Debate over Monetary Rule Should Trump Labor Market Conundrum

Lawmakers and the public must get involved with discussion over whether Fed should move from role as activist to one limited by rules

By James A. Dorn
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This year's symposium at Jackson Hole, Wyoming, sponsored by the Federal Reserve Bank of Kansas City, focused on the difficulties faced by monetary policymakers in reading the tea leaves of labor market conditions and thus the puzzle of when the federal funds target rate should be increased.

As early as July, Richard Fisher, president of the Federal Reserve Bank of Dallas, stated: "I believe we are at risk of doing what the Fed has too often done: overstaying our welcome by staying too loose, too long." Most economists, however, believe the fed fund target rate won't be increased until mid-2015.

St. Louis Fed President James Bullard questioned that assumption at the Jackson Hole meeting. In an interview with Bloomberg's Kathleen Hays, he predicted rates would begin to increase near the end of the first quarter of 2015 and that the Fed would use its overnight reverse repo facility to engineer the rate increase.

In her keynote address, Federal Reserve Board Chairwoman Janet Yellen noted that "our understanding of labor market developments and their potential implications for inflation will remain far from perfect. As a consequence, monetary policy ultimately must be conducted in a pragmatic manner that relies not on any particular indicator or model, but instead reflects an ongoing assessment of a wide range of information in the context of our ever-evolving understanding of the economy."

The Fed's dual mandate of maximum employment and price stability means the Federal Open Market Committee (FOMC) must forecast the degree of slack in labor markets as well as determine how best to achieve long-run price stability. If Congress amended the Federal Reserve Act to limit the Fed to a single mandate of achieving stable prices – that is, safeguarding the purchasing power of the dollar – monetary policy would be simple and pragmatic; it would recognize the limits of what the Fed can actually accomplish. In

particular, a simple monetary rule would significantly reduce reliance on macro-models and forecasting.

In this sense, the Jackson Hole symposium on "Re-evaluating Labor Market Dynamics" would have been better directed to the debate over rules versus discretion in the search for stable-valued money, rather than how discretionary monetary policy might manipulate interest rates to achieve full employment. Questioning the status quo, however, is not at the top of the Fed's policy agenda.

Today, U.S. monetary policymakers face considerable political pressure to do something that is beyond their capabilities: namely, predict the gap between full employment and actual employment, also known as the "output gap." To do so would require a perfect understanding of the structure of the real economy and thus the "slack" in labor markets, or the potential output of the U.S. economy when all resources are fully employed. The reality is that no one has such detailed information; there is no crystal ball available to policymakers.

Yellen, unlike Charles Plosser, head of the Federal Reserve Bank of Philadelphia, is not in favor of a monetary rule that would bind the Fed. She prefers wide discretion and favors holding the fed funds target rate close to zero "for a considerable time," as do most members of the FOMC. Nevertheless, at the Jackson Hole meeting she warned that "if progress in the labor market continues to be more rapid than anticipated by the committee or if inflation moves up more rapidly than anticipated, resulting in faster convergence toward our dual objectives, then increases in the federal funds rate target could come sooner than the committee currently expects and could be more rapid thereafter."

According to Yellen, there is no "preset path" for monetary policy, which means there is no rule to guide policy. Congress has delegated enormous power to the Fed and has abandoned its responsibility for maintaining the value of the dollar, as required under Article 1, Section 8 of the U.S. Constitution.

Maintaining artificially low interest rates, allocating credit and monetizing U.S. government debt are at odds with sound money and finance. After more than five years of near zero short-run interest rates and with current real rates on longer-term Treasuries also near zero, the Fed is distorting capital markets and inflating asset prices as investors reach for yield. Firms with junk bonds are obtaining credit while smaller start-up firms are having great difficulty obtaining funds for investments that would increase jobs and real wages.

There is no magic wand: the Fed's unconventional monetary policies have not led to full employment and cannot do so in the long run. If labor market "slack" is due to minimum wage laws, unions that overprice labor services, onerous regulations that increase the cost of hiring workers, and other structural factors (such as an aging population), pumping up the monetary base and suppressing interest rates can't solve the labor market conundrum.

Reducing taxes on capital, improving the education system by increasing competition and choice, reducing barriers to entry, improving the regulatory climate, and reducing the size of government to release resources for private-sector development are much surer routes to full employment than Fed fine-tuning.

Wage growth is slow because labor productivity growth is slow as a consequence of the negative forces that impair economic freedom, not because there is insufficient aggregate demand. Real economic growth in the age of laissez-faire during the classical gold standard was robust and resulted in prosperity along with gently falling prices ("good deflation"). The problem today is not lack of aggregate demand but the lack of economic freedom.

Congress is finally waking up to the dangers posed by pure discretionary government fiat money. The "Federal Reserve Accountability and Transparency Act" (H.R. 5018) was recently introduced by Republican Representatives Scott Garrett and Bill Huizenga, and has been voted out of the House Financial Services Committee. Earlier this year, the committee's chairman, Republican Representative Jeb Hensarling, announced the "Federal Reserve Centennial Oversight Project," intended to subject the Fed's history to public scrutiny and engage the debate over rules versus discretion. Indeed, H.R. 5018 is designed to reduce monetary uncertainty by substituting a rule-based regime for pure discretion.

Under the proposed legislation, the Fed would be able to choose among alternative monetary rules but would be required to adopt the "Taylor Rule" as a benchmark. That rule, if adopted, would require the Fed to increase its nominal interest rate target to 4 percent, assuming an inflation target of 2 percent and a long-run real rate of 2 percent. Today real short-run rates are negative, after taxes.

The Fed would still have significant discretion under the proposed monetary regime: no one would be liable for departing from the adopted rule; the dual mandate would continue complicating/politicizing monetary policy; and uncertainty would persist about the future path of policy because policymakers would still depend on macro-forecasting for estimating the output and inflation gaps, as well having to make assumptions about the equilibrium real fed funds rate (the so-called natural rate of interest).

There are many rules the Fed could choose from, including a simple money growth rule, a price level rule, an inflation target and a nominal demand rule, in addition to the Taylor Rule that would target a fed funds rate. Of course, one rule that is ruled out by most economists, but that has a historical precedent, is a convertibility rule based on defining the dollar in terms of gold or silver. The classical gold standard is consistent with the U.S. Constitution and with long-run price stability. It should be part of the debate over alternative monetary regimes.

Moving from an activist central bank in a fiat money world to one constrained by a monetary rule is a topic that is too important to leave to central bankers. Congress and the public must get involved. The 100th anniversary of the Fed is an opportune time to

begin the debate over rules versus discretion and to consider alternatives to pure discretionary government fiat money.

James A. Dorn is vice president for monetary studies and a senior fellow at the Cato Institute in Washington