# The Federal Reserve needs to explain why it will raise rates

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With near certainty, the Federal Reserve will raise its interest rates at this week's Federal Open Market Committee meeting, marking the third rates rise this year, in keeping with its monetary policy normalization plans. But the Fed's case for raising rates is shaky, as it has yet to articulate a consistent case for raising its policy rates, while the most reliable economic indicator does not justify this hike. The Fed has offered three possible reasons for raising rates. But each is problematic.

The first reason is the Phillips Curve model, which is an economic theory guiding Fed policy that says there are certain tradeoffs between the unemployment rate and inflation. One tradeoff is that when unemployment is below a certain level then the inflation rate should increase. This combination of low unemployment and accelerating inflation would call for tighter monetary policy with higher interest rates.

This is not happening today. The unemployment rate has declined steadily since the end of the Great Recession. Last week's employment report from the Bureau of Labor Statistics had an unchanged 4.1 percent unemployment rate, though job creation exceeded estimates by economists. Yet, measured inflationhas fallen this year, to 1.4 percent off a January high of 1.8 percent.

The Phillips Curve relationship is simply not in the data. Fed Chairman Janet Yellen has admitted this, as has Fed Governor Lael Brainard. Minneapolis Fed President Neel Kashkari has gone so far as to identify the continued reliance on the Phillips Curve as "faith-based" monetary policy. Yet, the Phillips Curve remains a key analytical tool for the FOMC. Because the Fed continues to rely, in part, on the Phillips Curve to set monetary policy, the simultaneously low unemployment and inflation numbers have forced more exotic explanations, particularly for inflation.

The second reason the Fed offers for raising rates is that the inflation data are being driven by "transitory" factors. However, the Fed has been citing transitory factors for at least the length of Yellen's tenure as Fed chairman. Since adopting its explicit and symmetric 2 percent inflation target in 2012, the Fed has routinely undershot it, almost without exception, citing transitory factors as the cause year-after-year. In 2014, it was temporary movements in oil prices.

Then in early 2015 it was declining import prices and dollar strength, which were joined by falling energy prices toward the end of the year. Yellen's prepared remarks at all four press conferences in 2016 pointed to transitory factors affecting the inflation data. In June of this year, Yellen pointed to changes in wireless plans and prescription drugs as inflation headwinds. In testimony last month, Yellen modified the Fed's storyline, acknowledging that this year's inflation data were "surprisingly subdued" and even "puzzling."

But then she reiterated that there may be a "number of transitory or idiosyncratic factors" holding down inflation. This repeated sequence raises an obvious question: How can the Fed be certain that the scheduled path of rate increases is consistent with its inflation target, while simultaneously becoming less and less certain about what causes inflation?

Lastly, Fed officials routinely claim that monetary policy effects the economy with a lag, making the current path of rates hikes necessary to prevent problems in the future. Lags certainly exist in some of the economic data the Fed looks at when setting policy. But it's not necessarily the case for other data, such as nominal gross domestic product.

As a simple, direct measure of overall economic activity in the economy that incorporates information about prices, production, wages and employment, nominal GDP more readily reflects the changing stance of monetary policy. That makes it a better metric to judge Fed policy and its effectiveness. A proper monetary policy would keep nominal GDP growth steady.

Over the last two years, leading up to and continuing through the Fed's tightening cycle, nominal GDP growth has averaged just over 3 percent. In contrast, during the two prior years, nominal GDP grew at more than 4 percent. The data reveal the contractionary impact of current Fed policy. It is critical to note, even an unwise rates hike of only 25 basis points will not crash the economy. But a persistent course of policy rates increases, as shown in the Fed's projections, is concerning.

When justifying raising rates now, the Fed likes to cite a model, the Phillips Curve, that even its members admit does not fit the data. The Fed also has an inflation target, which it has routinely undershot for the better part of six years. While the board claims its policy works with lags, the most reliable indicator of the stance of monetary policy, nominal GDP, is already showing the contractionary impact of the Fed's policy decisions.

The Federal Reserve has not articulated a coherent case for the path of rates increases. Meanwhile, the most reliable indicator for judging monetary policy is signaling that its plan will result in further monetary tightening, or worse, even recession.

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