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# Don't Ask If The Fed Will Raise Interest Rates, It's The Wrong Question

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The Federal Reserve's Federal Open Market Committee is scheduled to meet this week and, as usual, the media is abuzz. Some note falling stock prices. Some comment on policy uncertainty. But all are concerned with one question: Will the Fed raise the interest rate?
As I have previously pointed out, the Fed does not set the federal funds rate. Rather, it sets its federal funds rate target and then engages in open market operations based on how its target compares to rates observed in the federal funds market. Still, asking whether the Fed should increase its interest rate target in the near term is the wrong question. It is a lot like asking how much force one should apply to the brake while driving blindfolded. Instead, we should settle debates over the Fed's long-term vision by requiring it to commit to a nominal income level target.

Interest rate targeting is fraught with problems. In a perfect world, the Fed would set its target equal to the market clearing—or, natural—rate of interest. But the natural rate of interest is not observable and there is little agreement about how high it is at the moment. The Fed is therefore left guessing how high its target should be. This is a problem because if it sets its target too low, open market operations are likely to encourage overproduction. On the other hand, if it sets its target too high, open market operations are likely to encourage underproduction. Errors in both directions make us worse off on net.

To make matters more difficult, the natural rate of interest is not stable over time. When productivity growth is higher than normal, businesses tend to borrow more to take on new profitable projects. Naturally, this pushes the market-clearing rate up. When productivity growth is lower than normal, businesses tend to borrow less and the market-clearing rate is lower. So, if you are committed to interest rate targeting, Ron Popeil style monetary policy is not an option. Continuous fine-tuning is a must.

Let's recap: The Fed is trying to set its interest rate target equal to a natural rate that (1) it cannot observe and (2) is constantly in flux.

Good luck, Janet Yellen.

A better option would be to target the level of nominal income. Under such a rule, the Fed announces in advance that it will conduct open market operations to maintain a path of nominal income, where the level of nominal income along the path grows at a steady rate of, say, 5% per year. If it fails to hit its target in one period, it will have to make up for its error to return to the path in the next period. Unlike the natural rate of interest, the ideal nominal income path (1) is observable and (2) doesn't change.

Fans of the current interest rate targeting regime will point out that nominal income data is available with a lag, whereas the Fed can see market rates of interest in real time. But observing interest rates in real time is only useful insofar as the Fed knows what those market rates should be—which is to say, not very useful at all. Moreover, the Fed could observe market expectations of nominal income if it were to establish a nominal income futures market. Such a market would eliminate much of the dreaded lag. And, perhaps more importantly, we could be confident under such a rule that the Fed is targeting a variable it can control at a level that is appropriate.

So let's end the misguided fixation with short-term interest rates. Let's commit to a nominal income level target and enjoy the long-run productivity gains that come with sound money.

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