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The Fed's Uncertain Leap Forward

Using forward guidance instead of a monetary rule once again leaves financial markets unsettled.

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As expected, the Federal Reserve on Wednesday announced that it would raise the target range for the federal-funds rate to between 0.25% and 0.5%. The decision raises more questions than it settles. Most involve uncertainty about future interest-rate changes, and some about technical or operational issues.

The Federal Open Market Committee's rationale for its decision offers clues about what may come next. Future decisions, the FOMC said, will be dependent on "a wide range of information." That by itself is not informative, but a reading of the entire news release suggests that continued improvements in labor-market conditions will be critical to future rate decisions. The first paragraph discusses the improvement in labor-market conditions. These conditions are also the first item mentioned in the list of information to be considered for monetary-policy decisions.

The Fed's dual mandate requires the FOMC "to foster maximum employment and price stability." The Fed is counting on the actual inflation rate to move up to its target rate of 2%. Thus far, inflation has stubbornly remained below that target. Fed officials are anticipating that tightening labor-market conditions will produce upward pressure on wage rates and then prices.

That analysis derives from the Fed's continued belief in the Phillips curve, the theory that there is an inverse relationship between the unemployment rate and the inflation rate. Like many economists, I think the reasoning behind the Phillips curve theory is flawed and has been discredited by the work of numerous researchers, of which Milton Friedman is the most notable. But it is fundamentally the Fed's model. Accordingly, improvements in indicators of labor-market conditions are important predictors of future Fed behavior.

Moreover, indicators of labor-market conditions are now carrying a double burden. They gauge how close the economy is to maximum employment (the first Fed mandate) and are being used to predict the inflation rate (the second mandate). I expect more than the usual week-to-week and month-to-month obsession with labor-market releases.

The problem with this is what it has always been. Measures of labor-market conditions are volatile and subject to revisions over time. Plus, the level of employment is not a variable that the Fed can determine in the long run. Once again, however, conditions in labor markets will be what the Fed will be focused on (although not to the exclusion of everything else).

What will the Fed do? If employment measures continue to improve and economic activity continues, in the words of the FOMC's news release, to expand "at a moderate rate," then there will be more such 0.25% moves. One risk to that scenario is mentioned in the release: "net exports have been soft."

The mere anticipation of the rate increase, plus weakness in other major economies, has already driven the dollar up on world currency markets. The strong dollar, plus global economic weakness, has dampened U.S. exports. Perhaps, then, the economy is not as strong as the FOMC now thinks.

This brings us to the timing of Wednesday's move. Fed officials, and especially Fed Chair Janet Yellen, have been signaling a rate increase for some time. They have painted the economic data in the best light. Yet global economic conditions have been softening in 2015. On conventional economic grounds, the decision to raise rates is dubious. But it may have been influenced by fear of a loss of credibility if the Fed failed to act.

If so, that is a bad reason to act. And it suggests that this rate increase could be "one and done," at least for a long time. That is the great risk to the scenario of gradual rate increases over the next one to two years.

Some uncertainty about future monetary policy is inevitable. The Fed has greatly added to that uncertainty by its decision to employ forward guidance rather than to follow a monetary rule. Unlike a rule, forward guidance reflects the thinking of policy makers today but does not bind them to action tomorrow. We have seen that play out through 2015. The chief effect of Wednesday's action and accompanying statement is to once again increase uncertainty in financial markets.

There also is one major operational question: How is the Fed going to effect an increase in the fed-funds rate—the interest banks charge each other for overnight loans?

In the past, the Fed would sell short-term Treasurys, soaking up bank reserves. That would put pressure on banks to fund their operations, and drive up the fed-funds rate as borrowing demand rose. In other words, the Fed decreased the supply of bank reserves to change a price, the fed-funds rate. But the Fed no longer holds any short-term Treasurys to sell. Normally, either the supply or demand for something must change in order to change a price.

The Fed's Board of Governors will raise the interest rate paid on reserves to 0.5% and the FOMC will offer a rate of 0.25% on reverse repurchase agreements. It remains to be seen how effective these actions are in raising the fed-funds rate, and what effect a higher rate will have on economic activity.

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