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The central bank abandons its 2020 idea that inflation above its target can be useful.

Powell Flips the Fed's 'Framework'

REVIEW & OUTLOOK

Federal Reserve Chair Jerome Powell sent equity markets soaring Friday with his dovish language signaling easier monetary conditions ahead. What may be more important in the long run, however, is that Mr. Powell and the Fed reversed their policy "framework" language from 2020 that signaled greater tolerance for inflation.

The framework emerges from the Fed's periodic review of its basic policy assumptions and guidelines. The 2020 language was among the most poorly timed in the history of U.S. monetary policy. It came amid the pandemic lockdowns and shortly before what would become the worst burst of inflation since the 1970s.

The Fed at that time adopted what it called "flexible average inflation targeting." That's Fed-speak for saying the central bank would tolerate inflation higher than its 2% target for a time to compensate for inflation that was lower than 2% for a period. As we warned at the time, this was "a leap into the monetary unknown and potentially a very expensive one." And was it ever—inflation hit 9.1% at its peak in June 2022. *Note*

The Fed said sayonara to this on Friday, returning to plain old "flexible inflation targeting"—with the target being 2% inflation. This is an improvement, though it's leavened by the failure of the Fed to acknowledge its role in igniting the pandemic-era inflation that we haven't fully recovered from. Mr. Powell still blames the inflation burst this decade largely on the pandemic and its supply shortages. But at least he's restoring the Fed's framework to what it was before 2020.

The disappointment is that Mr. Powell and the Fed ignored the need for larger changes at the central bank. One question is why the Fed has an inflation target at all. Congress has given the Fed the duty to maintain stable money, and a 2% target over time means a steady decline in the dollar's purchasing power. Why not a target of zero inflation? The fear at the Fed is that this could sometimes mean the economy falls into deflation. That's a risk, but based on the historical record it's a relatively small one. Deflationary fears have been overwrought in recent years and have led the Fed to create bigger problems—such as the early 2000s deflation minipanic that led to monetary mistakes that produced the housing boom and bust.

The Fed also missed a chance to lay out a path back to the pre-crisis monetary policy when the Fed limited its bond purchases to Treasuries and engaged in open-market operations. The era of quantitative easing, however needed during the panic, was supposed to be temporary. Instead the Fed has maintained its \$7 trillion balance sheet and pays interest on reserves to the biggest banks. The Fed would do better to return to its previously more modest place in economic policy. *← Note*

This will be one of several opportunities for Mr. Powell's successor, assuming President Trump chooses a nominee for his vision and competence, rather than because he promises to always keep interest rates low. Mr. Trump focused on the latter when he nominated Mr. Powell, and it proved to be a mistake.

The Fed Chair on Friday seemed to move toward the view that tariffs won't lead to permanently higher inflation. "A reasonable base case is that the effects will be relatively short lived—a one-time shift in the price level," Mr. Powell said. That's what markets seemed to like, even if he didn't signal a specific interest-rate cut. Mr. Powell and the Fed are still recovering from their great inflation mistake, and finishing that job would be a fitting way to leave as Chair. *Note*

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