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**NEW LEVY INSTITUTE STUDY QUESTIONS PREEMPTIVE MOVES BY FED**

ANNANDALE-ON-HUDSON, N.Y.—As the Federal Reserve continues its widely anticipated series of interest rate hikes, a new study from The Levy Economics Institute of Bard College finds little support for the effectiveness of such moves and questions the thinking behind them. In his public policy brief, *The Fed and the New Monetary Consensus: The Case for Rate Hikes, Part Two*, Levy Senior Scholar L. Randall Wray explores the thinking behind the monetary policy at work in two similar situations: the Fed’s decision to gradually begin raising rates in 1994 and its decision to do the same during the past year. He contends that in both instances, the Fed needlessly raised interest rates at the first signs of economic recovery when there were few signals that inflation was looming.

In his policy brief, Wray explores monetary policy making in the United States as revealed through public pronouncements, minutes of recent meetings, and transcripts of secret discussions at Federal Open Market Committee (FOMC) meetings in 1994. Wray argues that the Fed pursued a policy course in 1994 similar to that of the past year, by prematurely raising rates to counter unfounded inflation fears at the start of recovery. “We know that the recovery from the recession of the early 1990s had not even begun with vigor by 1994, that labor markets would not become tight until many millions more jobs had been created, and that inflationary pressures would never become significant in spite of the strength of the Clinton boom,” writes Wray. “We do know that the increase of rates from 1994 did not bring growth and unemployment into the ranges believed by the FOMC at the time to be sustainable—in fact growth picked up and inflation fell.”

Furthermore, Wray is critical of the Fed’s decision at the time of the 1994 interest rate

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hikes to adopt a more activist, gradual, and transparent monetary policy by which the Fed would act swiftly to respond to economic dangers and that its moves would be well-telegraphed and enacted through a series of incremental adjustments. Wray argues that these policies commit the Fed to follow through on its directives, regardless of evolving economic conditions, to meet market expectations that it has itself built up. “The combination of openness and gradualism can force the central bank to make policy moves at the wrong time in order to fulfill market expectations it has created—a problem that the Fed seemed to anticipate back in 1994, if only incompletely, and a problem that has surfaced again as the Fed is forced to continue to raise rates in spite of lackluster economic performance.”

Wray is especially critical of the Fed’s efforts, which can be traced to policies formulated in the early 1990s, to pursue an elusive benchmark or “neutral” rate that neither provokes inflation nor slows down the economy. He questions the appropriateness of forming policy based on a phantom neutral rate that, he says, the Fed itself has acknowledged can only be hit or known once it has been attained. He stresses that Japan has maintained interest rates at zero for much of the past decade without sparking inflation, and that low rates in the United States have failed to produce substantial and sustained growth or solid signs of inflation. “If the neutral rate varies through time and across nations, presumably with the state of the economy, and is unknown, it cannot provide useful guidance,” writes Wray. “The Fed and conventional wisdom alike view a 1 percent (Federal Funds Rate) target as necessarily ‘accommodative’ and, thus, rate hikes as ‘inevitable,’ without any clear explanation as to why an undoubtedly ‘low’ rate is an ‘accommodative’ rate.”

Beyond the reasoning behind the policy, Wray points out that there are serious risks to raising rates at this juncture. “The United States has not yet begun a robust recovery, and when compared with other recent recoveries it would appear that we have several years to go before a shift from ‘accommodation’ would be deemed appropriate,” he writes. “Given the huge increases in debt load carried by the private sector, maintenance of low interest rates would seem to be prudent in the face of a weak, nearly jobless recovery.”

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Public Policy Brief 80, *The Fed and the New Monetary Consensus: The Case for Rate Hikes, Part Two*

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