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How Hard Should the Fed Squeeze to Reach 2% Inflation?

The strategy the central bank adopts to fight the last mile of inflation has big, potentially painful implications for consumers, the markets and the economy

By Nick Timiraos Follow

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Much of the work lowering inflation is done: Amid the most aggressive series of interest rate increases in four decades, it has fallen to 3.2% from 9.1%.

This good news presents the Federal Reserve with a new thorny question. How aggressive should it be in squeezing out what's left?

Their decision holds major implications for consumers, the markets and the economy—and whether Fed Chair Jerome Powell achieves a so-called soft landing that beats inflation without causing a recession.

Officially, the Fed's target for inflation is 2%. With inflation running well above that number, officials are still focused on whether to raise rates one more time this year. But that is a relatively small consideration compared with the bigger question of how long to keep rates at that high level.

Fed officials could try to get to 2% quickly, such as by the end of next year, by raising rates higher and only slowly reducing them as the economy weakens. That would risk a sharper downturn and possibly kill the chances of achieving the soft landing.

On the other hand, if they're satisfied that inflation is slowing durably, they could hold them at their current level and consider trimming rates later next year. That would take more time to get to the inflation target—around three years.

What if getting to 2% isn't worth the pain? Another strain of thinking says the Fed should accept a rate around 3% as the new target. Powell and other Fed officials say moving the goal posts like that isn't an option.

The challenge of finishing the fight against inflation will likely be a big topic of debate for central bankers when they gather for the Kansas City Fed's annual retreat in the mountains of Jackson Hole, Wyo., where Powell is set to speak Friday.

The Fed's policy has helped drive up mortgage rates, making it more expensive to purchase a house and stalling the real-estate market. PHOTO: MADDIE MCGARVEY FOR THE WALL STREET JOURNAL

Many economists still see a risk of recession over the next year under the weight of the Fed's rapid rate increases, which have put stress on commercial real estate and regional banks. The central bank lifted its benchmark rate last month to a range between 5.25% and 5.5%, a 22-year high. That rate influences other borrowing costs throughout the economy, including for mortgages, car loans and credit cards.

Others worry that inflation's recent decline will stall as consumer and business spending accelerates in coming months, forcing the Fed to raise rates again to trigger a downturn in inflation.

Quicker, or slower?

Among economists and politicians, debate is already raging over how the Fed should manage the coming phase. The move-quickly camp argues for the Fed to keep the screws tight to force inflation down to 2% briskly, even if that leads to recession. They say taking too long to bring prices back to the target could erode the Fed's credibility, especially if the economy is hit with new shocks that drive up inflation.

If that happens, it would likely take an even more painful downturn later to ultimately bring inflation down, as occurred in the early 1980s. In their mind, taking our medicine now is a safer bet.

Another camp suggests the central bank could take a lesson from former Fed Chair Alan Greenspan and get to its 2% target more leisurely. Greenspan in the early 1990s charted an approach later dubbed "opportunistic." Rather than push immediately for 2%, get there gradually over several years by holding rates at a level that could seem slightly higher than they need to be, and letting opportunities, such as the occasional economic slowdown, nudge inflation down bit by bit.

They say this approach would better balance the Fed's mandate of low and stable inflation with maximum employment.

Several former Fed officials say the approach makes sense if inflation falls below 3% and then stalls. "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," said former Boston Fed President Eric Rosengren.

Richmond Fed President Tom Barkin said the 1990s aren't a useful parallel because back then, the Fed was lowering inflation following a longer period when it was much higher. The Fed could go more slowly then because the public expected inflation to remain high. Now, in contrast, inflation expectations have been reset at a lower level. "Today, you'd worry about the risk of [high inflation] lingering and bringing expectations up," he said.

Fed officials aren't likely to be patient if inflation stabilizes above 3%. That would be a problem because without more obvious signs of an economic slowdown, pressure on wages could feed through to prices, said several former officials, including Rosengren, Richard Clarida, who served as Fed vice chair from 2018 until early 2022, and former Chicago Fed President Charles Evans.

"They've got to get the core inflation down below 3% before you start feeling really good about this," said Evans. Underlying or "core" inflation, which strips out volatile food and energy prices, looks headed toward 3.5% by early next year.

Inflation continuing to run above 3% could require the Fed to keep raising rates. Once inflation falls below that level, the case for the Fed to consider rate cuts would heat up, Evans said.

"I've been in the two-point-something camp. It is important that it starts with a two," said Clarida. "That sounds arbitrary, but some things in life are arbitrary."

Moving the goal posts

The raise-the-target camp says the central bank should simply declare 3% as its new target.

Some economists favor lifting the target because the cost of forcing inflation down to 2% over the next two years would likely be significantly higher unemployment.

Unemployment is around a half-century low. A focused push by the Fed to lower inflation quickly to the 2% target could lead to job losses. PHOTO: JIM LO SCALZO/ZUMA PRESS

Some had concluded years ago that, because of more frequent spells in which the Fed couldn't cut interest rates once they were lowered to zero, the 2% inflation target was too low. With a higher target of 3%, interest rates would be higher in good times, giving the Fed more scope to counteract downturns by cutting them.

They think with inflation well off recent highs, the Fed could manage a transition to a 3% target without risking a persistently higher rate.

"The inflation target…is not meant to be an absolute rule," said Adam Posen, a former Bank of England policy maker who now runs the Peterson Institute for International Economics. "We should be understandably reluctant about crushing the economy to get from 3.5% to 2.25% inflation."

