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The Fed and the New Monetary Consensus

The Case for Rate Hikes, Part Two

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The Federal Reserve has embarked on a series of rate hikes designed to raise the federal funds rate (FFR) to what it terms "neutrality"—a hypothetical level that neither stimulates nor impedes growth. While almost all data indicate that labor markets are still exceedingly "loose"—probably short some five million jobs—and that there is no real danger of inflation, we should not doubt that the Fed will continue to raise rates in its quest for the elusive "neutral rate."

This brief is an extension of Levy Institute Public Policy Brief No. 79 (Wray 2004), which argued that the rate hikes that began in June are premature. Here, we examine the thinking that currently guides 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. This brief will argue that transcripts from the period 1993–94 shed light on current policy making, because the Fed's actions and public statements in that period look eerily similar to those of today. It will also argue that the 1994 policy change marked a nascent approach to policy formation that came to full fruition by 2004.

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A Practical Application of the New Monetary Consensus?

The Fed's new approach to policy can be viewed as a practical application of what has been called the new monetary consensus. In the hands of the Fed, policy formation is based on six key principles:

1. *Transparency*
2. *Gradualism*
3. *Activism*
4. *Low inflation as the only official goal*
5. *Surreptitious targeting of distributional variables*
6. *Neutral rate as the policy instrument to achieve these goals*

In 1994, the Fed experimented with greater openness by clearly signaling its intention to raise rates. Over the subsequent decade, the Fed continued to increase *transparency*, both by telegraphing its planned moves well in advance of policy changes and by explicitly announcing interest rate targets. In 1994, it implemented its tightening through a series of very small rate hikes, an approach that came to be known as *gradualism.* Ironically, 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 that it has created.

These developments have evolved against the backdrop of a long-term trend toward increased monetary policy *activism*, which contrasts markedly with Milton Friedman's famous call for rules rather than discretion. The policy indicator used by the Fed, both in 1994 and now, is something called a *neutral rate,* which varies across countries and through time. Combined with gradualism and activism, this means the central bank must begin moving the FFR toward the neutral rate many quarters before it desires to achieve "neutrality," since only small rate adjustments will normally be used. However, the neutral rate cannot be recognized until it is achieved, so it cannot be announced in advance—a paradox that is somewhat in conflict with the Fed's adoption of increased transparency.

In recent years, it has become virtually a universal given that central banks ought to pursue only one goal—*low inflation.* Actually, the Fed also targets asset prices and income shares, and it shows a strong bias against labor and wage-push inflation, even as it tacitly accepts profits-driven inflation. The truth is the Fed knows its policies have distributional effects—indeed, its policies operate largely through distributional impacts—and it considers these in its policy deliberations.

Groping for Targets: Real and Neutral Rates

Where did the notion of a neutral rate originate? In the 1980s and 1990s, after the failed "monetarist experiment," the Fed toyed with a variety of indicators and targets for monetary policy formation, including price indices, "P-star," surveys of expected inflation, gold prices, Taylor rules, and the equilibrium "real" interest rate. Finally, the Fed settled on an "intuitive" approach, as expressed by Governor Lawrence Lindsey when he said, "We look at a whole raft of variables—we ignore nothing and we focus on nothing," and by Governor John LaWare, who said simply, "I get a feel for what I think is going on" (Papadimitriou and Wray 1994, p. 49). Still, as we will see below, internal discussions at FOMC meetings focused variously on "real" or "neutral" interest rates.

Indeed, since it began to hike rates, the Fed has been openly trumpeting the neutral rate as an indicator for policy formation. When questioned about the neutral rate, Chairman Alan Greenspan responded: "You can tell whether you're below or above, but until you're there, you're not quite sure you are there. And we know at this stage, at one and a quarter percent federal funds rate, that we are below neutral. When we arrive at neutral, we will know it" (Andrews 2004). While economists outside the Fed are willing to put a number on the neutral rate—rates of 3.5 to 5.0 have been quoted in the press (Andrews 2004; Crosson 2004)—the Fed prefers to remain circumspect, simply defining it as the interest rate that neither provokes inflation nor slows down the economy (Andrews 2004).

