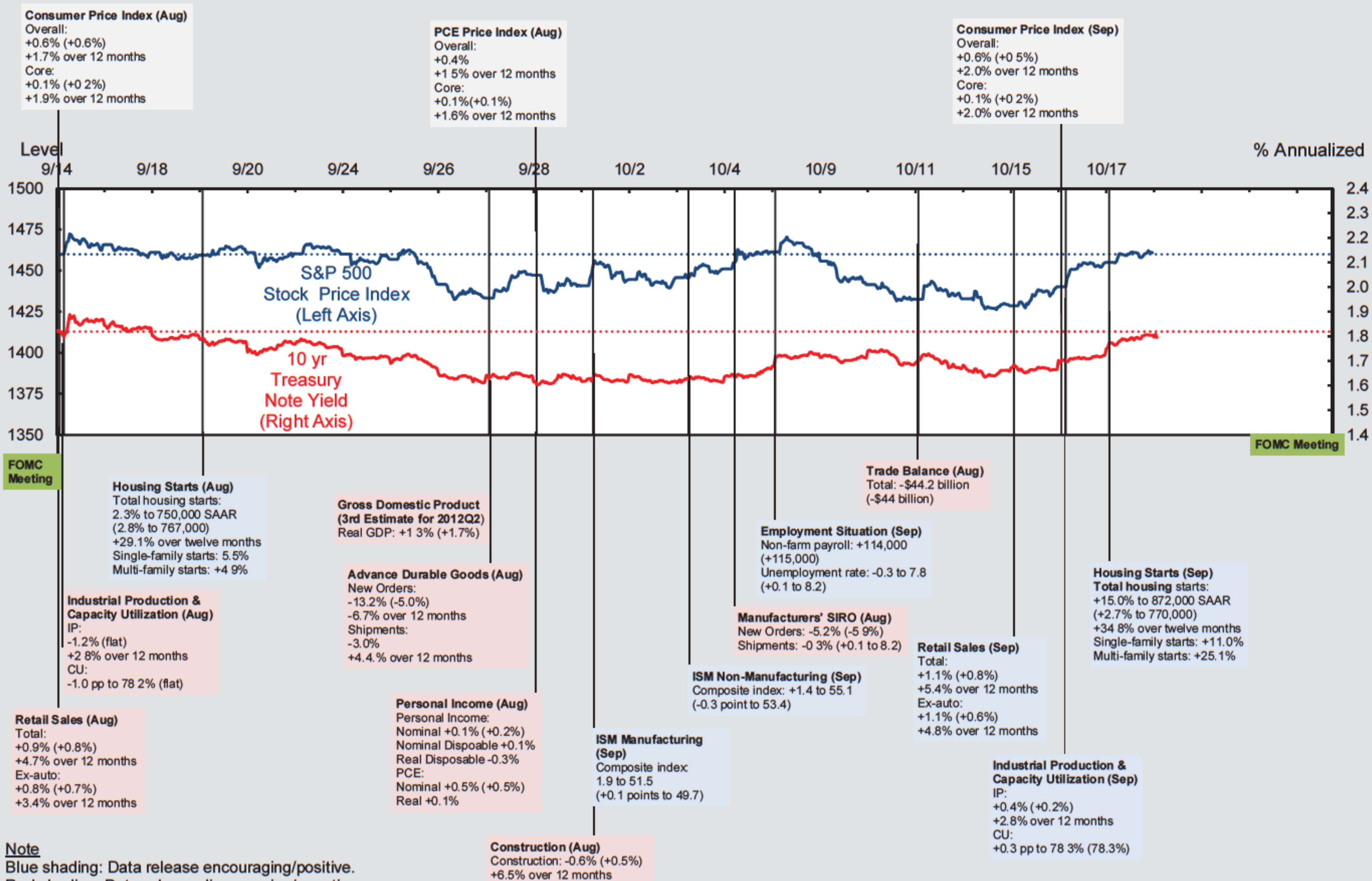
The assessment of risks to our outlook has not changed substantially over the intermeeting period, except that the downside risks to inflation have decreased marginally in the short run. Risks to both inflation and output are roughly balanced, although the downside risks to output are slightly more predominant, especially over the medium term. Importantly, the assessment of risks to our outlook is dependent upon the assumed path of policy in our recommendation. In particular, the assumed policy stance would remove some of the downside risks to the outlook.

