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The Fed's Incredible Rate Forecasting Hubris

James A. Dorn is a monetary specialist at the Cato Institute. Here, he argues that the Federal Reserve has no business manipulating interest rates.

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The Federal Reserve's decision to provide multiyear forecasts for the federal funds rate, and to indicate when that rate might be increased is intended to improve monetary policy by making it more transparent. Currently, the Fed funds rate is close to zero and is expected to remain there until at least mid-2013.

With the Fed's new policy, a small group of experts—the Board of Governors and the presidents of the twelve Federal Reserve Banks—will individually report their longer-run projections for the target federal funds rate they think is consistent with their dual mandate to maintain price stability and achieve full employment.

In principle, the Fed hopes the new policy will convince markets that short-term rates will stay low for the foreseeable future. That "guidance" is expected to lower longer-term rates, stimulate economic growth, and lower the unemployment rate— without igniting inflation.

The problem is that the Fed's dual mandate is flawed and the Fed has no business manipulating interest rates, which are relative prices best set by millions of counterparties in free capital markets. There are limits to what monetary policy can accomplish and to forecasting random variables like interest rates and asset prices.

Monetary policy cannot have any permanent effect on economic growth, which is determined by real factors; but rapid growth of money and credit can cause inflation, erode the value of the dollar, and increase uncertainty. The belief that larger data sets and fancy forecasting models (such as the dynamic stochastic general equilibrium models used by the Fed) can generate better forecasting and improve the conduct of discretionary monetary policy is naïve. Adding short-run interest rate forecasts to the Fed's summary economic projections each quarter does not guarantee sound money.

When the Fed holds short-run interest rates at artificially low levels for a prolonged period, as it has, and forecasts that rates will continue to be low for an indefinite period, it is not necessarily binding itself to some target Fed funds rate—but it is distorting the structure of interest rates and thus affecting the allocation of investment funds that would have occurred in competitive capital markets.

The Fed's new policy continues the financial repression that helped bring about the 2008 financial crisis. Yet, after two rounds of quantitative easing and tilting the Fed's portfolio toward longer-term securities, unemployment remains stubbornly high while headline inflation is more than 3 percent.

The Fed's focus on forecasting is misplaced. The real focus should be on letting markets set relative prices, including interest rates, and adopting a monetary rule to protect the long-run value of money. By drifting into the realm of fiscal policy and allocating credit, the Fed has lost credibility. And by pretending that interest-rate forecasting—without any clear monetary rule—will improve policy, the Fed is setting itself up for failure.

Sound money is not produced by better forecasts under a pure fiat money regime; it is generated by a monetary standard in which there is certainty about the future value of money. As W. Lee Hoskins, former president of the Federal Reserve Bank of Cleveland and a proponent of zero inflation, has argued, "The key to effective policy is not the accuracy of economic forecasts but rather the credibility and predictability of policy actions." A rules-based monetary regime is superior in this sense to the present discretionary government fiat money system.

The use of the Fed to peg nominal interest rates at artificially low levels, fine tune the yield curve, incentivize risk taking, monetize government debt, and inflate selected asset prices by allocating credit are deviations from sound money and free markets. Instead of promoting financial stability, such policies foster uncertainty and politicize money and credit.

There are many types of monetary rules under a fiat money regime that could reduce uncertainty, but most rely on some degree of forecasting. Adopting a convertibility rule, however, such as existed under the classical gold standard, would result in a forecast-free monetary regime. The market (meaning millions of private traders, not a few experts at the central bank) would determine the optimal quantity of money, as well as the efficient array of interest rates that reflect consumers' time preferences and the productivity of

investment.

Under a genuine gold standard, the money supply responds automatically to the demand for money, and the value of money is anchored by defining the dollar in terms of gold. The credibility of the convertibility principle/rule lent certainty to the monetary standard. Creditors had confidence in the long-run value of the currency. Thus, during the era of commodity money in England, lenders were willing to float bonds (consols) without any redemption dates, and interest rates remained relatively low and stable.

Today, in a pure fiat money regime, there is no guarantee of the dollar's future value. Indeed, since President Nixon closed the gold window in 1971, the U.S. price level has drifted upward, sometimes rapidly, eroding the purchasing power of the dollar.

The Fed's hubris that it can somehow divine the path of real economic variables, determine the optimal quantity of money, and discern the Fed funds rate that will bring about price stability and full employment cannot be taken seriously. Central banking, like central planning, cannot hope to duplicate efficient market prices and the dynamic market process. Monetary policy is not a panacea, as even Ben Bernanke admitted.

It's time to move from the elusive goal of trying to perfect macroeconomic forecasting and fine-tune monetary policy to the goal of making the transition to a forecast-free monetary regime that relies on the convertibility principle and spontaneous market order, rather than trust in discretionary fiat money.

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