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One potential problem with the Fed's vote to raise interest rates: The Fed might not know how the economy works

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One potential problem with the Fed's vote to raise interest rates: The Fed might not know how the economy works

By Louis D. Johnston | 12/14/17

REUTERS/Jonathan Ernst

Outgoing Federal Reserve Chair Janet Yellen and the FOMC majority see the current 4.1 percent unemployment as a sign that the economy is near its potential and thus the economy needs to slow down to keep unemployment from falling further.

Janet Yellen chaired her last meeting of the Federal Open Market Committee (FOMC) on Wednesday. The meeting, during which the members set monetary policy, went as expected. A majority of the committee voted to raise the Federal Reserve's target range for short-term interest rates to 1¼ –1½ percent. And, as anticipated, Minneapolis Fed President Neel Kashkari dissented for the third time this year, arguing that there was no need for the Fed to raise interest rates.

Thus, for all appearances everything looks to be going smoothly as the Fed transitions from one chair to the next and continues to normalize monetary policy after the extraordinary actions it took after the 2008 financial crisis.

Unfortunately, things are not as calm and clear as they might appear. The Fed will soon have to face a problem: They don't know what causes inflation and therefore don't know what to do if it starts to rise or fall.

What causes inflation?

Perhaps I'm exaggerating. Economists know that high rates of money growth that are expected to continue for a long time cause high rates of inflation. Think of Weimar Germany in the 1920s, Russia in the early 1990s, or Zimbabwe and Venezuela in recent years.

We also know that there are two cures for this illness. One is to introduce a new currency, promise that the government will never engage in rapid money creation ever again, and then stick to that promise. Germany, for example, continues to follow this path. The other prescription is to take money creation out of the government's hands and use another country's currency. For instance, Zimbabwe in 2009 stopped printing its own currency and told its citizens to use dollars or euros for business transactions.

Inflation and the Phillips Curve

U.S. inflation is nowhere near the levels of 1920s Germany or contemporary Venezuela. Since 2008, U.S. inflation averaged less than 2 percent per year.

Over the past two years, the Fed worried that inflation might start to rise above the 2 percent target and started raising interest rates to prevent this from happening. The theory behind this strategy is known among economists as the Phillips Curve. The idea works like this: Low unemployment signals that the economy is operating at or near its productive capacity. This, in turn, causes wages and prices to rise at faster rates, causing higher inflation.

Chair Yellen and the FOMC majority see the current 4.1 percent unemployment as a sign that the economy is near its potential and thus the economy needs to slow down to keep unemployment from falling further. The way to do this is to raise interest rates and put the brakes on spending by households and businesses.

The dissenters at Wednesday's FOMC meeting, President Kashkari along with Chicago Fed President Charles Evans, argue that there are no signs of upward pressure on wages and prices and no indications that inflation is rising. Thus, the FOMC should wait until it detects these symptoms before raising interest rates.

But what if the Fed is wrong?

The FOMC is following the Phillips Curve logic, but there's a big problem: The Phillips Curve might be wrong. Economists such as Stephen Williamson and John Cochrane point out that empirical models based on the Phillips Curve don't fit the data and go on to argue that there is a very different process for inflation.

This view, known as Neo-Fisherism because it is based on a relationship first postulated by economist Irving Fisher, argues that the difference between interest rates that are not adjusted for inflation (what economists call nominal interest rates) and interest rates that are adjusted for inflation (known as real interest rates) equals the inflation rate. Thus, for a given level of real interest rates (determined by, for example, the profitability of capital investment), the inflation rate and the nominal interest rate move in the same direction at a one-to-one rate.

According to this view, the Fed is doing exactly the opposite of what it should be doing. To keep inflation low and stable, the Fed should be keep nominal interest rates low and stable. Instead, they are raising nominal interest rates and thus risking a higher inflation rate. Put more bluntly, if the Fed wants to keep inflation low and stable, they should follow the exact opposite policy of that suggested by the Phillips Curve.

The road from here

Right now, the danger of the Fed causing a spike in inflation is negligible. If the Neo-Fisherian view is correct, then raising interest rates by ¼ point won't cause inflation to rise by more than that.

The bigger threat is that the Fed is choking off the possibility of lower unemployment rates in a misguided attempt to prevent higher inflation. Thousands of Americans who might otherwise find work will find the way blocked by an excessively, and perhaps misguided, Federal Reserve.

Janet Yellen should leave a note for her successor, Jerome Powell, wishing him well as he and the FOMC navigate these currents.

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Louis Johnston writes Macro, Micro, Minnesota for MinnPost, reporting on economic developments in the news and what those developments mean to Minnesota. He is Joseph P. Farry professor in the Eugene J. McCarthy Center for Public Policy and Civic Engagement at Saint John's University. He is also a professor of economics at the university.