



The FOMC's North Star: A Rule for Price Stability and Growth

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After its meeting on September 16, 2026, the Federal Open Market Committee (FOMC) issued a statement communicating its decision to raise the federal funds rate target range by a quarter percentage point from $3\frac{1}{2}$ – $3\frac{3}{4}$ percent to $3\frac{3}{4}$ –4 percent.¹ Based on the behavior of the five-year breakeven inflation rate, which declined from 2.4 percent to 2.3 percent from the day before the meeting to the day after, new FOMC Chair Kevin Warsh reassured the market of his commitment to 2 percent inflation. The dot plot, which shows FOMC participants' projections for the future funds rate path, accompanied the Summary of Economic Projections (SEP) and sent a hawkish signal: A strong majority of FOMC participants foresaw one more rate hike this year. There were no dissents. As discussed below, available economic data strongly supported the decision, given the FOMC's 2 percent inflation target. But a single policy decision, however appropriate, is no substitute for a coherent monetary policy strategy. The FOMC should adopt an explicit rule that aligns nominal GDP growth (output measured in current dollars) with potential real GDP growth (the economy's sustainable inflation-adjusted output) plus its 2 percent inflation target. Such a rule would guide future interest rate decisions, strengthen accountability, and help preserve Federal Reserve independence.

Why One Rate Decision Is Not a Strategy

Without an explicit strategy, what assurance is there that the FOMC will raise the funds rate in a controlled way that avoids economic contraction? Economist Milton Friedman's long-and-variable-lag critique highlights the pitfalls: The problem is that the FOMC cannot predict the effect of an individual funds rate change on the economy. Its impact is not immediate and is mixed in with the multiple other factors influencing the economy.² Empirical evidence by Friedman and fellow economist Anna Schwartz shows that contractionary monetary policy—raising interest rates to slow economic activity—impacts real output long before it lowers inflation.³ In the 1970s, the “stop” part of stop-go monetary policy, in which policymakers alternated between tightening and easing, reflected the desire to lower inflation and the hesitancy to lower the funds rate even

as the economy weakened because inflation remained persistent. In the current situation, the FOMC could similarly feel pressured to continue raising the funds rate or be reluctant to lower it even with evidence of a weakening economy.

The persistence of inflation shocks is especially worrying because it could challenge the FOMC's credibility for price stability if the FOMC is seen as backing away from its 2 percent inflation target even as the economy weakens. An explicit strategy would reassure in this regard. An explicit strategy would also help the Fed defend its independence by making clear that the behavior of the FOMC, an unelected body of individuals, is subject to the transparency and accountability made possible by rule-like behavior.

A Rule-Based Strategy for Price Stability

A strategy must maintain balanced growth in real economic activity while preserving price stability. That is, it must maintain real growth equal to potential real growth. It must also maintain credibility for price stability so that, when firms set dollar prices, they do so with the expectation of price stability. A strategy that would fulfill these requirements would maintain nominal GDP growth equal to potential real GDP growth plus the FOMC's 2 percent inflation target.

In these respects, the increase in the funds rate at the September 2026 FOMC meeting was highly desirable. At the time of the meeting, a reasonable estimate of nominal GDP growth exceeded estimated potential real GDP growth plus 2 percentage points. The Atlanta Fed's GDPNow estimate of real GDP growth for the third quarter of 2026, as of September 17, was 5.1 percent.⁴ The compounded growth rate of the GDP implicit price deflator for the second quarter was 6.4 percent. The sum of those two numbers is 11.5 percent. No doubt special factors raised this estimate of nominal GDP growth. For example, growth in the GDP implicit price deflator in the first quarter was a lower 3.6 percent.

The Congressional Budget Office (CBO), in its February *Budget and Economic Outlook*, estimated potential real GDP growth for the third quarter of 2026 at 2.2 percent.⁵ That estimate is close to the FOMC participants' median estimate of 2 percent for "longer-run" real GDP growth in the SEP. Given the FOMC's 2 percent inflation target, and even accounting for transitory supply shocks pushing up inflation, estimated nominal GDP growth in the third quarter was well above 4.4 percent (the sum of the CBO estimate of potential real output growth and the 2 percent inflation target). Moreover, given Kevin Warsh's Jackson Hole speech in August, in which he reaffirmed 2 percent as the FOMC's inflation goal, markets would have interpreted a failure to raise the funds rate at the September meeting as a lack of resolve to restore 2 percent inflation.⁶

Despite the desirability of the September funds rate increase and the hawkish message accompanying it, the FOMC still needs a strategy. Its current communications emphasizing period-by-period discretion falls short. The FOMC simply lacks the ability to forecast the impact of individual policy

actions accurately enough to lower inflation through meeting-by-meeting decisions while maintaining control over real growth. What, then, should the FOMC's strategy be?