In practice, a neutral rate cannot be temporally or spatially fixed. For four years the United States held the FFR at 1 percent, without sustaining robust growth or setting off significant inflation—hence, neutrality must have been below 1 percent. In fact, economic growth began to falter before the recent rate hikes, and any recent price blips have been dismissed by the Fed as temporary and due to factors unrelated to U.S. growth. This means that if the appropriate neutral rate to be achieved a couple of years in the future is indeed somewhere near 4 percent, the economy will have to start growing faster even as rates are raised. Finally, if the neutral rate is unknown and if it varies through time and across nations, presumably with the state of the economy, it cannot provide useful guidance. Rather, the Fed must focus on current and projected economic growth and inflation data, raising its target when it believes employment and growth are about to rise so high as to cause accelerating inflation. In other words, the notion of a neutral rate does not provide any additional useful guidance, because the Fed will continue to raise rates until it becomes convinced that inflationary pressures are eliminated. The Fed offers as justification for rate hikes an unknown neutral rate that is supposedly above the FFR, along with the promise that once the FFR gets to the neutral rate, the Fed will be able to recognize this achievement. Can policy making become more convoluted than that?

The Deliberations of 1994: A Trial Run with the New Monetary Consensus

A detailed examination of the deliberations of 1994 demonstrates that all of the key ingredients of the current approach to policy making were already present in embryonic form: transparency, gradualism, activism, neutral rates, and low inflation as the official goal, although there was considerable concern with asset prices and distributional variables. We will explore the first four components in this section, and look at the final two components in a later section.

A. Representative González Applies Pressure, Forcing the Fed to Increase Transparency

To put matters in context, it is useful to remember that FOMC deliberations before 1994 were highly secretive and that rate hikes were disguised in coded releases as decisions to "increase slightly the degree of pressure on reserve positions." It was left to markets to figure out what FFR target the FOMC had in mind. Critics of the Fed, led by Representative Henry González, chairman of the House Banking Committee, called for greater transparency (FOMC 1993). The Fed debated the political and economic consequences of greater transparency, and eventually agreed to release transcripts and other materials associated with FOMC meetings. The material is now available on the Fed's website with a five-year lag. Now, of course, the Fed not only warns that rates "must rise at some point" long in advance of its decisions to reverse policy, but it also announces precisely what its target FFR is. Still, because of the five-year lag on releasing transcripts, we cannot know exactly what deliberations led to the most recent rate hikes. Thus, we are not sure that history is repeating itself, but it certainly does rhyme, as a comparison of the transcripts of 1994 with the Fed's public statements in 2004 shows.

B. The 1994 Decision to Raise Rates

When the FOMC met in early February 1994, committee member Thomas Melzer expressed concern that "the stance of monetary policy has been very expansionary for about the last three years" (FOMC 1994, p. 26). During that period, policymakers had held rates relatively low; since October 1992, the FFR had hovered around 3 percent, and there had not been a rate hike in five years. Several of the governors mentioned strong growth, tight labor markets, accelerating growth of consumer debt, "a rather euphoric stock market," unemployment rates reaching their Nonaccelerating-Inflation Rate of Unemployment estimates, and a disappearing gap between actual and potential GDP as justification for the belief that inflation was likely to pick up. While FOMC staff and several governors mentioned that a case could be made to hold off on rate increases, they all seemed to believe that the time had come.

C. Greenspan Pushes for Consensus

At that meeting, Chairman Greenspan worried about maintaining "flexibility," fearing that by making its intentions to raise rates clear, the Fed would set a precedent. However, because this would be the first rate change in a long time, he warned, "we are going to have to make our action very visible" with "no ambiguity about our move." Breaking with tradition, he didn't want to leave it up to markets to guess the Fed's intended target: "I would very much like to have the permission of the Committee to announce that we're doing it and to state that the announcement is an extraordinary event" (FOMC 1994, February 3–4, p. 29). When the committee unanimously voted for a 25-basis-point hike, Greenspan gushed, "I thank you for that. I think it's the right move. I think in retrospect when we're looking back at what we're doing over the next year we'll find that it was the right decision" (p. 58).

