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OPINION | COMMENTARY

How to Keep the Fed From Following Its Models off a Cliff

For one thing, governors should have varied life experiences to broaden the perspectives in the room.



The Federal Reserve building in Washington, D.C. PHOTO: GETTY IMAGES

By Glenn Hubbard

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Wednesday's decision by the Federal Reserve to raise the target for the federal-funds rate by 25 basis points has continued a debate about the tightening cycle. Yet these "Fed watching" discussions aren't necessarily productive. It would be better to rethink the Fed by evaluating its strategy, structure and accountability.

How can the institution be restructured to better achieve its goals of financial and price stability? The late economist Allan Meltzer, a scholar and historian of the Fed, gave the central bank high marks in these objectives in only about a quarter of its years in operation. An understanding of why the Fed succeeded and failed in the past is a natural guide to reform.

Economists emphasize two factors accounting for periods of Fed

failure: political influence on Fed decisions and adherence to false models of the financial system and the economy. In the first, the Fed's balance sheet or regulatory power may be hijacked in service of the government's near-term electoral or fiscal objectives. In the second, ignorance of economic conditions or doctrinaire attention to false models may blow Fed policy off course.

Independence, sometimes put forth as the key insulation against politicization of the Fed, has not proved sufficient to guarantee stability. Policy errors during the Great Depression, the inflationary period of 1965-79, and the accommodative run-up to the 2007-09 financial crisis all occurred during times of substantial independence. Nor is ostensible freedom an antidote to politicization, as political pressures certainly figured in the 1960s and '70s.

Milton Friedman recognized the limits of independence—given the choice of an independent central bank with complete discretion, a commodity standard, and a monetary rule, he chose the rule. For today's debate, I would say an institution capable of executing a framework for price and financial stability needs independence from formal government control. But such a framework must be clear and credible at all times: specifying an analytical approach, laying out how departures from normal financial and economic conditions will be addressed, and explaining those departures when they occur. Call it “maintain and explain.”

Structural reforms of the Fed can mitigate political influence. First, a credible, simple monetary framework can offer significant insulation from political pressure, while increasing the likelihood of success in achieving the Fed's objectives. Inflation targeting—that is, a commitment to conduct monetary policy consistent with a target long-run inflation rate—is a familiar example for a goal. Likewise, the Fed should describe the balance-sheet size it believes it requires for the conduct of monetary policy. And it should spell out mechanisms it will use in lending during times of stress or crisis.

The Fed should also specify an operating framework. This could include, for example, following a variant of the Taylor rule, which sets an ideal level for the federal-funds rate based on output and inflation. Another crucial step: a mechanical path for normalization of the balance sheet and clarity about the assets the Fed will hold. Limiting itself to only Treasury securities, for example, would prevent opportunities for political pressure to be brought on the Fed not to acquire or sell them.

Allowing Fed officials discretion to deviate in times of stress would enhance their credibility—but only if such decisions are explained clearly in advance and are consistent with the overall framework. This

maintain-and-explain process would enhance understanding of the Fed's success in achieving its objectives and enforce accountability when it is not. Such discretion also would grant flexibility in monetary policy and lender-of-last-resort actions in periods of stress.

While a clear and consistent framework gives the Fed a strategy, structure remains important. Giving the Fed a larger role in financial regulation has proved to be fraught with opportunities for political pressure, since elected officials can review such regulatory actions. This was the case after the financial crisis, when the Fed's regulatory power expanded and its political scrutiny did too.

Strategy and structure matter, but ultimately personnel is policy. Including regional bank presidents in the Federal Open Market Committee brings intellectual and political diversity to the Fed decision-making process. Choosing Fed leaders committed to the maintain-and-explain framework and to resisting political influence is essential as a last line of defense.

The false-model account of Fed failure played a role in the Great Depression, the inflationary '60s and '70s, and the pre-financial-crisis years. During the Depression a failure to discriminate between real and nominal interest rates, as well as the now-discredited "real bills doctrine," were enabling failures. The Fed's emphasis on the simple Phillips curve also built in a policy bias toward accelerating inflation several decades later. And the Fed from 2002-05 placed too little weight on financial imbalances encouraged by an easy-money policy.

Three steps can bolster defenses against false models. The first is to strengthen research inside and outside the Fed on the integration of finance and monetary policy and the economy, an intellectual gap exposed by the financial crisis. Second, Fed officials should interact more with market participants and businesspeople to understand financial innovations and economic developments better. Policy should be more reflective of proactive data gathering than reactive data dependence. Finally, Fed governors should be chosen with varied life experiences to broaden economic perspectives and encourage a healthy skepticism about prevailing models.

The Fed faces a challenge in crafting and explaining normalization of the extraordinary measures undertaken during the financial crisis. There is now also an opportunity to make personnel decisions that shape the Fed's strategy, structure, and accountability. Fortunately, experience with Fed success and failure offers a road map.

Mr. Hubbard, dean of Columbia Business School, was chairman of the Council of Economic Advisers under President George W. Bush.

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