http://www.wsj.com/articles/america-needs-a-steady-strategic-fed-1485821476

OPINION | COMMENTARY

# America Needs a Steady, Strategic Fed

When central bankers react to short-term data, they confuse the immediate with the important.

Federal Reserve Chair Janet Yellen at a press conference at the Board of Governors in Washington, December 14, 2016. *PHOTO: GETTY IMAGES*

By **KEVIN WARSH**

Jan. 30, 2017 7:11 p.m. ET

On Wednesday the Federal Open Market Committee will conclude its first policy meeting of the year. The Fed is expected to issue two documents. The first is a jargon-filled policy statement that market pros and pundits will scrutinize intently for clues about when the next interest-rate increase will come. The second document—purporting to state the Fed's strategy and long-term goals—is likely to receive far less attention. In past years, it recited vacuous truisms and provided neither constructive guidance nor any meaningful constraint on the Fed's discretionary impulses.

Let's hope the Fed takes the opportunity this year to announce a practicable long-term strategy and stick to it. I am afraid, however, this won't happen. The central bank has offered plenty of plans over the years. But too often these prove to be as fleeting as the seasons.

A year ago around this time, the U.S. stock market fell about 10%. The Fed reacted precipitously, reversing its announced plan for 2016 of four quarter-point rate increases. But when prices rallied near the end of the year, the Fed decided it wouldn't look good to let the moment pass without raising rates. It raised its key interest rate by a quarter point in December.



In late October, Fed Chair Janet Yellen expressed willingness to run a "high-pressure economy" to push the unemployment rate lower and inflation higher. Yet in a speech two weeks ago, she said that allowing the economy to run "persistently 'hot' would be risky and unwise."

Changes in judgment should be encouraged, but they ought to indicate something other than day trading or academic fashion. They must be rooted in strategy. Otherwise, the real economy winds up worse off. Short-term thinking and ad hoc measures by the Fed beget short-term reactions by financial firms, businesses and households. And eight years into the economic recovery, the long run is at hand.

In recent years, the rationale for the Fed's choice to loosen or tighten policy has been as nebulous as Justice Potter Stewart's famed definition of pornography: You know it when you see it.

The Fed's technocratic expertise is no substitute for a durable strategy. This make-it-up-as-you-go-along approach causes many Fed members to race to their ideological corners, covering themselves as hawks and doves. It causes economists to litigate a false choice between fixed policy rules and unfettered discretion.

The absence of an observable Fed strategy is also causing congressional leaders, understandably, to seek legislative changes in the central bank's mandate. Congress cannot properly oversee what cannot be understood and evaluated. Rigorous Fed oversight is of a piece with an independent central bank. Reforms are coming, one way or another.

What would a well-conceived, rigorously implemented Fed strategy look like? It would be clearly delineated and broadly measurable. Its goals would be within the scope of the Fed's policy tools, attainable over time and circumstance. Critically, the strategy would be squarely focused on the medium term, that is, the next several years. Here is what reform of Fed strategy might look like in practice:

First, the Fed should establish an inflation objective of around 1% to 2%, with a band of acceptable outcomes. The current 2.0% inflation target offers false precision. According to the Fed's preferred measure, inflation is running at 1.7%, only a few tenths below target. The difference to the right of the decimal point is too thin a reed alone to justify the current policy stance. It also undermines credibility to claim more knowledge than the data support.

Second, the Fed should adjust monetary policy only when deviations from its employment and inflation objectives are readily observable and significant. The Fed should stop indulging in a policy of trying to fine-tune the economy. When the central bank acts in response to a monthly payroll report, it confuses the immediate with the important. Seeking in the short run to exploit a Phillips curve trade-off between inflation and employment is bound to end badly.

Third, the Fed should elevate the importance of nonwage prices, including commodity prices, as a forward-looking measure of inflation. It should stop treating labor-market data as the ultimate arbiter of price stability. The cost-push wage inflation of the 1970s is fundamentally different from the later-cycle wage increases that we're starting to see now. A material catch-up in wages after a long period of stagnation need not trigger a panicky response.

Fourth, the Fed should assess monetary policy by examining the business cycle *and* the financial cycle. Continued quantitative easing —which Fed leaders praise unabashedly—increases the value of financial assets like stocks, while doing little to bolster the real economy. Finance, money and credit curiously are at the fringe of the Fed's dominant models and deliberations. That must change, because booms and busts take the central bank farthest afield from its objectives.

Fifth, the Fed should institutionalize its new strategy and boldly pursue it with a keen eye toward the medium-term. Central bankers who vow allegiance to "data dependence" find themselves lurching to and fro according to undistilled, short-term noise. Instead, the Fed should adhere to a concept I would term "trend dependence." When the broader trends begin to turn—for example, in labor markets or output—the Fed should take account of the new prevailing signal.

A new Fed strategy would have the central bank acting as a responsible, forward-looking grown-up. Markedly better tax and regulatory policy is likely with the new administration. The Fed should recognize that American productivity, and potential economic growth, could improve significantly. Conversely, if economic trends turn south, the Fed needs a more credible, practicable strategy to respond.

In 1979, another consequential moment for the U.S. economy, Milton Friedman wrote to newly appointed Fed Chairman Paul Volcker that he was skeptical the Fed could "rise to the challenge without major changes in its method of operation." A change in the central bank's strategy and practice is no less essential today.

*Mr. Warsh, a former member of the Federal Reserve Board, is a distinguished visiting fellow in economics at Stanford University's Hoover Institution.*