

Dean Croushore Blog About Monetary Policy

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Ten Key Issues Facing New FOMC Members

With four vacancies on the Federal Reserve Board that will be filled soon, we hope, and one new president at a Federal Reserve Bank, it is a good time to think about key issues the Fed must face in coming years. Future blogs will provide additional details on each of these issues.

1. The Fed needs better economic models. The Federal Reserve Board's FRB-US model is a good model for some situations, but is not very consistent over time, as Tetlow (2013) discusses. Like all extant macroeconomic models, it gave no indication of the scope of the financial crisis in 2008. Building a better model requires a major commitment of resources, as suggested by Bullard (2011).
2. The Fed needs to remain independent from political pressure. In the financial crisis, the Fed engaged in activities that may have compromised its independence, by purchasing securities issued by private-sector firms, as Lacker (2011) notes. This leads to the potential for politicians to have the Fed intervene in other private markets in the future, such as the market for student loans. The Fed should quickly exit from its ownership of the assets issued by Fannie Mae and Freddie Mac, as Plosser (2013) suggests. And the Fed should make it clear that it will never again purchase such securities.
3. The Fed needs to provide updated details on its exit strategy, laying out the details of how it will shrink its balance sheet in response to economic conditions. There is no doubt that the Fed has worked out such details but it has not shared them with the public, perhaps because the details might run counter to its forward guidance policy. With forward guidance, the Fed is trying to convince the public that it wants to keep interest rates lower than is likely to be sensible, which is a time-inconsistent policy, as Plosser (2013) notes. If the Fed is really committed to transparency, it should provide more details to the public and not hide them.
4. The Fed needs to improve the quality of its research departments. With over 500 economists in the Federal Reserve System, you might think that the system has enough economists. But the Fed's actions affect the entire world economy and its economic research is the key to making good decisions. Society's priorities seem misplaced when the top two soda companies employ over 250,000 employees to sell their products, but only 500 economists help make decisions with a major impact on the global economy. The financial crisis illustrated how our lack of economic knowledge could have a severe cost to society.
5. The Fed should continue to increase its transparency. Fed chairman Bernanke (2014) made transparency a priority and his commitment to transparency needs to be validated by Chairwoman Yellen as soon as possible. Monetary policy will be more effective if everyone understands what the Fed is doing. If the Fed can clarify its contingent policy plans, as Plosser (2014) suggests, people will understand policy more clearly. The Fed needs to keep its focus on the long run, given the long and variable lag in the effects of policy, and should not be concerned as much as it appears to be about the short-run financial market response to its policies. It should avoid the impulse to constantly intervene in the economy, as Lacker (2011) suggests.

6. The Fed should reconsider its abject fear of deflation. Deflation is associated with very bad economic conditions, as in the U.S. Great Depression or Japan's last 20 years. But what is the direction of cause and effect? If deflation is a symptom of banking problems, then fix the banking problems and not the inflation rate. Remember that Friedman (1969) showed that the optimal inflation rate is negative.

7. The Fed should provide public goods, just as any other government-related entity does. Economic data are public goods and the Fed provides some very important data, including industrial production and data on interest rates. The Fed should continue to create useful economic data, such as the Business Outlook Survey and the Survey of Professional Forecasters provided by the Federal Reserve Bank of Philadelphia, and the FRED economic data web site, provided by the Federal Reserve Bank of St. Louis.

8. The Fed needs to understand the limitations of policy, as Meltzer (1987) suggests. Our economic models are not sufficient to fine-tune the economy. The Fed can use policy to nudge the economy in the right direction in response to a large shock. But the Fed runs the danger of confusing the evolution of the economy for a shock and doing the wrong thing. For example, in the late 1990s, some policymakers wanted the Fed to pursue tighter policy because they thought the economy was overheating. But Fed chairman Greenspan correctly saw the situation as a technology boom that the Fed should not restrain by raising interest rates, and Greenspan was proven correct by subsequent events.

9. The Fed needs to do more about systemic risk; talk is not enough. Before the recent financial crisis, Fed Vice-chairman Donald Kohn (2006) spoke about how the Fed monitors systemic risk; but it was too late for the Fed to prevent the financial crisis. With the Fed's expanded powers under the Dodd-Frank Act, the Fed must develop a plan to not just ponder systemic risk, but to reduce it. Avoiding another financial crisis is far more important than any other role the Fed has.

10. The Fed needs to avoid over-reacting to the latest data. There is a tendency to put far too much weight on the most recent data but such data may be inaccurate. For example, the FOMC approved QE3 in September 2012 because it was worried about the economy weakening. The employment report for August was released just before the meeting and showed a gain of only 96,000 net new jobs, which is fairly weak. But subsequent revisions to the data showed that, in fact, net new jobs increased by 150,000 that month instead, so the economy was quite a bit stronger than the Fed thought at the time. The Fed has also been worried about low inflation, but research by Croushore (2008) shows that the inflation rate is likely to be revised up significantly from its initial release and inflation is not really as low as the Fed might think.

So, new FOMC members have a lot to think about. Let's hope they do so and are able to make progress on this long list of issues.

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