Opinion

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Have a Little Sympathy for the Federal Reserve

Monetary policy is unavoidably complex, and anyone who says otherwise is not to be trusted.

His job is not simple. *Photographer: Pool/Getty Images North America*

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Are interest rates too high or too low? A simple enough question, you might think, demanding a straightforward answer. If only.

The problem is that the system connecting the Federal Reserve's main policy instrument – the setting of interest rates – to the things it ultimately wants to affect – inflation and employment – has many moving parts. You can't answer the question without understanding the context.

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The Fed sets a course for its policy interest rate, which (along with things it can't control) affects the cost of credit, asset prices and other financial conditions. Changing financial conditions (along with other things the Fed can't control) then affect aggregate demand. Changing aggregate demand (along with other things the Fed can't control) then shapes employment and inflation. To make matters worse, the Fed's goal is vague: It has to balance (over an unspecified timeframe) maximum employment and price stability (where "balance," "maximum employment," and "price stability" are weakly defined).

It's hard enough to look back and say with benefit of hindsight whether a given policy was right or wrong. To say what good policy looks like in real time is infinitely harder, involving questionable assumptions and disputable priorities at every point.

Yardsticks that simplify the Fed's task, and hence constrain its choices, do have their place – so long as they're handled wisely. The classic rule proposed by Stanford economist John Taylor deduces the correct policy rate by weighing the gap between actual inflation and the Fed's target for inflation against the gap between actual output and output at full employment.

Taylor has long argued that a formula of this kind yields better results than relying on the Fed's discretion. It so happens that, left to its discretion, the Fed follows a Taylor-type rule most of the time.

But what works under normal circumstances breaks down if the economy is struck by enormous supply-side shocks. Taylor-like rules say today's policy rate is much too low – on the order of 7 percentage points. Yet simply raising rates this much would deliver an enormous financial shock – thus driving up the output gap and rendering the rule's interest-rate prescription irrelevant. The economy would change so fast that a policy rate that was deemed too low one week would be judged too high the next.

With Taylor-type rules sidelined, other simplifying concepts are vying for attention. A favorite contender lately is the so-called neutral rate of interest – the policy rate consistent with full

employment and the target rate of inflation. In effect, this gestures at an appropriate Taylor-type interest rate once the economy is roughly back where the Fed wants it to be.

But the point is that the economy is not where the Fed wants it to be. Even if we knew what the neutral rate was in this other state of the world – 0.5% in real terms is a popular choice – this wouldn't say anything useful about where things stand right now.

Nevertheless, the simple answer is ever in demand. One can highlight any number of other metrics and say, "Use this to judge the policy rate." Together with the ghostly neutral rate, labor-market measures are much in vogue – understandably, because the Fed's challenge is to get inflation down without driving up unemployment. So the Fed is advised to focus on quit rates, or the ratio of vacancies to unemployment (the so-called Beveridge curve), or separations, or "discouraged workers," or whatever.

All these indicators and many more convey information about where the economy stands and the trade-offs the Fed has to weigh. None is the key that says whether policy is too tight or too loose. Aside from each indicator's specific defects, it's also worth keeping in mind Goodhart's Law (coined by the economist Charles Goodhart when discussing British monetary policy in the 1970s): "Any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes."

The best approach is for the Fed to direct its own and others' attention to the broadest aggregate it hopes to influence while emphasizing the limits to its control. It should say what it believes its projected policy rate implies for the path of aggregate demand, and why this path is appropriate. (Strangely, despite all the comment and information the Fed provides, these intentions aren't directly stated: They have to be inferred.) According to the Fed and the average of private forecasts, the indicated course of interest rates implies gently declining growth in demand, consistent with a gradual easing of inflation, alongside little or no increase in unemployment.

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The Fed should keep reminding us that things are likely to turn out differently because of all the factors it can't control and, if so, a new path of interest rates will be needed. But with that understood, one can reasonably ask, is the Fed's *intended* path of demand well-judged? My guess – which is all anybody can do here – is that a slightly brisker reduction of demand would help reduce inflation a

little faster without materially worsening the outlook for jobs. All things considered, the Fed should push interest rates up a bit faster.

Those qualifiers are infuriating, I know – but also the point. They're needed to acknowledge the doubts, uncertainties and space for legitimate disagreement. Weak commitments are never satisfying but, when it comes to economic forecasting, they are always wise.

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