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Saving the economy, 25 basis points at a time

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Milton Friedman must be rolling in his grave. Friedman, who died in 2006, is widely regarded as the father of modern monetary economics. Among other suggestions, he called upon policymakers to stop trying to manipulate short-run fluctuations in the economy by adjusting the Federal funds rate. Instead, they should focus on longer-term problems, like inflation.

Trying to fine-tune a $21 trillion economy is a fool's errand. Policymakers, as well-trained as they are, simply do not know enough to be successful at it. Too many uncertainties exist: When and if the Fed will or will not raise the funds rate by twenty-five basis points—one quarter of a percentage point—depends upon whether the economy is or is not growing, whether the president's trade war will or will not negatively affect the economy, whether the stock market's run continues or not. Friedman would cringe.

Because the Fed uses the funds rate as its major policy tool, it has become more of a signaling device. When the Fed officials talk about considering an increase or decrease in the rate, they are telling the public that the current rate may not be appropriate for achieving its policy goals of full employment and low inflation.

That is what is happening now. Does it make sense to lower the rate? Only if two criteria are met.

First, the Fed knows the economy is slowing, and slowing significantly. But the economy is at operating close to full employment. An unemployment rate of 3.7 percent is at historic lows; the level of real GDP is slightly above its potential or full-employment level; and the recent June data on non-farm employment increases exceeded everyone's expectations.

Given this information, why would the Fed even think about decreasing the funds rate when the signals indicate an economy operating at or close to capacity?

Second, the Fed knows what the level of the funds rate should be to maintain full employment and low inflation. Beginning in late 2015, the funds rate stood at 0.4 percent. Such low rates, a reaction to the economic vicissitudes of the Great Recession, were unsustainable. As the economy recovered, the Fed began to raise the funds rate in small increments, usually twenty-five basis points, to reach the current rate, about 2.5 percent.

Those low rates helped fuel the economic expansion that has lasted nearly a decade. Now some believe that the current rate is too high, choking off continued economic expansion.

What is the Federal funds rate that keeps the economy in this economic sweet spot? Is the current rate too high or too low? We just do not know. The so-called Taylor Rule, an approach favored by then Fed Chairman Allan Greenspan, combines information about output and inflation to calculate the "correct" level of the funds rate. According to this approach, the funds rate should be closer to 3.75 percent. Is the funds rate generated by the Taylor Rule any better or worse than the figure used by Fed policymakers?

Analysts outside and inside the Fed argue that economic expansion is weakening, and the Fed must be proactive. Do policymakers think themselves so prescient that they can predict with certainty the effects of a quarter-point reduction in the funds rate on yet unknown effects stemming from other policies? That defines chutzpah.

What is worrisome is that because the President and financial markets have been campaigning for and largely expect a reduction of the funds rate at upcoming meetings of the Fed's policy-making arm, the Federal Open Market Committee (FOMC), the latter will be reluctant to upset those expectations. A twenty-five basis point decrease in the funds rate will not alter the course of the economy.

Sadly, maybe it is good that Friedman is not around to witness this.

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