2026.8.26

ECO

WSJ Print Edition

Amid conflicting signals on inflation, economic growth and employment, there's a case either way.

Should the Fed Raise Rates? That's Clear as Mud

By Alan S. Blinder

Judging by the emails I get from Wall Street firms, a consensus is developing in the markets that the Federal Reserve will stand pat at its September meeting. That could be right. The case for waiting and watching is intellectually coherent. But so is the case for raising rates soon—as evidenced by the three dissents at the last meeting of the Federal Open Market Committee.

Now may be the time for what Chairman Kevin Warsh calls a "good family fight." Unanimity is the committee's norm and desire, but it shouldn't be expected at the next meeting.

Compare today's situation with that of the mid-1990s, when I served on the FOMC. We were in a complex position at the start of 1994, with a strong economy and inflation stable but expected to rise. Through a complicated set of moves, we managed to achieve the celebrated "perfect soft landing." We raised the federal-funds rate by 300 basis points in multiple steps of varying size over a year. Then we stopped for a few months before cutting rates by 75 basis points in three steps. During that time, there were lots of debates but few dissents. Part of the reason was our deference to a trusted leader, Chairman Alan Greenspan. But we also achieved near-unanimity because the calls were relatively easy.

Note

Today's situation is quite different. Mr. Warsh is new and untested. Unlike Greenspan, he encourages dissent. More important, the interestrate calls now aren't easy. A coherent argument can be made for raising rates or leaving them be.

Start with the most important variable: inflation. By the Fed's preferred measure (the deflator for personal- consumption expenditures, or PCE), inflation stopped declining about a year ago and has been creeping up ever since. It is now above 3.6%, compared with a 2% target. That said, quite a few forecasters predict declining inflation as the effects of tariffs and higher oil prices wear off. Could be. But further oil price shocks are also possible, and the president keeps flirting with more tariffs. So you can see why inflation hawks are worried.

Note

What about economic growth? It has slowed, clocking in at a mere 1.4% average annual rate over the last three quarters compared with 2.5% over the previous three and 2.4% over calendar year 2024. Payroll employment gains have dropped even more sharply, to only 316,000 net new jobs over the past 12 months from 794,000 the previous 12. These and other mediocre growth numbers have the FOMC's doves worried.

Note

The Fed's main interest-rate instrument, the federal-funds rate, now stands at 3.5 to 3.75%. With PCE inflation around that same level, the real (inflation-adjusted) funds rate is about zero, indicating easy money. That's a bit worrisome if you're fighting inflation. More ammunition for the hawks.

Note

The latest unemployment rate, at 4.1%, virtually matches the Fed's 4.2% estimate of full employment. More important, unemployment has been hovering in the 4.1% to 4.4% range for more than two years, making that look like an equilibrium position for the labor market.

The case for raising rates would be clear if inflation were creeping up, the economy was steaming ahead with growth at or above trend, and unemployment was below its socalled natural rate. But that isn't the state of the U.S. economy today.

Alternately, there would be a clear case for holding interest rates constant if inflation were declining, economic growth were slowing, unemployment were at or above its natural rate, and the real fed-funds rate were close to "neutral"—perhaps 1.5% or so. But that's not where we are either.

Neither "clear case" applies. We have, instead, muddy waters. Which option any particular FOMC member prefers depends on how he weighs the various factors—the socalled reaction functions. What the committee does will depend on all that plus how the chairman manages disagreements.

We learn about such matters from the Fed's actions, but also from what it says, including "forward guidance." Mr. Warsh seems particularly hostile to that kind of talk, preferring to let markets guess.

Such guessing will lead to unnecessary volatility in the fixed-income markets. While that's far from the country's biggest economic problem, why deliberately cause it?

Mr. Blinder is a professor of economics and public affairs at Prince--ton. He served as vice chairman of the Federal Reserve, 1994-96.