As it was the case in September, the *Fiscal Consolidation* scenario is the most likely alternative scenario, although its likelihood has decreased and now stands slightly above 30 percent [Exhibit C-1]. Following the relatively upbeat news contained in the September labor market report and the positive reaction to the FOMC statement, we have increased the likelihood of the *Faster Growth* scenario, which is the second most likely alternative scenario and has a probability slightly below that of the *Fiscal Consolidation* scenario. Changes in the other scenarios are relatively small. The forecasts under the *Central* scenario have changed only modestly from those in the last Blackbook. Because the paths under the alternative scenarios are defined relative to the *Central* scenario outlook, they also have changed relatively little from the last Blackbook [Exhibit C-2].

As a result of the changes in the scenario probabilities, downside inflation risks are lower in the short run relative to the last Blackbook [Exhibit C-3]. Both upside and downside risks to output are also lower in the short run, but this results mainly from the fact that we have more information about the current state of the economy relative to September.

Exhibit C-3 also displays the baseline forecasts from the FRBNY-DSGE model (orange line). The DSGE forecasts are near the expected values over near-term horizons, but are noticeably below the expected values in 2014-15, particularly for real GDP growth.

Key Data Releases



Note
Blue shading: Data release encouraging/positive.
Red shading: Data release discouraging/negative.
Beige shading: Data release was neutral.
Gray shading: No attempt to sign the impact.
Numbers in parentheses are the median of the Bloomberg survey.

Source: Bloomberg
On-the-run securities, 8:00AM - 4:00PM.
S&P 500 Stock Price Index: 9:30AM - 4:00PM.

