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At Long Last, the Fed Faces Reality

Gerald P. O'Driscoll, Jr.

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As was widely anticipated, Federal Reserve officials voted Wednesday to raise short-term interest rates by a quarter percentage point—only the second increase since the 2008 financial crash. The central bank appears to have finally confronted reality: that its unconventional monetary policy, particularly ultralow rates, simply has not delivered the goods.

In **a speech last week,** the president of the New York Fed, William Dudley, brought up "the limitations of monetary policy." He suggested a greater reliance on "automatic fiscal stabilizers" that would "take some pressure off of the Federal Reserve." His proposals—such as extending unemployment benefits and cutting the payroll tax—were conventionally Keynesian.

Speaking two weeks earlier at the Council on Foreign Relations, Fed Vice Chairman Stanley Fischer **touted** the power of fiscal policy to enhance productivity and speed economic growth. He called for "improved public infrastructure, better education, more encouragement for private investment, and more effective regulation." The speech, delivered shortly after the election, almost channeled Donald Trump.

Indeed, the markets seem to be expecting a bigger, bolder version of Mr. Fischer's suggestions from the Trump administration.

• *Infrastructure*: Mr. Trump campaigned on $1 trillion in new infrastructure, though the details are not fully worked out. The left thinks green-energy projects—such as windmill farms—qualify as infrastructure. Living in the West, I'd prefer to build the proposed Interstate 11, a direct line from Phoenix, to Las Vegas and then to Reno and beyond.

• *Education*: Nominating Betsy DeVos to lead the Education Department shows Mr. Trump's commitment to real education reform, including expanded school choice. Much of America's economic malaise, including income inequality and slow growth, can be laid at the feet of deficient schools. Although some students receive a world-class education, many get mediocrity or worse.

• *Private investment and deregulation*: Mr. Trump promises progress on both fronts. He is filling his cabinet with people—including Andy Puzder for labor secretary and Scott Pruitt to lead the Environmental Protection Agency—who understand the burden that Washington places on job creators.

Businesses need greater regulatory certainty, and reasonable statutory time limits should be placed on environmental reviews and permit applications. That, along with tax cuts, would do the trick for boosting investment.

All that said, central bankers have a role to play as well. The Fed's ultralow interest rates were intended to be stimulative, but they also squeezed lending margins, which further dampened banks' willingness to loan money.

There's a strong case for a return to normal monetary policy. The prospects for economic growth are brighter than they have been in some time, and that is good. The inflation rate may tick upward, which is not good. Both factors argue for lifting short-term interest rates to at least equal the expected rate of inflation. Depending on one's inflation forecast, that suggests moving toward a fed-funds rate in the range of 2% to 3%.

The Fed need not act abruptly, but it also does not want to get further behind the curve. Next year there will be eight meetings of the Federal Open Market Committee. A quarter-point increase at every other meeting, at least, would be in order.

This could produce some blowback from Congress and the White House. Paying higher interest on bank reserves will reduce the surplus that the Fed returns to the Treasury—thus increasing the deficit. But the Fed could ease the political pressure if it stopped resisting Republican lawmakers' effort to introduce a monetary rule, which would curb the central bank's discretion and make its policy more predictable. This isn't an attack on the central bank's independence, as Fed Chair Janet Yellen has wildly argued, but an exercise of Congress's powers under the Constitution.

The one big cloud that darkens this optimistic forecast is Mr. Trump's antitrade stance. Sparking a trade war could undo all the potential benefits that his policies bring. David Malpass, a Trump adviser and regular contributor to these pages, argues that trade deals like the North American Free Trade Agreement are rife with special benefits for big companies, but that they do not work for America's small businesses. The argument is that Mr. Trump wants to renegotiate these deals to make them work better. I hope Mr. Malpass is correct, and that President-elect Trump can pull it off.

But for now, a strengthening economy offers a chance to return to normal monetary policy. Fed officials seem to have come around to that view. With any luck Wednesday's rate increase will be only the first step in that direction.

Mr. O'Driscoll, a senior fellow at the Cato Institute, was a vice president at the Federal Reserve Bank of Dallas.