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The central bank can improve forecasts by including the value of the dollar in its modeling.



Chairman Kevin Warsh MARK SCHIEFELBEIN/ ASSOCIATED PRESS

The Fed Needs Better Models

By David Malpass

The Federal Reserve's outdated economic models and board structure are pushing it toward interestrate increases that would hurt affordability and small businesses without curbing inflation. This approach risks keeping bond yields and mortgage rates higher than necessary while waiting too long to cut rates. Instead, the Fed should consider broadening its models to include the value of the dollar as a key factor in price stability, which would help deliver low inflation, fast growth and dollar dominance.

Inflation regularly misses its target. Chairman Kevin Warsh addressed the data part of this problem in an Oct. 16 speech in Bangkok: "It's really lag data, it's about what happened. . . . We torture data with oldfashioned models to try to find out what's underlying inflation trends. Not so long from now, it won't be torture. We will have access at the fin-

gertips of central banks to all the information in the world." Distinguishing between real-time data and outdated information will "fundamentally change the conduct of monetary policy," he said.

Better data and analytical tools will help, but the Fed faces larger problems. Its old-fashioned models exclude the dollar even though its value significantly affects inflation and price stability. The models also assume that faster growth and wage gains cause inflation and that higher rates are the best tool to slow it.

It is hard to see how. Even with better data, inflation is a flawed guide to setting rates. It depends on factors beyond the Fed's control, such as gasoline and diesel prices, and on liquidity in the economy from asset-price gains. Inflation also depends on the dollar and external supply factors such as energy production, deregulation, wage growth, tariffs, innovation, tax cuts and China's pricing decisions.

Perhaps the biggest problem with the inflation indicators is that bonds pay interest based on the agreed coupon, not inflation. Targeting inflation misses the point that investors in U.S. Treasurys receive fixed-dollar payments and are highly sensitive to the dollar's purchasing power. If investors had confidence in the dollar's long-term value or knew the Fed included the dollar in its rate-setting models, yields would be lower.

Further rate increases aren't likely to be effective against the current inflation. Higher rates can't produce additional diesel or semiconductors or resolve other supply constraints. They can suppress spending and hiring, but at a high cost to the investment and growth needed to increase production. Unnecessarily high interest rates worsen inequality because the wealthy keep consuming and those with savings earn a higher return at the expense of borrowers seeking to invest and produce. The heaviest burden falls on the drivers of growth—small businesses, new workers and home buyers.

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The September interest rate increase was the highest starting point for a rate-hiking cycle since the Fed hiked rates from 4.75% in June 1999 to a high of 6.5% in May 2000. That pushed the dollar into the stratosphere, which harmed manufacturing jobs, deepened the Asian debt crisis, and punctured the dot-com bubble. Having overshot, the Fed then cut rates to 1% in 2003—a costly seesaw.

The Fed's September projections reveal a continuing reliance on the same output-gap model and labormarket indicators. Its forecasts last month warn of growth above potential through 2028, inflation above the 2% target into 2029 and unemployment below normal through that year.

These models may cause the Fed to set rates higher than would be necessary if it included prices in its models. Robert E. Hall and Michael Woodford's receiving this year's Nobel Prize in economics underscores the need to revise the macroeconomic framework when the evidence shows it can be improved. Their innovations were important, but monetary policy requires more upgrades to reflect today's environment.

As the Fed takes advantage of advanced price-monitoring technology, it should consider incorporating gold, commodity and currency prices in its rate-setting models. They provide useful signals about monetary conditions because they trade in real time and reflect changes in the dollar's value. The dollar has strengthened since President Trump's Jan. 30 announcement naming Mr. Warsh as Fed chair, while gold is down 25% from its January peak. These factors should be considered in setting rates.

Bond markets are pricing in painfully high interest rates for the foreseeable future because of the Fed's models. Hence the rise in bond yields and mortgage rates contributing to losses in the equity markets. Higher--than- necessary rates will also add significantly to the U.S. budget deficit given the size and short maturity of the national debt.

A final point: Including prices and viewing growth as a positive factor in the Fed's models would increase investor confidence in the dollar's value and attractive returns on Treasurys. Linking the Fed's price-stability mandate to a stable dollar would also solidify the dollar's market share in the rapid growth of digital currencies and stablecoins. Dollar stability would, in turn, intensify pressure on China's investment portfolio, which is underweight the dollar and overweight zero-yielding gold.

Mr. Malpass served as an undersecretary of the Treasury (2017-19) and president of the World Bank (2019-23). He is vice chairman of American Global Strategies.

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