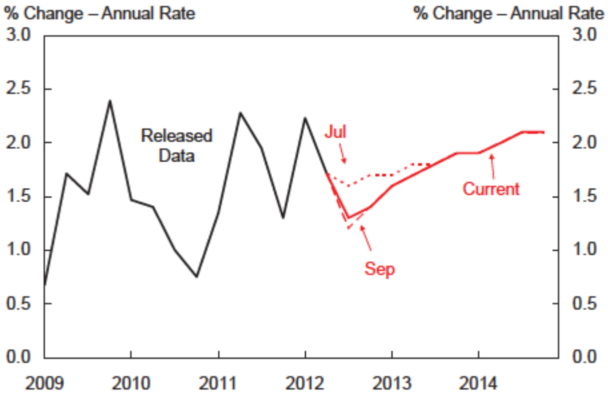
B. FRBNY Forecast Details

Exhibit B-2: Evolution of Projected Quarterly Paths

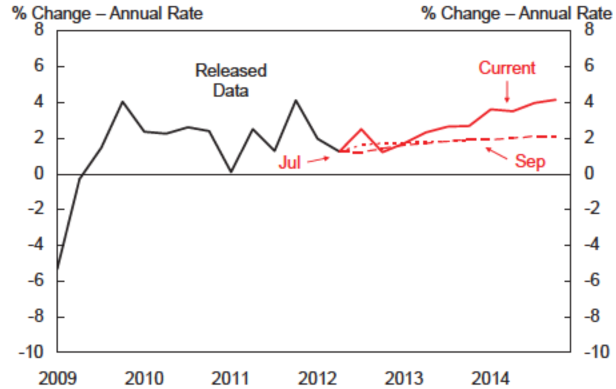
Key Indicators

Forecast Assumptions

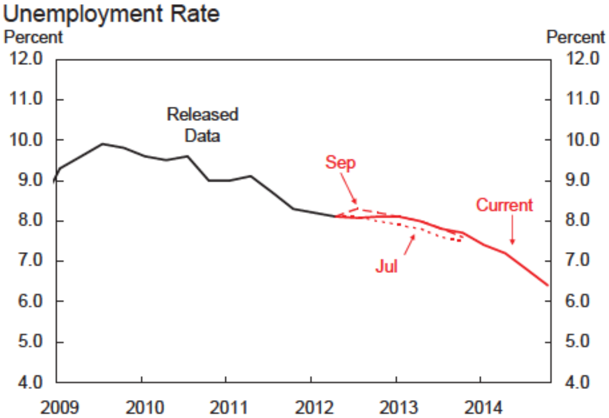
Core PCE Inflation



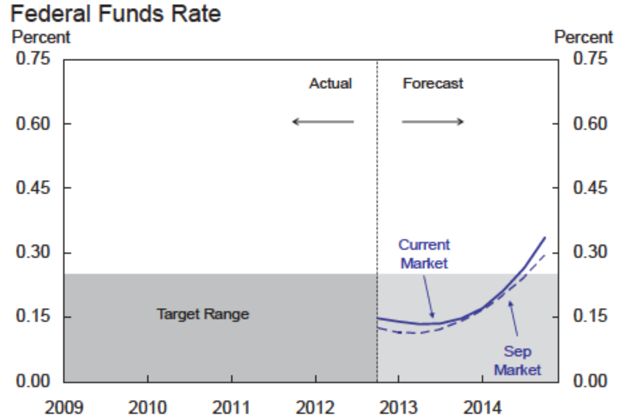
Real GDP Growth



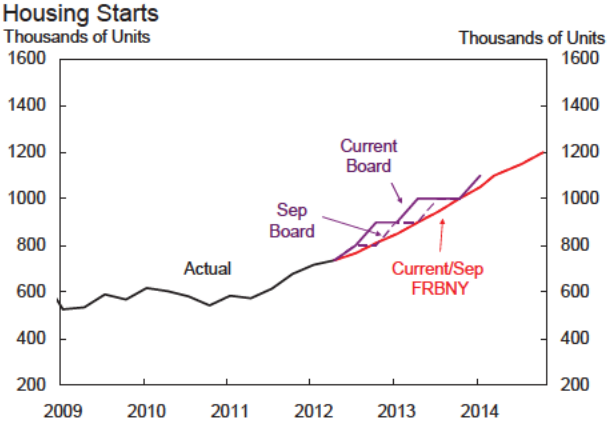
Unemployment Rate



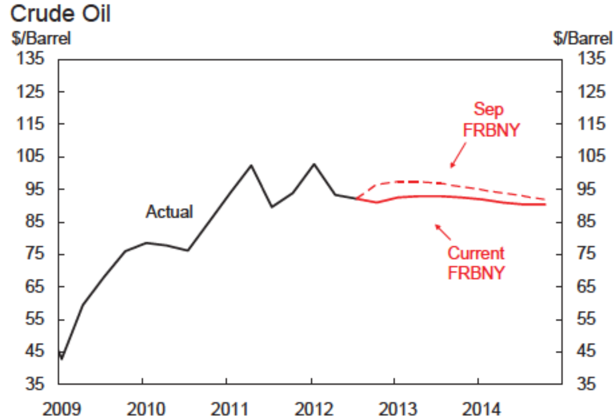
Federal Funds Rate



Housing Starts



Crude Oil



Source: MMS and IR Functions (FRBNY) and Federal Reserve Board

B. FRBNY Forecast Details

Exhibit B-3: Near-Term Projections

	Quarterly Growth Rates (AR)		Quarterly Growth Contributions (AR)	
	2012Q4	2013Q1	2012Q4	2013Q1
OUTPUT				
Real GDP	1.2	1.7	1.2	1.7
	(2.0)	(2.1)	(2.0)	(2.0)
Final Sales to Domestic Purchasers	1.6	1.3	1.6	1.3
	(1.7)	(1.4)	(1.7)	(1.7)
Consumption	1.8	1.2	1.3	0.8
	(1.9)	(1.3)	(1.4)	(1.4)
BFI: Equipment and Software	3.0	5.0	0.2	0.4
	(5.0)	(6.0)	(0.4)	(0.4)
BFI: Nonresidential Structures	2.0	4.0	0.1	0.1
	(4.0)	(5.0)	(0.1)	(0.1)
Residential Investment	18.0	16.0	0.4	0.4
	(16.0)	(16.0)	(0.4)	(0.4)
Government: Federal	-3.2	-4.0	-0.2	-0.3
	(-3.2)	(-4.0)	(-0.2)	(-0.2)
Government: State and Local	-1.0	-0.8	-0.1	-0.1
	(-2.0)	(-1.5)	(-0.2)	(-0.2)
Inventory Investment	--	--	-0.8	-0.1
	--	--	(-0.1)	(-0.1)
Net Exports	--	--	0.5	0.5
	--	--	(0.4)	(0.4)
INFLATION				
Total PCE Deflator	2.8	2.0		
	(2.4)	(2.0)		
Core PCE Deflator	1.4	1.6		
	(1.4)	(1.6)		
PRODUCTIVITY AND LABOR COSTS*				
Output per Hour	2.0	1.5		
	(1.5)	(1.5)		
Compensation per Hour	1.6	1.8		
	(1.6)	(1.8)		
Unit Labor Costs	-0.4	0.3		
	(0.1)	(0.1)		

