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How The Fed Could Channel Greenspan

His method for adjusting rates might be replaced by a written formula

The Federal Reserve has raised the federal funds rate at eight consecutive meetings of the Open Market Committee since last June -- moving from a minuscule 1% to the more normal 3%. Stock and bond markets are sensitive to these changes, with investors particularly focused on predicting how much farther the Fed will go in raising rates. My estimate is that the rate will increase by one-quarter point at each of the next two meetings -- June and August -- and another quarter point at the September or November meeting. Thus, rates seem to be headed in the near term toward the vicinity of 3.75%. After that, I'm not willing to make any predictions.

Under Chairman Alan Greenspan, Fed monetary policy since 1987 has roughly demonstrated a pattern in which the Fed funds rate reacts to two main variables. First, the Fed boosts rates in response to inflation, measured by a broad index, such as the deflator for the gross domestic product. Second, rates are hiked when the economy is strong, gauged by the labor market and the growth rate of payroll employment.

MY STATISTICAL MODEL THAT INCORPORATES these features gives a clear signal that the funds rate will rise by a quarter point at the Fed's June meeting. That projection reflects strong recent employment growth -- more than 200,000 jobs per month since January -- and the uptick to 3% inflation in the first quarter's GDP deflator.

To forecast beyond June, one must project future inflation and employment growth. The yields on U.S. Treasury conventional and indexed bonds forecast consumer price index inflation of 2.5% to 3% over the next five years. (This projection is the difference between the 5-year nominal yield, recently a little less than 4%, and the inflation-adjusted yield, recently 1.3%.) Since broad inflation (gauged by the GDP deflator) is usually about a half-percentage point less than CPI inflation, 2% to 2.5% is a reasonable forecast of broad inflation. For employment growth, my analysis projects strong near-term growth -- more than 150,000 jobs per month -- but weaker growth over the longer term. These values produce the funds rate predictions mentioned earlier.

My rate projections concur with information communicated by the financial markets. For example, the federal funds futures contracts traded on the Chicago Board of Trade (CBOT) also project quarter-point rate hikes in June and August and a further increase in either September or November. But in contrast with my analysis, the Chicago market had placed a higher probability on a rise to 4% in February, 2006.

The yield curve for U.S. Treasury securities also implies a forecast for future federal funds rates. Recently the 5-year interest rate has been a little below 4%, and the 10-year rate has been a bit above 4%. When the funds rate is much lower than the 5- and 10-year yields -- as it was until the recent hikes -- the bond market is predicting that the funds rate will rise over time. Since the funds rate has now increased to 3%, today's 5- and 10-year rates of close to 4% mean that the bond market is not expecting the Fed to boost rates much further.

To be more precise, we have to consider that short-term rates, such as the funds rate, are typically lower than longer-term rates -- so the Treasury yield curve usually has an upward tilt. Since 1954 the average 5-year Treasury yield has been 0.7 percentage point above the funds rate. Thus, a 5-year rate of 4% usually corresponds to an average funds rate of below 3.5% -- a projection lower than those derived from my model or the CBOT futures market.

Over the past 20 years the Fed's procedure for adjusting rates has helped promote economic stability. In particular, its disciplined policy of lifting interest rates whenever the inflation rate rose has been critical in achieving low and stable inflation. So a key question for the post-Greenspan future is whether the sound judgments he usually exercised will be replaced by something closer to an actual, written formula.

There's both an opportunity and a danger here: Codifying procedures, as some other central banks have done, could help improve performance and ensure good results over the long term. But implementing the wrong formula could generate results worse than those produced by Greenspan's intuition. This means that the choice of the new Fed chairman will likely be the most important economic appointment that President George W. Bush makes.

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