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Opinion: The Fed Thinks Its Job Will Be Done at 2% Inflation. Its Policies Promised Even Lower.

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With inflation running hot, U.S. Federal Reserve Chair Jay Powell has promised to "keep at it until the job is done." Powell and many in the markets believe that will be when inflation returns to 2%. But the Fed's own policies promise an even lower goal: 1%.

The Federal Reserve announced a new policy target in August 2020. Low inflation had characterized the economy for years at that point. The new strategy, called "flexible average inflation targeting," was intended to allow the Fed to tolerate higher inflation temporarily. We have argued in the past that this was a serious mistake, in part because it gave the Fed a reason to say the inflation emerging in the wake of the pandemic was transitory.

But the new policy target hasn't been revoked. Simple math implies that the Fed's promised policy under its new guidelines should be symmetric. If periods of inflation below 2% are supposed to be followed by higher inflation, then episodes of inflation above 2% should be followed by cooler inflation. The August 2020 statement issued by the Federal Open Market Committee did not explicitly emphasize those implications. It said, "In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2% over time, and therefore judges that, following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time."

In particular, the policy did not say the Fed would allow inflation to run below 2% following periods of higher inflation. But anchoring inflation to an average of 2% over time would require it to do so. In the three years since the August 2020 policy change, the annual rate of inflation has been about 5.5%. For inflation to average 2% per year since August 2020, inflation should run at 1% per year for about the next decade. So, the Federal Reserve's August 2020 guidelines indicate that to make up for recently overshooting its 2% target, the Fed will aim for 1% inflation for the next several years.

Instead of following this simple logic, a diverse group of commentators is now calling for the Federal Reserve to rewrite its guidelines by raising its annual inflation target, perhaps to 3%. They fear a slowdown in the economy could accompany bringing down inflation to the 2% target. Thus, Jason Furman, former chair of President Obama's Council of Economic Advisors recently wrote, "It is time for the Fed to start making a hawkish pivot to a higher inflation target." Former Boston Fed President Eric Rosengren gave an insider's view of how central bankers think: "If inflation gets down below 3%, your risk preferences may change for how much you're willing to induce slower labor markets to get to 2% inflation." That view is echoed in Congress. Rep. Ro Khanna (D., Calif.) said that the goal of 2% inflation "is not a science. It's a political judgment they have to make." He added, "I don't see why having a particular number as the Holy Grail…is the right way to get that judgment."

To be sure, the Fed is unlikely to take its August 2020 statement seriously enough to aim for 1% inflation per year over a decade or even longer. But our simple numerical calculation with 2% shows why the Fed should not change its target to 3%. The cost of letting inflation run out of control is a loss of public trust in the Fed's word. Citizens give the government the authority to print money, trusting that it will not misuse it by debasing the currency. Compounding makes it easy to cause harm. For example, if inflation runs at 3% a year, just one percentage point above the current target, prices will double in about 25 years. A $100 bill then buys only half as much as before.

Federal Reserve Chair Jerome Powell has so far resisted abandoning the average inflation target of the August 2020 guidelines that misled the Fed into the inflationary policies of 2021. But to his credit, Powell has also resisted changing the 2% objective: "This is not a time at which we can start talking about changing it," he told Congress in March.

Government officials would erode our trust by failing to maintain the value of paper money, a trust that is easy to shatter and difficult to restore. And in today's fractured U.S. politics, the value of trust in our government has soared.

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