D. An Active Fed Is a Credible Fed!

Why did the FOMC begin to raise rates in February, and continue to raise them over the next year by a total of 300 basis points? Not because the economy was booming. Indeed, at the May 1994 meeting, following several rate hikes, Governor Jerry Jordan argued that "where we are is not that we are entering the fourth year of the expansion, but rather that we are someplace in the first year of a classic expansion" (FOMC 1994, May 17, p. 23)—meaning the Fed had raised rates at the very beginning of recovery! Rather, the Fed acted to enhance its credibility. As

Governor J. Alfred Broaddus said, "I really think the System's anti-inflationary stance has done a great deal to increase our credibility in recent years" (FOMC 1994, February 3–4, p. 23). Added Vice Chairman William J. McDonough, "A 25 basis point move . . . would send the right signal in the sense that the Federal Reserve, the central bank, is being watchful, as it should be. And we would be moving earlier in the economic cycle than the Fed has done historically and, therefore, we are doing our job even better than in the past" (p. 46). And Governor Robert Forrestal said, "I think we will gain credibility by moving now even though there might be some marginal risk that we might have to reverse course" (p. 49). In other words, an *active* Fed is a credible Fed, and the sooner it acts, the better.

E. Gradualism and the Neutral Rate

After the February rate increase, financial markets stumbled. At the March 22, 1994 meeting, Chairman Greenspan noted that the committee had held "expectations that we would prick the bubble in the equity markets" with the February hike, and while he favored getting "policy to neutrality as fast as we can," he didn't believe "the financial system can take a very large increase without a break in its tensile strength—which we strained significantly the last time but did not break" (FOMC 1994, March 22, p. 43) Hence, he favored a gradual series of small rate hikes to get the FFR to the 4.0 to 4.5 percent "neutral" range. We see the justification for *gradualism* in the fear that the impact of large rate hikes on financial markets would be too big.

Lessons from the 1994 Experiment

The FOMC transcripts offer valuable insights into the Fed's decision to raise interest rates sharply in the early years of the Clinton expansion, and it is likely that similar deliberations are taking place today, as the Fed embarks on a new series of rate hikes. Hence, it is worthwhile to take stock of the lessons.

It is notable that neither the "irrational exuberance" of the post-1996 stock market bubble nor its 2000 crash appears to have been moderated by increased Fed transparency or preemption, as Greenspan might have hoped. The Fed's attempt to "prick the bubble" in 1994 caused only a temporary setback for the euphoria that would develop over the next six years. The assumption that a long series of small, expected rate increases would prick financial bubbles was incorrect.

Moreover, the Fed now realizes that adoption of transparency and gradualism means that it surrenders a degree of discretion to market expectations. Policymakers must continually take the pulse of the market to ensure that these expectations are not disappointed. The June 30, 2004 minutes make clear that the FOMC's recent decision to reverse policy was based largely on the market's expectation that rates would be raised. Like a cat chasing its tail, the Fed must perversely follow expectations upward.

This brings us to another important lesson from the 1994 transcripts. The Fed would like to be perceived as "above the fray," staying out of debates about employment, income distribution, and more specifically, differential impacts of rate changes on different groups. Further, while the chairman famously mused about the "irrational exuberance" of equity prices during the New Economy boom, he later denied that the Fed targets asset prices. However, we know from the transcripts that the Fed was, indeed, consciously trying to "prick" what it perceived to be an equity price bubble in 1994. And it is clear that a primary reason for choosing "gradualism" was an attempt to engineer a "soft landing" for financial markets.

