Will There Be Another Wizard?

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In 1900, Frank Baum published "The Wonderful Wizard of Oz," a literary endorsement of a move to a bimetallic dollar based on both gold and silver. Fueled by William Jennings Bryan's speeches, the dispute over the nation's money supply had reached its rhetorical highpoint well before the Federal Reserve was even created.

Bryan and the populist pro-silver movement lost the debate and the elections of 1896 and 1900, despite their better command of language. But their goal of reflation happened anyway. Vast new deposits of gold were subsequently discovered in South Africa, Alaska, and Colorado, increasing the money supply enough to allow prices to rise over 40% between 1897 and 1914. Politically, the debate was really about the preferred rate of money-creation and whether to favor in-debt farmers with easy money or the powerful city financiers with tight money. But the more fundamental choice was between a discretionary monetary policy in which politicians decided how much money was created and a discretion-free system enforced by gold.

A century later, an actual wizard of monetary policy is making perhaps his last appearance before Congress, and the president must find a replacement. The monetary debate has evolved, of course, since 1900, with nearly everyone now agreeing that inflation should be kept as close to zero as possible without letting prices fall. But there is a great debate over how best to accomplish this goal, and whether other goals like risk management and full employment deserve a seat at the Fed's weighty table.

Once again, the central choice is between monetary policy driven by human judgment or by a set of rules that constrain discretion. The current vogue in central banking is the movement toward inflation targeting, whereby the central bank uses an explicit inflation target as the primary guide to making monetary policy. While contemplating what monetary policy will look like in the next era, the president and Congress should also consider whether it would be a safer course to have a more rule-based policy. Inflation targeting has been tested recently in places like the U.K., Brazil and Mexico, and is most credible when there is some accountability of the central bank to the target. Inflation targeting makes great sense in places without a long history of effective independent monetary policy and can help anchor long-term interest rates.

Whether it makes sense for the U.S. is a more difficult question. In the semi-annual Monetary Policy Report to the Congress, the Fed today will announce their expected range of inflation based on the presumption of appropriate monetary policy, which last February was between 1.5% and 1.75% for 2005 and 2006. With long-run interest rates near historic lows and inflation expectations exceedingly well contained, there is little to be gained at the moment from making this target more binding. Most importantly, the Fed may want to keep this powerful tool in reserve in case it ever loses its hard-won credibility.

More worrisome, inflation-targeting could actually erode the credibility of the central bank during familiar circumstances. Suppose an oil-price shock temporarily accelerated inflation above the formal target. Even if the central bank expected economic growth to falter and future inflation to subside, it may worry that an interest-rate cut would erode its credibility even more than the initial breach of the inflation target. This isn't a hypothetical situation, but one in which the European Central Bank has found itself this year.

While the crowning achievement of the Greenspan Fed has been the achievement of price stability, it has accomplished even more. It has reacted promptly to domestic financial crises by lending through the discount window immediately after the October 1987 stock market crash and by pumping in over $80 billion in liquidity just after Sept. 11, 2001. The Fed also cut interest rates by about 80 basis points in the four months following the stock market crash and by 175 basis points in the three months after Sept. 11. In each case, the Fed's actions were critical to maintaining confidence in the U.S. economy at a vulnerable time. This crisis-management role is not simply a side-show. Responding to financial crises as a lender of last resort was one of the primary reasons for establishing the Federal Reserve, which was created in response to the particularly severe banking panic of 1907. For better or worse, the Fed is also as close as there is to an international central bank, having more power and standing than the IMF.

In 1998, the Fed responded indirectly to the Russian debt default, which spread into the U.S. via the LTCM hedge fund, by lowering interest rates 75 basis points over four months. Responses to international events are much more controversial, and there are legitimate arguments to criticize, in hindsight, the Fed's action, given how strong the U.S. economy was at the time. But in the era of globalization and leverage, the Fed needs to preserve the option of acting. A restrictive inflation-targeting regime would risk cutting off this alternative without even knowing what risks will turn into events over the next decade. A close look at China's banking system is enough to make any seasoned economist know that systemic risk is not a quaint problem of the last century.

A concrete inflation-targeting regime also raises the delicate question of what constitutes inflation. There are serious technical questions with existing measures, such as the different treatments of housing and medical care by different indices and the lack of chain-weighting by the headline CPI. Even more difficult is the question of how the Fed should handle rapidly rising asset prices, like the NASDAQ's 86% climb in 1999 or the housing market's double-digit-and-still-accelerating pace of today.

While the Fed doesn't have the ability to know what level asset prices should be at, it must have a general view on whether it is creating too much liquidity. And liquidity can raise assets prices just as it can raise wages or goods prices. Along the same lines, the Fed must have a view on whether leverage is excessive, especially since it has control of margin requirements and has the ability to weigh in on all areas of finance.

Another key consideration to the inflation targeting debate is whether the Fed should also be concerned about full employment. Its independence is a gift of Congress, not an inalienable right. The 1978 Full Employment and Balanced Growth Act amended the Fed's charter to make the bank's mandate the pursuit of both stable prices and maximum employment. Inflation targeting puts one goal explicitly ahead of the other, and a change to a rigid system would politically require the consent of Congress.

The narrow debate on inflation-targeting is part of a larger debate on how critical decisions are made. Are decisions ultimately best left to human judgment, allowing the human brain to tap into its immeasurable supply of theoretical, historical and real-time anecdotal evidence? Or is it better to allow a model to precisely calculate an answer based on quantifiable assumptions and potentially stale data? I'll bet if you gave investors or business leaders a choice of having access to the Fed's macroeconomic model or Alan Greenspan's frontal lobe, almost all would choose the lobe.

There is a split among replacement candidates between those who favor a more rule-based monetary policy and those who favor a completely discretionary policy. Mr. Greenspan himself favors a discretionary, risk-based policy. As a first step toward making a decision on the next Fed chairman, the president and Congress may want to decide whether they are looking for another wizard or someone who follows the rules.

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