EDITORIAL

FEDERAL RESERVE: THE 'DOTS' AS INTEREST RATE ANCHORS

The interest rate projections ('dots') of the FOMC members represent a reference point that can help investors and economic agents in general in forming their own interest rate expectations. This can be particularly welcome when the monetary environment is changing swiftly like has been the case over the past two years. To explore this, a comparison has been made between the federal funds rate projections of the Survey of Market Participants (SMP) and those of the FOMC members. It seems that the dots may play a role in anchoring long-term interest rate expectations. The private sector forecasts closely follow the dots for 2023 and to a lesser extent for 2024, beyond which they are essentially stable. This is important considering that it might influence the pricing of bonds. Moreover, it seems that the early phase of the tightening cycle has seen higher interest rate volatility in the Eurozone than in the US. Both observations raise the question whether the ECB should start publishing the interest rate projections of its Governing Council members.

Transparent communication has become an integral part of central bank policy. Long gone are the days without press conferences or of statements that were very hard to grasp by non-experts. On the latter point, the Federal Reserve and the ECB have stepped up their efforts to communicate in 'plain English', avoiding technical language to make sure that all citizens understand what the central bank is doing.

This is instrumental in anchoring inflation expectations -an important intermediate objective of monetary policy- and enhances the effectiveness of monetary transmission. The publication of economic projections is part of this communication effort, yet there are important differences between central banks. The ECB publishes staff projections about important macroeconomic variables -though not on interest rates- whereas the Federal Reserve only publishes its staff projections with a 5-year delay[1]. On the other hand, four times per year it publishes the projections of the FOMC members -a document called Summary of Economic Projections (SEP)- on GDP growth, inflation, the unemployment rate and the federal funds rate. These projections are conditional forecasts because they are based on the assumed path for monetary policy[2].

The Federal Reserve is part of a small group of central banks that releases interest rate projections. These can be particularly welcome when the environment is changing swiftly. Over the past two years this has been the case with the huge and lasting increase in inflation that has obliged central banks to act forcefully. In such a context, the publication of central bank interest rate projections, by providing a reference point, can help investors and economic agents in general, in forming their own interest rate expectations.

Charts 1-4 show the FOMC members' projections for the federal funds rate at the end of 2023, 2024, 2025 as well as for the longer run. The horizontal axis shows when these projections have been released. To assess to what extent they are correlated with private sector forecasts, the charts also show the results of the Survey of Market Participants (SMP)[3]. This survey is conducted by the Federal Reserve of New York ahead of each FOMC meeting. The participants -about 26- are institutional investment firms. This means that their expectations for the federal funds rate should influence their investment decisions and hence market dynamics. As policy was being tightened and the projection for the end of 2023 by FOMC members was revised upwards -higher dots-, institutional investors also raised their expectations. The dots for the end of 2024 were also increased by the FOMC members but this had far less of an impact on private sector expectations.

This could reflect doubts about the decisiveness of the Fed in its inflation fight[4], a more bearish view on the economic outlook or a more upbeat opinion on the pace of disinflation. Despite the aggressive interest rate hikes, the market participants' forecast for the end of 2025 was remarkably stable compared to the projections of the FOMC members that initially increased and declined thereafter. For the longer run, both the official and the private projections were very stable. This suggests that the FOMC dots may play a role in anchoring long-term interest rate expectations.

To explore this point, chart 5 compares the US experience to the Eurozone experience, where, as mentioned before, the ECB is not publishing interest rate projections of its Governing Council members. One would expect that in the absence of such a reference point, market pricing would fluctuate more compared to the US.

Instead of using bond yields, which can be influenced by fluctuations in the term premium, chart 5 uses the instantaneous forward rate within 7 years. This rate can economically be interpreted as representing the market-based expectation of the overnight rate within 7 years[5]. Chart 5 shows the rolling standard deviation of this rate in the US and the Eurozone. Between March and November last year -a period that corresponds to a fundamental shift in monetary policy in both jurisdictions- the instantaneous forward rate was more volatile in the Eurozone than in the US, although the cumulative policy rate hikes were larger in the latter. This might reflect the role of the FOMC members' dots in anchoring interest rate expectations in the US. In a second stage, both standard deviations had a similar behaviour, in terms of level and direction -a downward trend-, which may reflect a market view that the bulk of the tightening had already occurred.

To conclude, the experience in the US -private sector forecasts that closely follow the dots for 2023, that only do so partly for 2024, beyond which they are essentially stable- are important considering that they should influence the pricing of bonds[6]. This matters for the financing costs of the private and public sector and may have implications in terms of financial stability (bond market volatility). Moreover, it seems that the early phase of the tightening cycle has seen higher interest rate volatility in the Eurozone than in the US. Both observations raise the question whether the ECB should start publishing the interest rate projections of its governing council members.

William De Vijlder

1 They are published in the Tealbook (previously called the Greenbook) by the Federal Reserve of Philadelphia.
2 Fed watchers refer to the federal funds rate projections as 'the dots'. They reflect the rate that the FOMC members consider appropriate considering the economic environment and outlook and the Federal Reserve's mandate.
3 The dates for the SEP correspond to the FOMC meeting dates. Those for the SMP correspond to the date at which the Federal Reserve received the answers of the survey participants.
4 This argument probably has limited validity considering that market-based inflation expectations -based on the break-even inflation embedded in inflation-linked Treasuries (TIPS)- has been trending lower since the spring of 2022.
5 The yield curve enables to calculate forward rates, e.g. the yield (rate) on a one year bond (loan) within 7 years. Longer or shorter maturities for this bond (loan) can be considered. *"In the limit, as the period of the loan considered tends to zero, we arrive at the instantaneous forward rate."* Source: based on Bank of England, Yield curve terminology and concepts.
6 According to the expectations theory of interest rates, the yield on a long-dated bond of a given maturity reflects the short-term interest rate expectations over the same maturity.