Note: Numbers in parentheses are from the previous FOMC meeting.
*Nonfarm business sector.

B. FRBNY Forecast Details

Exhibit B-4: Medium-Term Projections

	Q4/Q4 Growth Rates			Q4/Q4 Growth Contributions		
	2012	2013	2014	2012	2013	2014
OUTPUT						
Real GDP	1.7	2.3	3.8	1.7	2.3	3.8
	(1.9)	(2.5)	(3.9)	(1.9)	(2.5)	(2.5)
Final Sales to Domestic Purchasers	1.7	1.9	4.0	1.8	2.0	4.1
	(1.8)	(2.0)	(4.0)	(1.9)	(2.1)	(2.1)
Consumption	2.0	1.6	2.8	1.4	1.1	2.0
	(2.1)	(1.7)	(2.8)	(1.5)	(1.2)	(1.2)
BFI: Equipment and Software	2.8	8.7	15.5	0.2	0.6	1.2
	(5.0)	(9.0)	(15.5)	(0.4)	(0.7)	(0.7)
BFI: Nonresidential Structures	2.4	5.7	13.0	0.1	0.2	0.4
	(4.8)	(6.0)	(13.0)	(0.1)	(0.2)	(0.2)
Residential Investment	16.6	16.0	16.0	0.4	0.4	0.5
	(14.3)	(16.5)	(16.0)	(0.3)	(0.4)	(0.4)
Government: Federal	-1.2	-4.0	-2.5	-0.1	-0.3	-0.2
	(-2.5)	(-4.0)	(-2.5)	(-0.2)	(-0.3)	(-0.3)
Government: State and Local	-1.3	-0.2	2.2	-0.2	0.0	0.3
	(-1.9)	(-0.5)	(2.2)	(-0.2)	(-0.1)	(-0.1)
Inventory Investment	--	--	--	-0.3	0.1	0.3
	--	--	--	(-0.3)	(0.1)	(0.1)
Net Exports	--	--	--	0.2	0.2	-0.6
	--	--	--	(0.3)	(0.3)	(0.3)
INCOME						
Personal Income	4.0	3.2	5.9			
	(4.6)	(3.5)	(5.9)			
Real Disposable Personal Income	1.8	0.7	3.4			
	(2.5)	(0.9)	(3.4)			
Personal Saving Rate	3.3	2.4	3.0			
	(3.8)	(3.0)	(3.7)			
Corporate Profits Before Taxes	2.7	2.5	3.8			
	(0.1)	(2.5)	(3.8)			

Note: Numbers in parentheses are from the previous FOMC meeting.