The place to start is with a Committee SEP that makes clear the discipline the FOMC must impose on itself to achieve and maintain price stability. Specifically, how should the FOMC discipline its meeting-by-meeting decisions on the funds rate target? To begin, the Board staff would organize the Tealbook, which provides economic forecasts prior to FOMC meetings, around a rule that produces a projected funds rate path consistent with nominal GDP growth aligned with potential real GDP growth plus the 2 percent inflation target. Various shocks to the economy and inflation would necessarily cause near-term discrepancies. The rule, however, would constrain forecasts to produce the necessary alignment over time as forecasted shocks, by definition, dissipate.

At the FOMC meeting, debate would begin with a go-around in which participants would assess the Tealbook forecast by adding their own views. These would include information gathered by regional Reserve Bank presidents from contacts in their districts. The FOMC chair would have the standard responsibility of building consensus around the forecast. The FOMC SEP forecast would also be constrained, however, by the longer-run alignment of nominal GDP growth with estimated potential real output growth plus 2 percent.⁷ At the post-meeting press conference, the chair would make the Tealbook forecast available and explain any differences between it and the FOMC consensus forecast embodied in the Committee SEP. During the intermeeting period, private forecasters could assess the Committee's forecasts against independent estimates of real GDP growth and inflation, either buttressing or challenging this Committee view and promoting accountability.

Newspaper commentary during the subsequent intermeeting period would draw on various high-frequency estimates of current real GDP growth and actual and expected inflation. Measures of real GDP include the Weekly Economic Index (WEI) developed by Lewis, Mertens, and Stock and available from the Dallas Fed, as well as the New York Fed Staff Nowcast of current-quarter real GDP. The Cleveland Fed's Center for Information Research (CFIR) provides current-quarter inflation forecasts for both core and headline measures of the Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) price index. Measures of public inflation expectations, which can be compared with the FOMC's target, are available from the New York Fed Survey of Consumer Expectations for median one-, three-, and five-year horizons. Treasury Inflation-Protected Securities (TIPS) breakeven rates provide measures of market inflation expectations over a wide range of future periods. Newspaper commentary comparing the FOMC's SEP forecasts with these high-frequency measures would raise the level of public debate over monetary policy.

Transparency and Federal Reserve Independence

These procedures would institutionalize practices developed during the Volcker–Greenspan era, characterized by “lean-against-the-wind with preemptive changes in the funds rate to maintain price stability.”⁸ It is important to note that these preemptive changes are symmetrical: If the

economy weakens before underlying inflation—excluding temporary price fluctuations—returns to 2 percent, the FOMC would lower the funds rate. The discipline imposed by these procedures would reassure markets that the FOMC remains committed to its long-run goal of price stability, reducing pressure on the FOMC to maintain high interest rates at the risk of pushing the economy into recession.

That combination of discipline and symmetry would also raise the level of debate in response to administration criticisms of monetary policy. The debate would focus on whether the administration has a superior ability to forecast the economy. The strategy would build public support for Fed independence by making clear how political pressures to lower the cost of financing the public debt could, and if acceded to by the FOMC would, result in inflation. It would also become clear over time that there is no negative correlation between increases in the funds rate and unemployment, nor between inflation and unemployment. There is no exploitable Phillips curve—that is, the Fed cannot use monetary policy reliably to lower unemployment simply by allowing inflation to rise above its 2 percent target. Nominal and real stability just require a rule that allows the stabilizing properties of the price system to work. The *raison d'être* for the Fed's independence is to ensure price stability. Given the political pressures on the Fed, the FOMC needs to communicate clearly the rule that ensures price stability.

About the Author

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Notes

1. Board of Governors of the Federal Reserve System, "Federal Reserve Issues FOMC Statement," news release, September 16, 2026.
2. Milton Friedman, *A Program for Monetary Stability* (Fordham University Press, 1960).
3. Milton Friedman and Anna J. Schwartz, "Money and Business Cycles," *Review of Economics and Statistics* 45 (February 1963): 32–64.
4. Federal Reserve Bank of Atlanta, "GDPNow" (website), accessed October 21, 2026, <https://www.atlantafed.org/research-and-data/data/gdpnow>.
5. Congressional Budget Office, *The Budget and Economic Outlook: 2026 to 2036*, February 2026.
6. Kevin Warsh, "In Our Time" (speech at the "Financial Innovation: Implications for Payments and Policy" economic policy symposium by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 28, 2026).
7. An early draft of Athanasios Orphanides, "Enhancing Resilience with Natural Growth Targeting," *Southern Economic Journal* 91, no. 4 (2025), prepared for the American Institute for Economic Research (AIER) Framework Review Workshop at Florida Atlantic University, Boca Raton, January 20, 2024.
8. Robert L. Hetzel, *The Federal Reserve System: A New History* (University of Chicago Press, 2022).