EDITORIAL

PROJECTED FEDERAL FUNDS RATE FOR THE END OF 2023

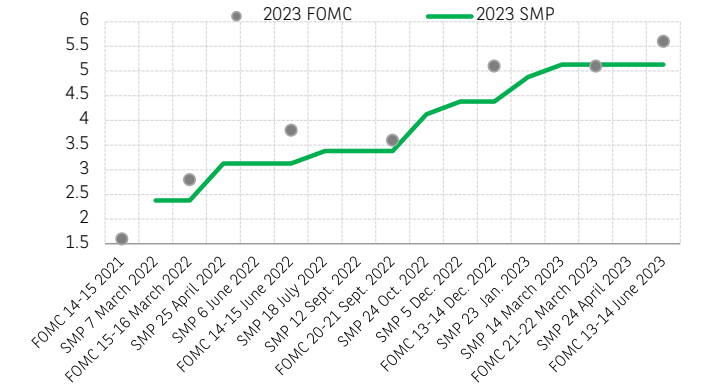

CHART 1

SOURCE: FEDERAL RESERVE, BNP PARIBAS

PROJECTED FEDERAL FUNDS RATE FOR THE END OF 2024

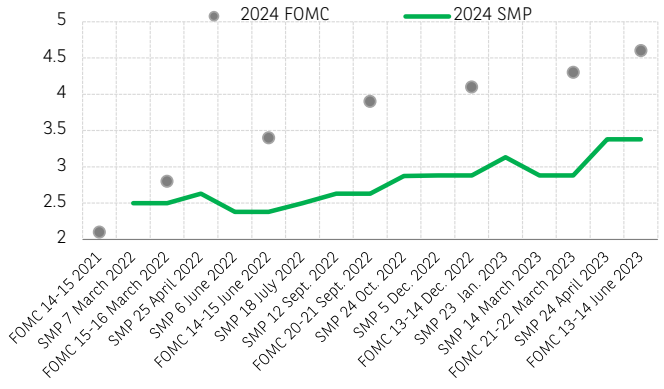

CHART 2

SOURCE: FEDERAL RESERVE, BNP PARIBAS

PROJECTED FEDERAL FUNDS RATE FOR THE END OF 2025

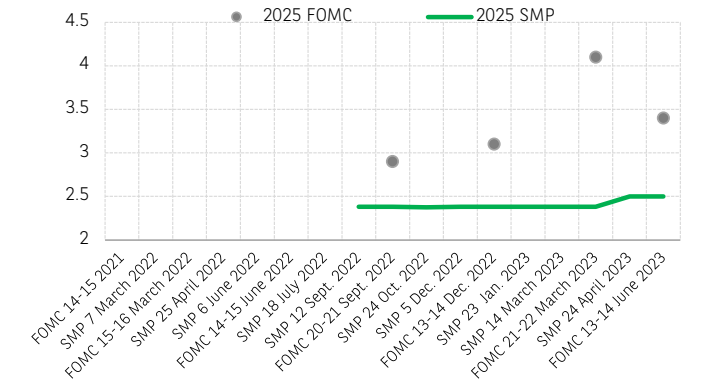

CHART 3

SOURCE: FEDERAL RESERVE, BNP PARIBAS

PROJECTED FEDERAL FUNDS RATE FOR THE LONGER RUN

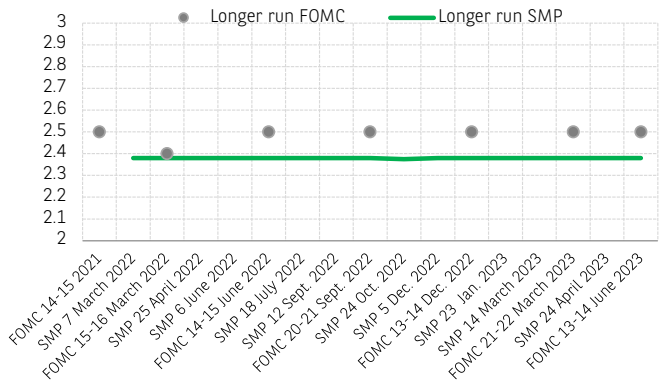

CHART 4

SOURCE: FEDERAL RESERVE, BNP PARIBAS

INSTANTANEOUS FORWARD RATE (WITHIN 7 YEARS)

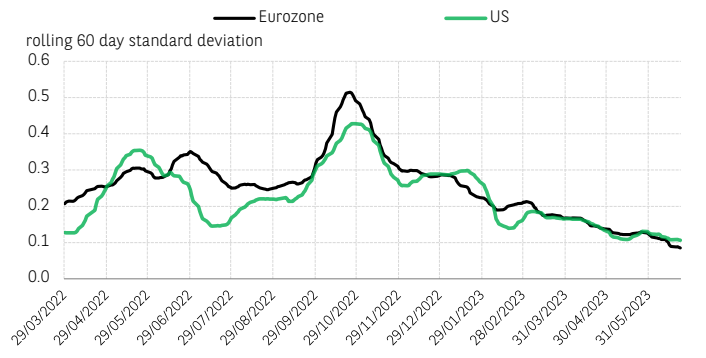

CHART 5

SOURCE: ECB, FRED, BNP PARIBAS