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Yellen Gives Conservatives Something to Cheer

With three Trump appointees, the Fed is likely to move toward rules-based policy.

By Donald L. Luskin

With the announcement that Daniel Tarullo will retire in April from the Federal Reserve Board of Governors, President Trump will have the chance to fill three of the board's seven seats. Next year the president could also promote two of his new governors to chairman and vice chairman, since Janet Yellen's leadership term ends in January 2018 and Stanley Fischer's is up in June. This presents an opportunity to achieve a long-held conservative goal: moving the Fed toward rules-based monetary policy. Mr. Trump could end a century of dangerous improvisation by a central bank with seemingly unlimited power over the economy.

During a January speech Ms. Yellen seemed to argue that rules-based monetary policy won't work. Yet the Fed's make-it-up-as-you-go approach clearly isn't successful, having neither supported satisfactory growth after the Great Recession nor achieved the central bank's inflation target. Yet for whatever reason, Ms. Yellen and other officials have been moving the Fed subtly over the past year toward what amounts to a policy rule. Maybe she saw Mr. Trump coming.

Though Ms. Yellen wouldn't dare express it this way, the new rule goes something like this: Interest rates should be set at the level that the market would produce by itself if the Fed didn't exist. Conservatives ought to love a rule that forces the Fed to mimic its own abolition. It would, in the end, effectively reduce the Fed from an all-powerful economic meddler to a mere clearing house for banking-system reserves.

This rule is the monetary-policy equivalent of Frank Capra's film "It's a Wonderful Life," in which the protagonist, George Bailey, gets to see what the world would be like if he'd never been born. Like the film, Ms. Yellen's rule is a classic: Swedish economist Knut Wicksell, writing in the late 19th century before the Fed was founded, imagined an interest rate that would exist in a world without central banks, which he dubbed the "natural rate."

Bailey had Clarence the Angel, but how can the Fed know what the natural rate is, since the world is not really Fed-free? Wicksell's answer was simple: inflation. If the interest rate set by policy is below the natural rate, then too much credit will be created and it will show up as inflation. That's how to know that the Fed can raise rates a little.

On the other hand, if the interest rate set by policy is above the natural rate, there will be too little credit and price deflation. The Fed can fix this by lowering the policy rate a little.

Mr. Fischer has spoken extensively and warmly of Wicksell's idea of the natural interest rate. Whenever Ms. Yellen talks about it, she calls it the "neutral rate"—or in the jargon of monetary theory, the R-star. She defines it as "the interest rate that is neither expansionary nor contractionary." Inevitably, she has a fancy econometric model for estimating it.

Ms. Yellen has been talking about the neutral rate a lot lately. In her congressional testimony this week, she explained the Fed's gradualist approach to raising rates entirely in the framework of the neutral rate, using the term no less than three times in a single key paragraph. In her testimony two years ago, there wasn't a single mention of it. For Ms. Yellen, this almost 120-year-old idea is the new new thing.

While Republicans should welcome an objective rule like this to replace the Fed's unbounded discretion, they'll have to accept that sometimes such rules give unintuitive results that violate conservative dogma. In this case, Wicksell's rule argues that because inflation was far below the Fed's 2% target after the Great Recession, the Fed was entirely right to keep the funds rate near zero. Many predicted that keeping rates so low for so long would cause inflation to explode. That it didn't must mean that the natural interest rate was probably about zero, as unnatural as that might seem. Mr. Fischer has recently suggested that is the case.

Now that inflation is back near 2%, Wicksell would smile upon the Fed's slow rate increases and its plan for continued gradualism. This approach means that if Mr. Trump manages to make the American economy great again, the Fed won't kill the expansion by tightening. Seen in the context of the natural-rate rule, these gradual increases wouldn't be tightening at all. The Fed would merely be tracking the natural rate higher as the economy shifted to a faster-growth footing.

There are other rules that could be considered. Stanford's John Taylor has introduced a much-discussed rule and argued persuasively on these pages that his formula would have kept the Fed from holding rates too low for too long in the mid-2000s, a policy that inflated the housing and mortgage bubble.

But Mr. Taylor's idea has a fatal flaw common to most rules. The economic variables that go into it must be calibrated somehow, and then recalibrated somehow at intervals determined somehow as the world changes in unanticipated ways. All those "somehows" add up to the very discretion that we are trying to get rid of. Wicksell's natural-rate rule requires no discretionary variables at all, only the observation of inflation, which is surely the Fed's proper business.

It's Wicksell's idea, but we have Ms. Yellen to thank for resurrecting it. So how about this for an artful deal: Mr. Trump and Ms. Yellen jointly endorse a bipartisan act of Congress to replace the Fed's impossible "dual mandate" with a directive to follow the natural interest rate. Mr. Trump then thanks her with another term as chair. Heresy for Mr. Trump to reappoint the liberal Democrat? Not at all. If this bell rings, an angel should get her wings.

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