Could The Fed Do More to Please the Public?

Peter Ireland
Boston College and Shadow Open Market Committee
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The US unemployment rate now stands at 4.9 percent, with core PCE price inflation running slightly above 1.5. Has there ever been a gap this wide between the reality of moderate real growth with stable prices and the popular perception that our economy remains on the verge of collapse? And with the Federal Reserve so close to achieving both sides of its dual mandate, how it is possible for the *Wall Street Journal* to publish a major front-page article (Hilsenrath 2016) detailing "years of missteps" by our nation's central bank? It doesn't make sense, and it doesn't seem fair!

To an extent, however, Federal Reserve policymakers have only themselves to blame for this improbable and highly frustrating state of affairs. With the very best of intentions, they've appeared to promise too much, and now they've disappointed the same public that they tried so hard to please.

Since 2008, when their federal funds rate target first hit its zero lower bound, Federal Reserve officials have struggled to find new ways of providing monetary stimulus to support the economic recovery. They have, in particular, worked unusually hard to shape expectations of future interest rate movements by providing detailed forward guidance about their policy intentions. As part of the these efforts, they've regularly released a Summary of Economic Projections, making explicit not only their plans for the funds rate but also their forecasts for real economic growth, unemployment, and inflation.

In theory, this forecast-based strategy seems sensible and sound. That expectations of future policy actions matter as much as current settings for policy rates is, after all, one of the principal lessons taught by modern macroeconomics. By providing forward guidance, the Federal Open Market Committee should be making it *easier* for the public to form those expectations in ways that its members deem desirable. And by providing forward guidance along with the SEPs, FOMC members should be finding it *easier* to explain to the public just what they are doing and why.

In practice, however, it hasn't worked out that way. Throughout the economic recovery and expansion, real GDP growth and inflation have consistently come in below the FOMC's published expectations. Adding to the confusion, the unemployment rate has declined more quickly than anticipated. And, worst of all, even the very modest and gradual interest rate increases that FOMC members have discussed publicly as part of their forward guidance strategy have been repeatedly postponed.

As Meltzer (1987) emphasizes, macroeconomic forecasting is tricky business. Anyone who's ever tried it would surely be willing to excuse the Fed for at least some of its errors. But, to the general public, it must seem like FOMC members are just not very good at forecasting the economy, even though they've made it into a central part of their job. And, worse still, it must appear that FOMC members can't accurately anticipate their *own* future actions very well, even looking just one to three months ahead. Thus, the public has been left disappointed and frustrated, damaging the Fed's reputation and credibility.

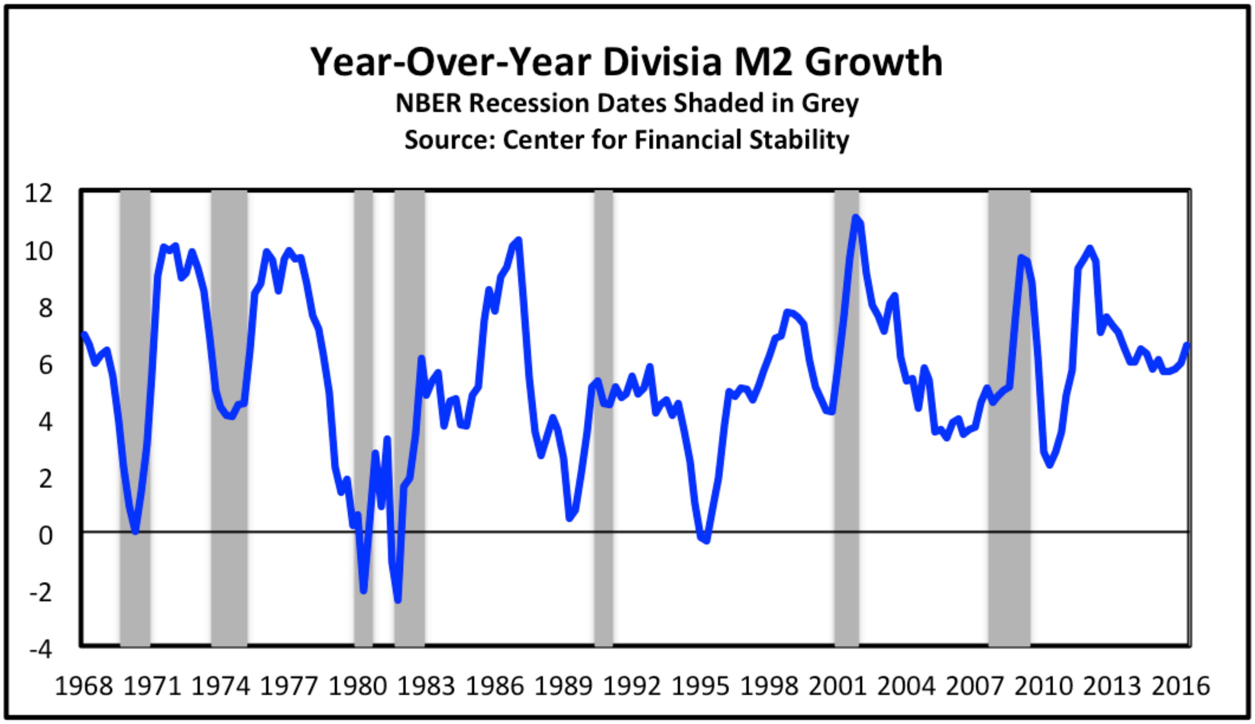
Hetzel (2016) outlines a detailed set of procedures according to which the FOMC might consolidate its members' individual outlooks and opinions into a consensus projection for the future funds rate path that is accompanied by internally-consistent sets of forecasts for real growth and inflation. These procedures could help in clarifying, for the public's benefit, what the Committee as a whole hopes to achieve and, by condensing an entire set of projections into one, might also make room in Fed communications for a more explicit discussion of the uncertainties that will inevitably accompany those forecasts. The changes that Hetzel proposes would make forward guidance more effective. They are well worth considering seriously.

At the same time, however, it is also worth asking whether *any* forecast-based monetary policy strategy, no matter how well designed, will ever succeed in stabilizing the economy. Both Friedman (1953) and Meltzer (1987) were skeptical, arguing that efforts to fine-tune based on forecasts prone to error are much more likely to do harm than good. The latest evidence provides little reason for us to be any more confident than they were. But what alternatives does the Federal Reserve have?

One alternative would refocus the FOMC's policymaking and communication strategies on the one goal that the Fed surely *can* achieve, which is to stabilize inflation over the intermediate-to-long run. And both theory and evidence point to growth in the money supply – not oil prices, interest rates, unemployment, or real economic growth – as the key determinant of long-run inflation. The graph on the next page shows that, reassuringly, growth in the broad Divisia M2 aggregate continues today at a healthy pace of about 6 percent per year. Viewed in light of these data on money growth, the current stance of Fed policy – as opposed to the overall strategy according to which decisions are being made – seems just about right: appropriately accommodative but not overly expansionary, with the risks balanced evenly on either side.

On the other hand, the graph also makes clear that the Fed has not always been so successful at keeping money growth steady, either before or since the Great Recession. More generally, as discussed in further detail by Belongia and Ireland (2016), the distinct, procyclical patterns still evident in money growth appear remarkably similar to those that Friedman and Schwartz (1963) found in older, historical data. This suggests that, by trying to do so much more, the Fed has taken its eye off one policy indicator that really is useful and informative.

Could the Fed do more to please the public, simply by acting more deliberately to stabilize the growth rate of a broad monetary aggregate? Probably, the answer is yes!



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