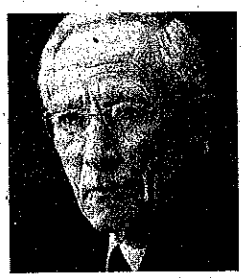
Fed may forecast slower growth

But outlook on jobs, inflation may fuel rates

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The Federal Reserve is expected to lower its economic growth forecast this week, but falling unemployment and rising inflation could prompt policymakers to project a slightly more rapid rise in interest rates.

At a meeting today and Wednesday, the Fed is widely expected to agree to continue to trim bond purchases aimed at holding down long-term interest rates and spurring growth. The Fed's policymaking committee is likely to cut the bond buying from $45 billion a month to $35 billion as the economy and labor market continue to improve.

Economists will be more focused on Fed forecasts. In March, policymakers predicted the economy would grow 2.8% to 3% this year. But after it shrank 1% in the first quarter amid harsh winter weather, the International Monetary Fund on Monday downgraded its U.S. growth forecast for 2014 to just 2% from 2.8%.

Economist Michael Feroli of J.P. Morgan Chase expects the Fed to make a similar adjustment; Barclays Capital's Michael Gapen is looking for a more modest drop to 2.5% to 2.7%. The economy is gaining steam after households shed debt amassed in the mid-2000s credit boom.

At the same time, unemployment has been falling more rapidly than the Fed anticipated, in part because Baby Boomers are retiring. Feroli expects the Fed to lower its end-of-year jobless rate forecast to 5.9% to 6.1%.

Annual inflation, disconcertingly low at 1.2% in 2013, is running about 1.6% this year — still below the Fed's 2% target but a signal the economy is picking up.

Feroli says a forecast for lower unemployment and higher inflation would mean the economy is moving closer to the Fed's central goals, so would "trump" the weaker economic growth projection. As a result, he says, policymakers likely will predict a slightly more rapid increase in interest rates next year. After keeping its benchmark rate near zero since 2008, the Fed is expected to start raising it in mid-2015.

In March, bond yields rose and stocks fell after policymakers' median forecast showed interest rates at 2.25% at the end of 2016, up from 1.75% previously. Gapen says another upward revision co likely would boost market rates.

Further complicating the picture, is that this meeting marks a shift in the committee's makeup. Former Philadelphia Fed executive Loretta Mester replaced Sandra Pianalto as Cleveland Fed chief. Fed Governor Jeremy Stein stepped down, while former assistant Treasury Secretary Lael Brainard joined the board. Also joining was Stanley Fischer, who formerly headed Israel's central bank and will be vice chairman.

While Mester is likely more concerned about inflation and eager to raise rates, Brainard and Fischer have a more pro-growth approach and are less likely to boost rates quickly, Gapen says; as a result, the Fed's interest rate forecasts could be unchanged.