B. FRBNY Forecast Details

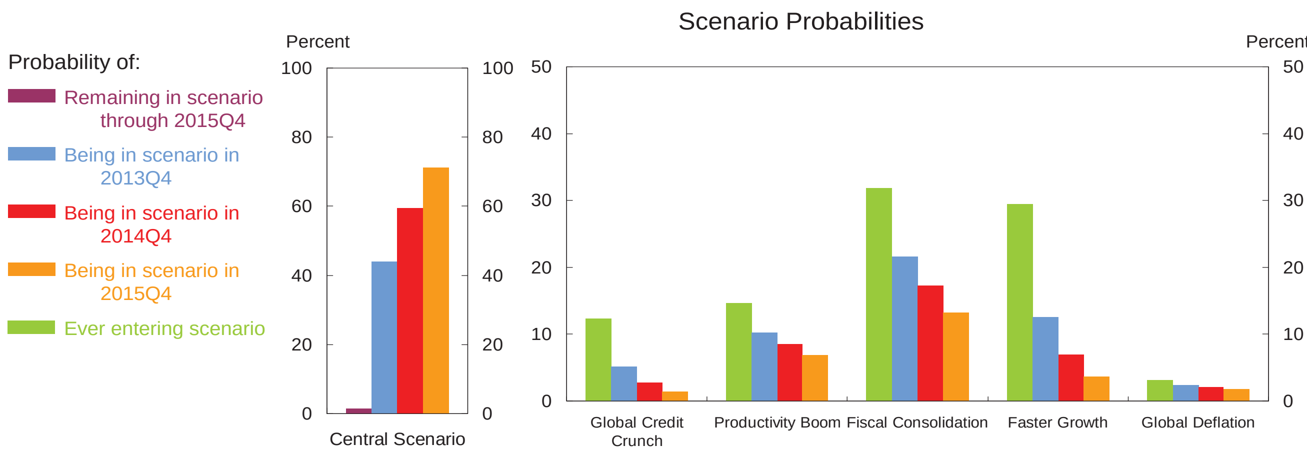
Exhibit B-5: Medium-Term Projections, Continued

	Q4/Q4 Growth Rates		
	2012	2013	2014
INFLATION			
Total PCE Deflator	1.9	2.1	2.2
	(1.8)	(2.1)	(2.2)
Core PCE Deflator	1.7	1.8	2.0
	(1.6)	(1.8)	(2.0)
Total CPI Inflation	2.4	2.4	--
	(2.2)	(2.4)	--
Core CPI Inflation	2.0	2.0	--
	(2.1)	(2.0)	--
GDP Deflator	2.0	2.0	2.3
	(2.0)	(2.0)	(2.2)
PRODUCTIVITY AND LABOR COSTS*			
Output	2.7	3.0	4.9
	(2.6)	(3.1)	(5.2)
Hours	1.2	1.5	2.9
	(1.4)	(1.6)	(3.2)
Output per Hour	1.5	1.5	2.0
	(1.2)	(1.5)	(2.0)
Compensation per Hour	3.1	2.1	2.7
	(3.1)	(2.1)	(2.7)
Unit Labor Costs	1.6	0.6	0.7
	(1.9)	(0.6)	(0.7)
LABOR MARKET			
Unemployment Rate (Avg. Q4 Level)	8.1	7.7	6.4
	(8.2)	(7.5)	(6.5)
Participation Rate (Avg. Q4 Level)	63.5	63.5	63.6
	(63.7)	(63.7)	(64.0)
Avg. Monthly Nonfarm Payroll Growth (Thous.)	116	155	302
	(141)	(184)	(293.0)

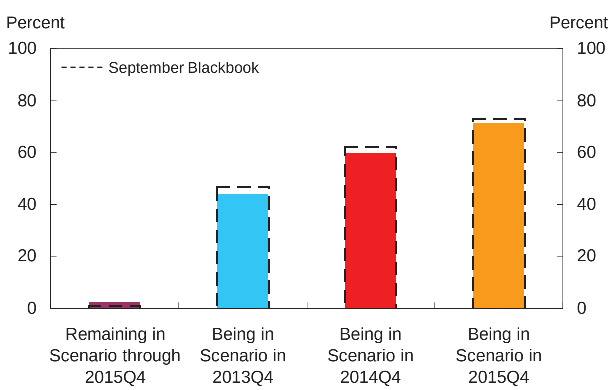
Note: Numbers in parentheses are from the previous FOMC meeting.
*Nonfarm business sector.

