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Why rules won't tame the Federal Reserve

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Less than a year into his tenure as Federal Reserve chair, Jerome Powell faces a crisis of confidence. He would be well-advised to follow his instincts and allow interest rates to rise, despite political pressure and despite the admonitions of D.C. think tanks and their fetish for technocratic "rules-based" monetary policy.

An off-hand remark from Mr. Powell in October about interest rates being "a long way" from neutral was enough to send the S&P 500 briefly into a 10 percent tailspin. In the two months since, markets across the world have flashed red. Global trade growth has slowed, commodity prices are in decline, and both U.S. housing and equity prices veer toward significant corrections.

Meanwhile the U.S. Treasury yield curve recently inverted for the first time in a decade. Federal deficits and debt have soared under the Trump administration, prompting former Fed Chair Alan Greenspan to warn of stagflation and a "very extraordinarily subdued economy." Heading into Christmas, the retail outlook brings more gloom than cheer, as brick-and-mortar chains like Dick's Sporting Goods, Lowe's and even Whole Foods struggle.

As a result of all this Mr. Powell's commitment to a series of rate hikes is wavering, judging by his recent remarks at the Economic Club of New York. Many praise this backpedaling as pragmatic, proof of a data-driven approach from a chairman who responds to the real world. Others insist it's a tacit admission the economy is much softer than advertised and a warning sign for investors.

Either way, one hopes Mr. Powell sticks to his guns and his earlier commitment to tightening in the face of bad economic news. He certainly will face pressure, and not only from President Trump and Congress. Nearly the entire think-tank chorus sounds alike when it comes to monetary policy: The Brookings Institution, the American Enterprise Institute, the Heritage Foundation, the Mercatus Center, and the Cato Institute all offer up some version of rules-based policy.

They all agree the Fed should monitor economic conditions and adjust rates and liquidity accordingly, based on previously-determined "rules" or statistical targets. Even Paul Krugman reluctantly concurs, having indicated his willingness to support "expectations-based" policies as our imperfect "best hope."

The allure of rules-based policies stems from their simplicity and seeming substitution of rational, objective policy levers in place of flawed human decision-making.

The best-known rules-based approach is the Taylor Rule, named for Stanford professor John Taylor. The Taylor Rule attempts to determine when and how much the Fed should raise or lower the targeted federal funds rate depending on inflation, preventing sluggishness or overheating. It applies a mathematical formula based on inflation rates and GDP. The nominal interest rate should respond to differences between actual and targeted inflation rates, with frequent adjustments by the Fed to steer the ship.

There are other approaches. Nominal GDP targeting, currently in vogue among some academic monetary economists, attempts to smooth out economic cycles by targeting the total amount of nominal spending in an economy rather than inflation.

Both the Taylor Rule and nominal GDP targeting share a rules-based approach with earlier monetarists like Milton Friedman, who argued for a fixed monetary rule to determine increases in the money supply.

Several problems with rules-based monetary policy present themselves. First, measures like CPI and GDP are nearly not as cut and dried as we imagine. The great 20th century economist Ludwig von Mises called inflation indices "at best rather crude and inaccurate illustrations of changes which have occurred."

Second, rules are meant to be broken. Rules-based proposals are relatively complex and not particularly suited to winning over Congress. It's one thing to legislate a broad dual mandate for the Fed and hope for the best. It's another to reach bipartisan agreement on the Taylor Rule and mandate its execution by law. Rules-based proposals are likely to become internalized Fed policies at most, not laws.

But as we've seen, policy rules tend to go out the window in times of economic crisis. Fed chairs do not serve in a vacuum; politics and current events often lay waste to the Fed's vaunted independence. Only Paul Volcker and William McChesney Martin seemed to have resisted the bidding of unhappy presidents.

Marriner Eccles radically restructured the Fed in the 1930s to remove constraints on setting interest rates and expanding the money supply, openly showing his political support for New Deal programs. Alan Greenspan famously responded to the 1987 stock market crash with the infamous "Greenspan Put" policy, a de facto guarantee of monetary liquidity to prevent prices from dropping further. And Ben Bernanke took Fed policy into utterly uncharted territory in response to the 2008 financial crisis, adding trillions to the Fed's balance sheet and ushering in an era of seemingly permanent "extraordinary" monetary policy.

Do we really think Mr. Powell or a future Fed chair will stick to rules or targets when faced with the next crisis?

Finally, monetary rules don't truly get at the heart of things. Technical analysis and mathematical formulas only obscure the complexity and human fallibility of the real world. Mr. Powell and company are tasked with determining the "best" monetary policy for 320 million Americans with widely diverse interests.

Chairman Powell should be commended for his earlier commitment to tighter monetary policy, with rising rates and more aggressive unwinding of quantitative easing. No sustainable economic growth is possible in an environment of low- or near-zero interest rates; the Eurozone has learned this the hard way.

The answer to our coming economic woes lies in recognizing that no monetary policy tinkering can replace the fundamental corrections that must take place: bankruptcy, liquidation and restructuring of firms to clear out bad debt; higher interest rates to encourage capital formation and discourage more malinvestment; an end to direct bailouts by Congress and roundabout bailouts by the Fed; and a serious program of spending and debt reduction in Washington that spares neither entitlements nor defense.

Mr. Powell cannot do this by himself. But he can do a lot, starting with a renewed commitment to tighter monetary policy that ignores "the market," ignores the think tanks and ignores political pressure emanating from the Trump administration. Insiders say Mr. Powell is remarkably well-read and not dogmatic. He would not flinch at the notion of malinvestment. He is about to be tested; let's hope he responds more like Paul Volcker than Ben Bernanke.