MarketWatch

Maybe a computer could replace the Fed’s Janet Yellen?

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Economist Milton Friedman was in favor of replacing the Federal Reserve with a computer. Maybe he was on to something.

The Nobel prize winner wasn’t dismissing the role of the central bank in providing a stable macro-economic environment. To the contrary, as a monetarist he wanted the Fed to increase the stock of money at a constant, 3%-5% rate a year, a task he thought a computer quite capable of performing.

The Fed’s lagged response to the 2008 financial crisis and an anemic recovery since then have given a new sense of urgency to the quest for a monetary rule or rules.

For economists, the main benefit of a rule is to make monetary policy transparent and predictable. Everyone knows where the ship is headed and can plan accordingly.

A rule could serve another purpose as well: It would enhance communication without having to utter a single word. As it now stands, the Fed just can’t seem to convince financial markets that a rate increase is in order.

“Yes we can,” says the Fed.

“No you can’t,” says the market.

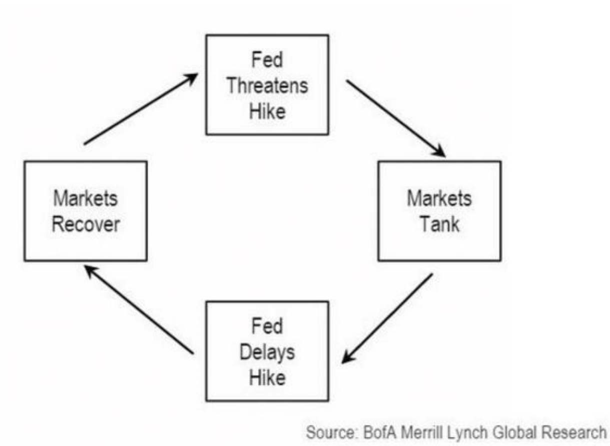
This dialogue between the Fed, which is eager to normalize its benchmark rate, and financial markets has been going on for quite some time. First came the “taper tantrum” in the latter half of 2013. The suggestion by former Chairman Ben Bernanke that the Fed would begin to slow its pace of asset purchases sent 10-year Treasury yields soaring by more than 100 basis points.

Last year, the Fed’s intended rate increases were rolled forward from one meeting to the next, for one reason or another. In September 2015, “global and economic financial developments” intervened to upend the Fed’s best laid plans, reducing a series of telegraphed rate hikes to a single, 25-basis-point increase in December.

This year has been more of the same. January began with a thud, as stock markets tumbled across the globe. Weak U.S. GDP growth in the first half of the year and a lousy employment report for May threw the Fed off track. Now a September rate increase is looking doubtful (perhaps due to the "high level of uncertainty" surrounding the presidential election?). The fed funds futures market has pared the probability of a hike at next week's meeting to 15%.

Last week, the Mercatus Center at George Mason University and the Cato Institute co-hosted a conference on monetary rules. It couldn't have come at a better time. The economists who participated in the forum talked about the evolution of monetary rules, from the gold standard to inflation targeting; proposals for a better rule, such as a nominal GDP target; the relative effectiveness of rules versus discretion; and the idea of holding central bankers accountable for any rule they adopt.

The discussion didn't touch on the current predicament in which the Fed finds itself, talking up a rate hike and then failing to follow through when stocks tank or the fed funds futures market casts a veto. (Whether the Fed should even be considering another rate increase is another question.) In the process, the Fed has lost credibility.



The rules versus discretion debate is hardly new. Whether designed to stabilize prices (Henry Simons, 1936), stabilize money supply growth (Friedman, 1958), or achieve a desired real rate by adjusting the nominal rate in response to changes in inflation and output (John Taylor, 1993), a rules-based system should be the ideal for central bankers.

Alas, many policy makers are reluctant to give up the flexibility to respond in the event of large shocks to the economy. They need to look at the bright side of a rules-based system.

The adoption of a policy rule would take the onus off the Fed, reducing it to an agent, not a decision maker. It would give policy makers an easy out in the case of an adverse market reaction or an unexpected outcome. "You don't like what we did? Too bad. We were just adhering to the rule."

Doesn't the Fed already have a rule of sorts? The Fed has a dual mandate from Congress: maximum employment and stable prices. It was only in 2012 that the Fed qualified "stable prices" as an explicit 2% inflation target. "Maximum employment" still offers lots of wiggle room.

So how is the Fed doing?, as the late New York City Mayor Ed Koch might have asked.

The Fed's preferred measure of inflation — the personal consumption expenditures price index — has undershot the 2% target since May 2012.

"Central banks have adopted an inflation target, but they did so without articulating a strategy for how to achieve it," said Robert Hetzel, a senior economist at the Richmond Fed, who presented a paper at the Mercatus/Cato Conference.

On the employment front, the current 4.9% unemployment rate has traditionally been associated with full employment. But as Chairwoman Janet Yellen often notes, that rate is not an accurate reflection of the degree of slack in the labor market because of the large number of people who have stopped looking for work.

Academic economists can debate the pros and cons of various rules, whether or not they should be imposed by the legislature, and to what extent central bankers should have the leeway in implementation, something known as "constrained discretion."

For those of us who have listened to the Fed tee up a rate hike month after month, only to watch an ex-ante market reaction throw the Fed off course, a rule would provide some clarity: some real forward guidance. What we have right now is just noise.