C. FRBNY Forecast Distributions

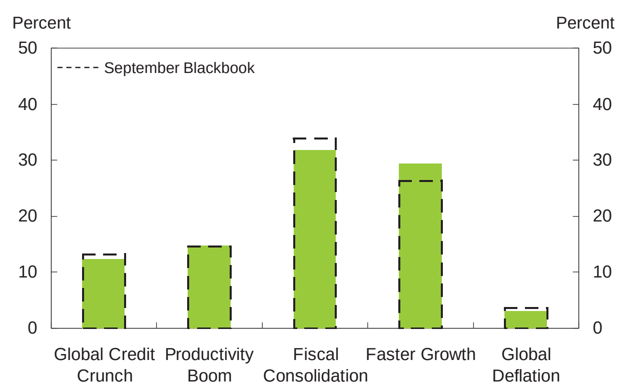
Exhibit C-1: Risks



Change in Central Scenario Probabilities



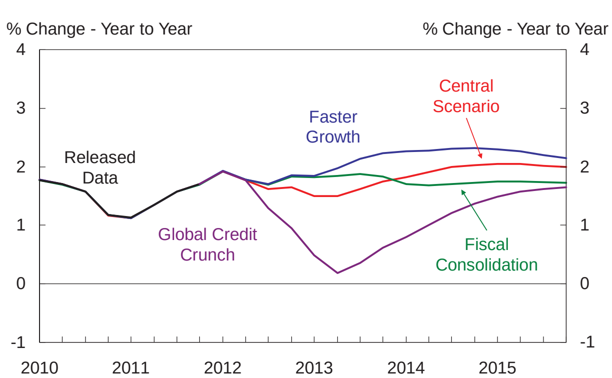
Change in Alternative Scenario Probabilities*



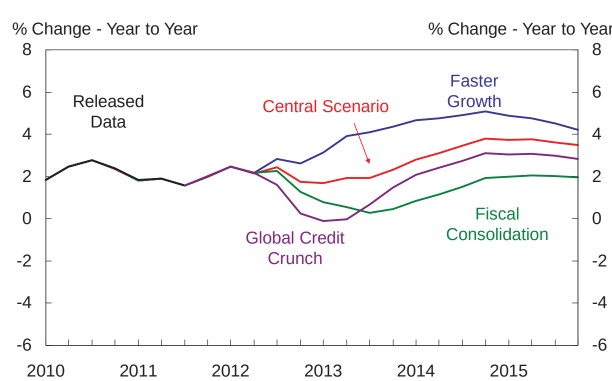
*Probability of ever reaching scenario

Exhibit C-2: Projections under Alternative Scenarios

Core PCE Inflation under Alternative Scenarios Selected



Real GDP Growth under Alternative Scenarios Selected

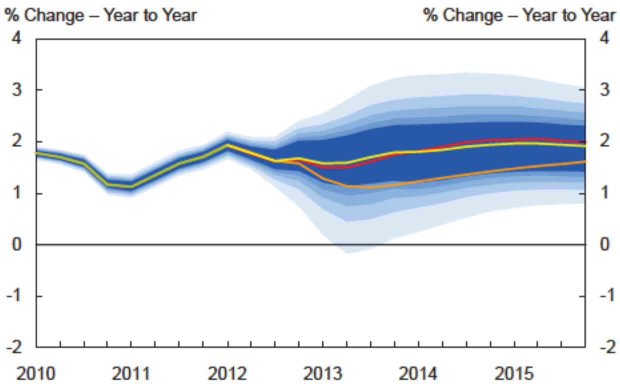


Source: MMS Function (FRBNY)

