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COVER STORY

Critics study Fed for methods tied to motions

By Bill Montague
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WASHINGTON — As Federal Reserve policymakers prepare for a crucial huddle, a growing number of spectators are wondering: Does the team have a game plan or is the quarterback simply making it up as he goes along?

At the moment, many investors believe the latter. When the Fed's Open Market Committee gathers here Tuesday to decide whether to push up short-term interest rates, the outcome is widely expected to swing on the opinions of one man: Federal Reserve Chair man Alan Greenspan.

More than most Fed leaders, Greenspan has cultivated an image as an independent thinker, relying on his own reading of the economic tea leaves — even when they differ from the forecasts churned out by the Fed's own internal computer model. Time and again, investors and analysts have pounced on an obscure statistic simply because Greenspan has mentioned it.

In part, that obsessive focus is a reflection of Greenspan's reputation as an ace economic forecaster and his clout as Fed chairman. But it also stems from a widespread perception that the Fed currently lacks any clear rules for setting monetary policy.

"The Fed is operating under what I would call the Greenspan standard," says Lawrence Kudlow, economist for American Skandia Life Assurance. "There are no rules and no targets. It's a fun standard if you're Mr. Greenspan, but it leaves the rest of us guessing."

Appearances may be deceptive, however. A look at Fed policy during the 1990s shows that it closely tracks a simple guideline developed by John Taylor, an economist at Stanford University. Under Taylor's rule, the Fed should set its key federal funds rate based on a formula that takes into account the current inflation rate and the economy's potential for noninflationary growth. Except for a period in 1993, when the Fed was holding rates artificially low to ease a banking crisis, the federal funds rate has hewed closely to the level suggested by Taylor's rule.

"That is no accident," former Fed vice chairman Alan Blinder says. "I think the Taylor rule provides a pretty good statistical description of the Fed's policies under Alan Greenspan."

But for a number of reasons, both political and practical, Greenspan has downplayed the Fed's use of the Taylor rule or any other fixed guide to setting interest rates. That has increased his freedom to shape policy, but it also has made it harder for the Fed to respond to the storm of criticism generated by its March decision to raise its key federal funds rate by a quarter percentage point. That tempest is likely to reach hurricane force if the Fed raises rates again Tuesday.

Carping about the Fed is nothing new, but the current debate is raising questions that Fed policymakers appear unable — or unwilling — to answer. Relying on Greenspan's reputation may fend off critics for now, but Greenspan is expected to retire when his term as Fed chairman ends in 2000. His successor's opinions may not carry the same weight.

Ultimately, if the Fed doesn't do a better job of explaining the reasons behind its actions, it runs the risk of losing its credibility, some analysts warn. But if it does explain them, it creates political trouble in Congress. Both risks will rise dramatically if the Fed stumbles into a major mistake, like a recession.

Greenspan's dilemma

Why is the Fed caught in such a Catch-22? Partly because of the breakdown of some time-tested tools of monetary policy. During the 1980s, changes in the financial system radically altered the behavior of the money supply, rendering it largely useless as a predictor of inflation.

The problem: The Fed's entire strategy is based on a policy of trying to pre-empt inflation by raising rates well before wage and price pressures become visible in the economy. Greenspan and other Fed officials long have argued that such an approach is crucial because monetary policy works with a lag — typically six to 12 months. If the Fed waits until inflation actually rears its ugly head, it will be too late to stop it.

But to stay ahead of inflation, the Fed needs a rule for predicting it. "If you are going to have a pre-emptive strategy, you better be able to explain your reasoning," says James Annable, economist for First Chicago Bank. "Because if you don't have any clear theory of how inflation works, it's a foolish strategy."

In fact, the Fed does have a theory, even though Greenspan doesn't like to talk about it. It's called the Phillips Curve, named for the economist who developed it. Put simply, the theory is that there is a short-run tradeoff between unemployment and inflation. If unemployment falls low enough, wages and prices will start to rise faster, pushing inflation up. When that happens, the Fed's job is to raise interest rates to slow the economy. That pushes joblessness back to the so-called non-accelerating inflation rate of unemployment — or NAIRU, in economists' jargon. That's the unemployment rate at which the inflation rate is neither rising nor falling.

Publicly, Greenspan repeatedly has denied using NAIRU as a guide. But the Taylor rule, which the Fed appears to have followed closely, is just a variation on the theme. "The rule assumes you have some idea what the economy's potential growth rate is," Taylor says. "That's based on NAIRU."

Political trouble

For the Fed, however, any rule based on NAIRU creates two big headaches. The first is political. To many liberals, the idea of raising unemployment to fight inflation is abhorrent. Many conservatives, meanwhile, reject the entire Phillips Curve concept, which they associate with the liberal ideas of British economist John Maynard Keynes.

“We need to dispel this notion that growth means inflation,” says U.S. Rep. James Saxton, R-N.J., chairman of the Joint Economic Committee. “As long as the Fed is wedded to a Phillips Curve model, we are going to have these excessive fears of inflation in the markets.”

The other problem is practical. To use NAIRU as a guide, the Fed has to have a fairly precise idea of what it is. While Fed officials and staff economists have refused to disclose their estimate, the Fed’s actions the past few years appear to have been based on an assumption that NAIRU is close to 6%.

But that proposition keeps getting harder to defend. Unemployment has been below 6% for nearly three years, but inflation stubbornly refuses to accelerate. Nobody knows why, although there are plenty of theories, ranging from computerization to the growth of global trade.

That leaves Fed policymakers in an extremely awkward spot. The Fed could lower its estimate of NAIRU, but that would mean admitting it has one, which Greenspan seems reluctant to do. It also would require the Fed to defend its new NAIRU target, which may prove as defective as the old one. “Somebody came along and changed the strike zone,” says Annable. “Nobody knows where the new one is, but the umpire doesn’t want to stop making calls.”

The Fed’s little secret

Right now, the Fed’s preferred strategy seems to be to keep the old rule on the books, but ignore it. Over the past year, Greenspan has argued that temporary factors, such as lingering worker insecurity, are retarding inflation, allowing the Fed to hold rates. In a recent speech, he described the Fed’s March rate increase as “a form of insurance” against the risk those forces will fade, allowing the old inflationary relationships to resurface.

But even those who back that tactic say Greenspan needs to be more open about explaining why the Fed has a NAIRU rule, and why it is — or is not — following it. “The Fed likes to be mysterious about these things, but I think we would all be better off with a more transparent process,” Blinder says.

Some conservative critics want the Fed to junk the NAIRU concept. Instead, they argue, the Fed should establish specific inflation targets, and then set rates according to a clearly identified set of inflation indicators, such as the price of gold.

But setting targets won’t eliminate tough decisions about how to reach them, other economists say. That includes trying to find the balancing point between inflation and unemployment — even if Fed officials don’t know exactly where it lies.

“No rule is going to give you the perfect monetary policy,” Taylor says. “But without one, you’re just groping around.”