Further, Governor Lindsey presented detailed data at the February 1994 meeting demonstrating that there had been "a big change in the functional distribution of income away from wages" (FOMC 1994, p. 21). He estimated that most interest receipts go to groups unlikely to borrow, while most borrowers rely on income from work. From this, he surmised that measured debt burdens were misleadingly low because the "middle-class, middle-aged people who are borrowing are really getting their income squeezed." Of course, when the Fed hiked rates, this boosted interest income for those with financial wealth and little debt, while raising debt burdens and reducing the after-interest income of "middle-class, middle-aged" people. The hope was that the reduction of spending by the burdened would more than offset policy-induced spending by those with rising interest income.

The Fed cannot help but notice that interest rate changes do have distributional impacts—a fact driven home by Governor Lindsey's calculations. In the consumer sector, households are net interest recipients. Therefore, if all households spent equal shares of their income, permanent rate hikes could stimulate consumption spending by raising net interest receipts. This stimulative, redistributive effect (from government and business to households) could offset other, negative effects. However, if interest recipients do spend more of their income, then rate hikes could stimulate spending. This could be the case, for example, if creditors are seniors living on interest income. Further, and this is important, the federal government is a very large net payer of interest to the private sector, so rate hikes increase budget deficits and hence stimulate private spending—to a degree that has not yet been reliably estimated. From this, we can conclude that interest rate changes certainly do "work" at least partially (if not mainly) through distributional effects. In any case, the secret cannot be denied: there are such effects, and the Fed considers them in its meetings.

Also, there seems to be a bias toward profit income and against wage income, and toward net interest recipients and against net debtors. The Fed admits that recent price increases have far outstripped labor compensation increases, a fact reflected in record profits accruing to owners. In other words, any inflation recorded today represents "profits inflation," or windfall gains to owners who have taken advantage of either rising labor productivity or supply bottlenecks. By waiting until now to raise rates, the Fed fostered the impression that it accepts profit-led inflation, but is averse to wage-led inflation—a clear bias against labor.

Conclusion: An Innocent Fraud?

In his new book, John Kenneth Galbraith takes on what he calls "innocent fraud," or the conventional view, which is both incorrect and also "serves, or is not adverse to, influential economic, political and social interest" (2004, p. xi).

> To limit unemployment and recession in the United States and the risk of inflation, the remedial entity is the Federal Reserve System, the central bank. For many years (with more to come) this has been under the direction from Washington of a greatly respected chairman, Mr. Alan Greenspan. The institution and its leader are the ordained answer to both boom and inflation and recession or depression . . . Quiet measures enforced by the Federal Reserve are thought to be the best approved, best accepted of economic actions. They are also manifestly ineffective. They do not accomplish what they are presumed to accomplish. (Galbraith 2004, pp. 43–44)

In a sense, the Fed is trapped by its own mythology, or "innocent fraud." It is held accountable both for smoothing the business cycle—a task for which it disclaims responsibility even as it (quietly) accepts credit when things go well—and for fighting inflation that will not show up for years. The only tool at its disposal is the FFR, a variable that is only loosely linked to employment and unemployment, wage and price inflation, or investment and economic growth. Worse, to sustain credibility, it must act in accordance with market expectations—expectation it largely generates.

The latest rate hike seems destined to follow the precedent set in 1994, when the Fed began to raise rates based on the argument that inflation would appear sooner or later. In retrospect, 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 millions more jobs had been created, and that inflationary pressures would never become significant in spite of the strength of the Clinton boom. We cannot know whether robust job creation would have begun sooner if the Fed had not raised rates in 1994. We do know that the increase of rates from 1994 did not bring growth and unemployment into the ranges believed by the FOMC to be sustainable. In fact, growth picked up, employment boomed, and inflation fell.

Further, we do not know whether discretion could work better than Friedman's rules, because our hyperactive Fed is not necessarily a discretionary Fed. Prudent policymakers could preserve options if they did not create market expectations of "inevitable" rate hikes that they then felt compelled to make without regard to economic performance. Given the lack of credible evidence that the Fed can impact important economic variables in a desired manner, and given the Fed's own doubts about the relations between these variables and inflation, a less preemptive Fed policy is in order. Finally, given all the uncertainty about the level of the "neutral" FFR, it makes little sense to change policy in an effort to find that elusive rate.

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