A higher target is also popular among Democrats concerned that rising unemployment or a recession would threaten President Biden's re-election prospects.

The goal of 2% inflation "is not a science. It's a political judgment they have to make," said Rep. Ro Khanna (D., Calif.) "I don't see why having a particular number as the Holy Grail…is the right way to get that judgment."

Current and former Fed officials think changing the target now would be a big mistake.

Central banks have used explicit inflation targets to help convince the public that inflation would remain low and stable because the banks were signaling, in advance, how they would react in periods of higher inflation.

Powell made clear he won't consider raising the target with inflation running above it, because it risks undercutting the entire strategy. "We're not going to be considering that under any circumstances," he said last fall. He repeated that view to a skeptical lawmaker in March. "This is not a time at which we can start talking about changing it," Powell said.

"If you were to unilaterally declare that you're not going to hit the target that you've set, then you are also declaring that you're less credible in any target you set," said Barkin.

The low inflation of the past two decades shows that 2% is a reasonable goal, Barkin said. "It was only 2½ years ago that we had 2% inflation, so…2% isn't some chimera that no one could ever achieve," he said. "It's actually something that's been very achievable for a very long time."

Clarida said the relatively low yields of long-term government securities suggest investors believe Powell will achieve 2% inflation within a few years. Raising the target to 3% now "would almost certainly lead to a very substantial selloff," said the former Fed vice chair, who oversaw a review of the Fed's inflation-targeting framework in 2020.

Restricting the economy

Some Fed officials say they need to see clearer signs of slowing economic activity to be convinced inflation will keep falling. They could push to raise rates again this year.

A key consideration is "whether the economy really does accelerate in the second half of 2023," which could pressure officials to raise rates above 6% next year, said James Bullard, who stepped down last month as president of the St. Louis Fed to become dean of the business school at Purdue University.

Many economists still see a risk of recession over the next year under the weight of the Fed's rapid rate increases. Above, a shopper in Miami in July. PHOTO: JOE RAEDLE/GETTY IMAGES

"What they are worried about right now is sustaining the disinflation we see, and getting the core inflation measures down on a 12-month basis, into the 3% range, and clearly falling further," said Bullard.

Several, including Powell, have said they think rates are now restricting economic activity by slowing hiring, spending and investment. They see much more balanced risks of raising them too much versus too little.

That brings the Fed close to the last of three stages of tightening. In the first stage, in 2022, officials raised rates rapidly—in jumbo half-percentage-point and three-quarter-point increments. They moved to the second stage early this year, nudging borrowing costs up more slowly to find a level that restrains demand without causing unnecessary economic weakness.

In the third stage, the focus shifts to inflation-adjusted or "real" rates. That means that even if the Fed holds its benchmark rate steady, since inflation has declined, the effect would be as if the rate was raised.

As inflation falls, “if we don’t cut interest rates, at some point the real interest rate will continue to go up,” said New York Fed President John Williams in an interview earlier this year. He said he expects to lower rates next year not because of a sharp slowdown but simply to prevent real rates from becoming unnecessarily restrictive.

“You’d stop raising long before you got to 2% inflation, and you’d start cutting before you go to 2% inflation, too,” Powell said in July. “It’ll be about how confident we are that inflation is, in fact, coming down to our 2% goal.”

Powell suggested then that without a serious slowdown, the Fed wasn't likely to entertain rate cuts until "a full year from now."

The Fed under Greenspan didn't have a publicly stated inflation goal. Congress charged the Fed with achieving "price stability," but Greenspan never defined the term, which made it easier to cut rates to support a weak economy even if inflation was higher than desired. Under Greenspan's successor, Ben Bernanke, the Fed adopted its official 2% inflation target in 2012.

Some officials bristle at comparing their potential approach of allowing inflation to move down more gradually to Greenspan's because it implies that they would be OK with 3% inflation—and would just hope to get to 2% by getting lucky.

But their projections suggest they are thinking along similar lines: Their current policy won't deliver 2% inflation immediately, but they will get there soon enough that they don't need to cause a recession.

Most officials anticipate cutting interest rates by about 1 percentage point next year, even though they see core inflation falling to 2.6% by the end of the year—still above the target. Most see inflation reaching 2% by the end of 2025.

Those projections may be too rosy. Riccardo Trezzi, a former Fed economist who has re-created the central bank's workhorse inflation-forecasting model—which assesses data alone and removes any judgment calls officials might make—estimates that the central bank's model is likely to project core inflation at 2.7% in 2025.

Fed officials said discussions around such tactics are premature. "It feels pretty early to get to that particular hypothetical when core inflation is still at 4%, not 3%," said Barkin.

In June, Barkin penciled in lower rates near the end of 2024 assuming the economy had contracted for two quarters. It's hard to see how the Fed gets inflation back to its target without slower growth, he said. "If we do end up in this hypothetical situation, I would distinguish between patience versus hope," he said. In other words, the Fed could entertain a more patient approach to bringing down inflation only after seeing evidence activity is weakening.

Others think the Fed is on track to bring down inflation over the next two years without significantly increasing unemployment. The path to a soft landing in recent months "seems to have gotten wider," said Boston Fed President Susan Collins in a recent interview. The Fed's current policy is deliberately and intentionally bringing inflation down, and to float a strategy that entertains a longer period of time to arrive at 2% “could be confusing and perhaps undermine the credibility” of the central bank’s policy, she said.

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