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OPINION | REVIEW & OUTLOOK

Low Rates Forever!

The Federal Reserve takes a leap into the monetary unknown.

By The Editorial Board
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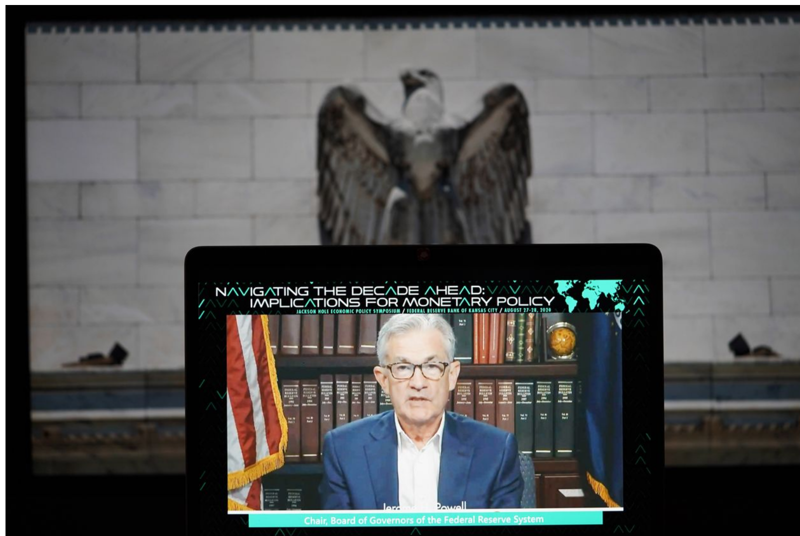

Federal Reserve Chairman Jerome Powell delivers a speech on Aug. 27.
PHOTO: LIU JIE/ZUMA PRESS

Jerome Powell's Federal Reserve on Thursday released a long-awaited review of its policy framework, and it's a mixed bag. On the upside, the central bank will no longer throttle the economy whenever "too many" Americans have jobs. On the downside, the Fed may never raise interest rates again.

The Fed was overdue to rethink how it pursues its dual mandate of full employment and price stability. Most obviously, the two goals no longer appear to conflict in the way monetary economists once assumed.

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Starting in the 1980s, the U.S. economy achieved unprecedented low unemployment without an uptick in consumer prices as orthodox theory had predicted. Instead, as Mr. Powell noted in announcing the new strategy, business cycles now seem more likely to end in financial panics than in inflationary spikes that trigger interest-rate increases.

One happy result is that the Fed is all but abandoning the discredited Phillips Curve, the theory that policy makers must trade off between employment and inflation. The Fed previously tried to head off inflation by raising rates whenever it thought the unemployment rate was falling too far—whatever that meant—but now the Fed will wait for inflation to appear before acting.

Abandoning the Phillips Curve is a win for the economy, but it comes at a substantial cost in this review as the Fed also is overhauling its inflation target. Since the Fed adopted inflation targeting in the late 1990s and early 2000s (and formalized a 2% target in 2012), policy makers have viewed the target as a ceiling.

No longer. The Fed now will aim to achieve “average” inflation of 2%, meaning it will tolerate periods of faster price rises to compensate for periods when inflation falls short. Mr. Powell believes such a symmetrical target is necessary to “anchor” inflation expectations.

This is a political minefield because the definition of the inflation time period will always be open for debate. Mr. Powell and future Fed chairs will face pressure to maintain low rates to compensate for some protracted period of low inflation, or because a Senator or Twitter-happy President “believes” inflation will fall below target in the near future.

That increases the economic risk that the Fed might end up looking through inflation until it's too late. Having effectively admitted it no longer fully understands the relationship between economic growth, employment and inflation, the Fed still promises to decide in real time when its healthy above-target inflation has become dangerous. If the central bank gets this wrong, it could be forced to raise rates much higher, much faster than it would want.

The more glaring problem is the long list of questions the Fed didn't review. The most important is Mr. Powell's observation, offered without elaboration Thursday, that business cycles now end in destructive financial crises. The Fed thinks this is a regulatory problem to be solved with stricter capital rules and stress tests.

It might instead ask whether its preference over two decades for "looking through" rising asset prices such as oil, gold and housing to keep rates low is contributing to financial instability instead of economic growth. Without exploring this question, the Fed has adopted a strategy with a built-in bias for low rates. The result is almost certain to be more financial manias, panics and crashes.

There are other unanswered questions. For instance, the Fed now assumes that the economy's natural rate of growth, and thus its natural interest rate ("r-star" in the lingo) are in a natural decline for demographic or other reasons. Mr. Powell cites this as a justification for the Fed's new symmetrical inflation target.

Well, what if there's nothing natural about falling growth because the Fed's policies are causing it? Research suggests sustained low rates can dent an economy's growth potential by steering investment to unproductive uses, sustaining zombie companies, rewarding corporate financial engineering instead of capital expenditure, and contributing to asset booms and busts. It's a shame the Fed has decided to double down on its low-rate, quantitative-easing bets before such a self-examination.

The Fed says its review is a result of careful study, including a national listening tour in which officials met with ordinary Americans. The truth is that it's a leap into the monetary unknown and potentially a very expensive one.

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