The New York Times, January 1, 2012

Dear Mr. Bernanke: Please Tell Us More

By N. Gregory Mankiw

WHAT can we do to get this economy going?

That's the question Ben Bernanke and his colleagues at the Federal Reserve must be asking. Officially, the recession ended a while ago. But with unemployment lingering above 8 percent, it still feels as if we're mired in a slump.

The Fed's typical response to lackluster growth is to reduce short-term interest rates. To its credit, it did that — quickly and drastically — as the recession unfolded in 2007 and 2008. Then it took various unconventional steps to push down long-term rates, including those on mortgages. Mr. Bernanke deserves more credit than anyone for preventing the financial crisis from turning into a second Great Depression.

Now, the key will be managing expectations. Financial markets always look ahead, albeit imperfectly. They not only care what the Fed does today but also about what it will do tomorrow. With official short-term rates already near zero, what the Fed does this year will be less important than what policy makers say they will do next year — or the year after that.

A crucial question is how quickly the Fed will raise interest rates as the economy recovers. So far, Fed policy makers have said they expect to keep rates "exceptionally low" at least until mid-2013. There has even been talk about extending that time frame by a year, to mid-2014.

But Charles I. Plosser, the president of the Federal Reserve Bank of Philadelphia, was right when he said recently that "policy needs to be contingent on the economy, not the calendar." The key to managing expectations will be spelling out this contingency plan in more detail. That is, what does the Fed need to see before it starts raising rates again?

Unfortunately, economists don't offer simple and unequivocal advice. Some suggest watching the overall inflation rate. Others say to watch inflation, but to exclude volatile food and energy prices. And still others advise targeting nominal gross domestic product, which weights inflation and economic growth equally.

Forging a consensus among members of Federal Open Market Committee, which sets monetary policy, won't be easy. In fact, it may well be impossible. But the more clarity the Fed offers about its contingency plans, the better off we'll all be in the years ahead.