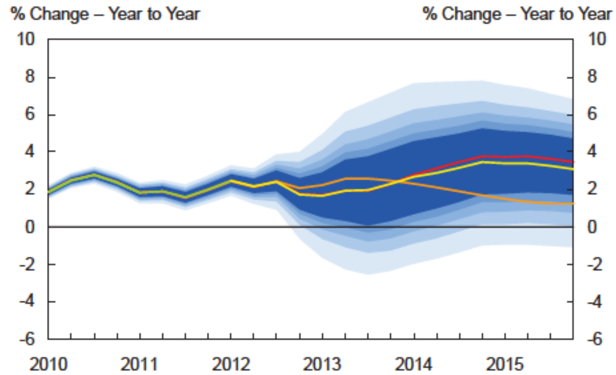
C. FRBNY Forecast Distributions

Exhibit C-3: Inflation and Output Forecast Distributions

Core PCE Inflation Forecast Distribution

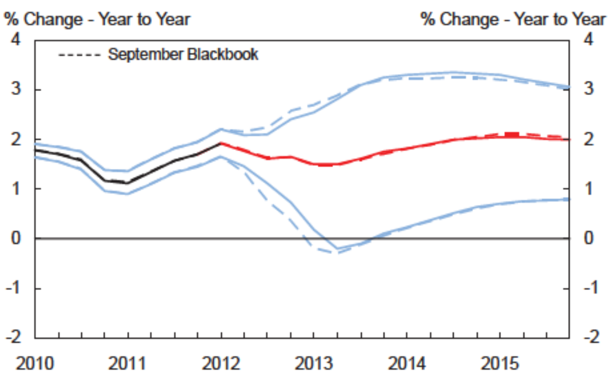


Real GDP Growth Forecast Distribution

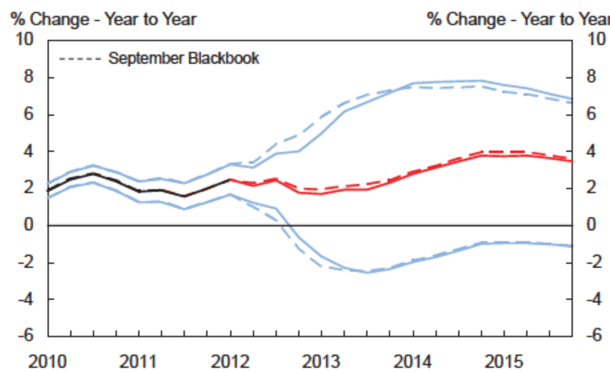


The yellow line is the expected value of the forecast distribution, the red line is the FRBNY central projection, the orange line is the DSGE forecast, and the green line is released data. The shading represents the 50, 60, 70, 80 and 90 percent probability that the four-quarter change will be within the respective range.

Change in Core PCE Inflation Forecast Distribution

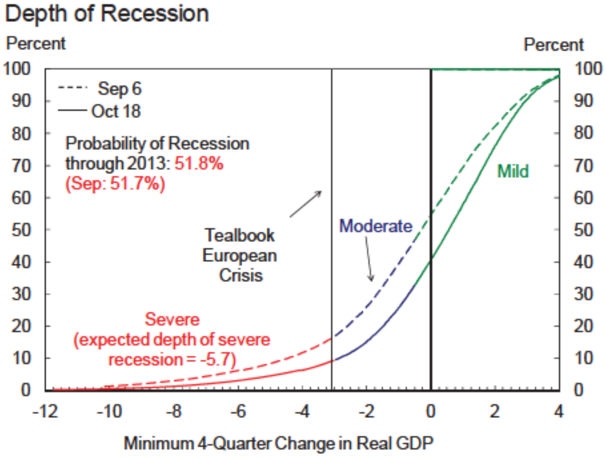


Change in Real GDP Growth Forecast Distribution

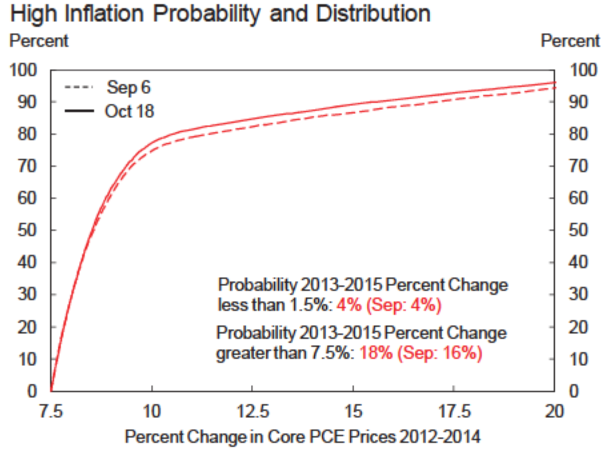


The blue lines are the 90% chance the four-quarter change will be within the lines, the red line is the central scenario projection, and the black line is released data. Dashed lines represent forecasts from the previous Blackbook.

Depth of Recession



High Inflation Probability and Distribution



Source: MMS Function (FRBNY)