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OPINION | COMMENTARY

The Fed and the Professor Standard

The central bank needs new voices that will speak up for a stable dollar, which leads to prosperity.

By Herman Cain

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Traders watch news about the Federal Reserve at the New York Stock Exchange, March 20. **PHOTO**: DREW ANGERER/GETTY IMAGES

Real income for America's bottom 90% reached an all-time high in 1999, and at the time Pew Research found that 81% of Americans agreed that free enterprise was a major reason for the country's success in the 20th century. By June 2015, however, Gallup reported 47% would vote for a socialist.

What happened? Real income for the bottom 90%, as measured for the World Top Incomes Database, declined after 1999 and never rebounded. Two terms each of Republican and Democratic administrations failed to end this stagnation, which says all you need to know about why Donald Trump was elected president. Now wages are rising at robust rates—above 3% a year—thanks to cuts in taxes and regulation, with the largest wage increases going to low-wage workers. And the Federal Reserve has been itching to raise interest rates.

The Fed still operates on the "professor standard," enshrined with Bill Clinton's nominations of pure academics. Their textbooks say strong economic growth, particularly strong wage growth, causes inflation, which Fed policy should temper. Both the Bush and Obama administrations perpetuated the professor standard, and both presided over income stagnation.

Ending that stagnation is one goal that unites the political spectrum. But do we really expect that to happen under the professor standard? The academics' favorite tool, the Phillips curve, tells them wage growth that is too strong can cause an outbreak of 1970s-style inflation, as former Fed Chair Janet Yellen alluded in her 2010 Senate confirmation hearing.

I have a different perspective. The professor standard doesn't work, and the Fed needs new voices to argue for an approach that does.

The 1980s and 1990s brought prosperity across the board. This success was driven by a voting bloc of Fed governors, such as Wayne Angell and Manley Johnson, who favored a stable dollar and were able to swing the consensus. The dollar is a unit of measure—like the foot or the ounce —and keeping units of measure stable is critical to the functioning of a complex economy. The result of their stable-dollar policy was prosperity.

Since the Federal Reserve Act of 1913, there have been three distinct periods of sustained dollar stability: 1922-29, 1947-70 and 1983-99. During these periods, real growth of gross domestic product averaged 3.9% a year and real income growth for the bottom 90% averaged 2.2%, according to calculations done by Rich Lowrie, senior economic adviser to my 2012 presidential campaign. During distinct periods of sustained dollar volatility—in 1913-21, 1930-46, 1971-82 and 2000-15, real GDP growth averaged only 1.9% and real income for the bottom 90% declined by an average of 1.3% annually.

The prosperity of the 1980s and 1990s gave way to stagnation precisely because dollar stability gave way to volatility. Blame the professor standard. Demand for dollars is determined globally on a real-time basis, but the Fed has preferred to look largely at domestic lagging indicators in determining supply. The frequent resulting mismatches cause dollar volatility, which the professor standard then dismisses as transitory.

America's future prosperity, and especially the end to income stagnation, depends on getting this distinction right. The Fed has the tools to stabilize the dollar. The open-market desk can buy bonds to counter a downward trend in commodity prices and sell bonds to arrest an upward trend, resulting in ongoing stability in the dollar's commodity value. The only thing missing are voices like Messrs. Angell's and Johnson's to advocate for it. If confirmed by the

Senate as a Fed governor, I will speak up for dollar stability.

Last September the professor standard led Fed governors to pick up the pace of quantitative tightening and stick to its plan of rate hikes. Never mind that commodity prices were falling, meaning the dollar's commodity value was rising, a market signal of deflationary pressure. Meanwhile, the forward outlook for industrial production and retail sales indicated signs of slowing rates of growth. This combination of slowing growth and a rising dollar is a deflationary slowdown. These are the worst conditions under which to raise interest rates, yet that's what happened, not once but twice, presumably because wage growth was deemed "too strong."

Markets rightly sent the Fed a strong signal to back off, prompting three subsequent dovish pivots. If the Fed listens to markets after the fact, why not listen to them before?

This mistake is not new. Had the Fed responded appropriately to the dollar's commodity value at the turn of this century, it wouldn't have tightened the U.S. economy into the 2000 deflationary slowdown, and technology speculation would have resolved itself without taking down the entire economy.

Had the Fed reacted to the dollar's commodity value coming out of that recession, it wouldn't have inflated the real-estate bubble, which led to the 2008 financial crisis. After June 2008, the dollar's skyrocketing commodity value was screaming that there was a sudden, huge, global scramble for dollar-based liquidity. Unfortunately, the market's cry fell on deaf ears, apparently because the signal hadn't yet registered in the Fed's lagging employment and consumer-price indicators. This deflationary pressure ignited the financial inferno that began in September 2008, yet the Fed didn't begin quantitative easing to put out their fire until that December.

If Congress responds only after a crisis, the Fed's record indicates it listens to markets only after enough damage has already been inflicted. The results of that policy look even worse in contrast: Show me a financial crisis that happened in America while the dollar's commodity value was stable.

We need new voices at the Fed that understand stable money and know how to interpret important market signals—and that means breaking the professor standard. Monocultures tend to be fragile, but is the Fed so closed off that it can't handle challenges to its models or the assumptions that feed them? So fragile it can't consider that the economy is driven by production, not consumption, and that the dollar's commodity value is important to the real investment that fuels production? I hope not.

The best way to achieve full employment, price stability, economic growth strong enough to

solve our fiscal problems, and sustained income growth for the striving majority is for the Fed to stabilize the dollar. The professor standard will not challenge itself—that much has been proved. That's why my voice is needed at the Fed.

Mr. Cain was chairman of the Federal Reserve Bank of Kansas City, 1995-96, and a candidate for the Republican presidential nomination in 2012.

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