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Congress Should Set the Fed's Inflation Target—Ideally at Zero

There's no evidence that aiming for 2% does any good, and it could do real economic harm.

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The Federal Reserve's relentless pursuit of 2% inflation creates more problems than it solves. The 2% target has become gospel for central bankers. But as former Fed Chairman Paul Volcker points out in his new memoir, no economic theory or evidence supports the claim that a little inflation greases the economic wheels or reduces the risks of depressions. In fact, monetary policies that aim for 2% inflation risk contributing to financial bubbles that can trigger real economic collapse when they burst.

The 1978 Full Employment Act gave the central bank a dual mandate, to promote full employment and price stability. The law also established specific targets for reducing unemployment and inflation, which at the time were getting out of hand. Congress mandated that within a decade the Fed should bring unemployment down to 3% and the inflation rate to zero.

The legislation provided some wiggle room. The theory that reducing inflation increases unemployment was still respectable in those days. That's why Congress gave the Fed permission to take a softer line on inflation if doing so would help bring unemployment down to 3%. That never happened, but 30 years later the Fed still exploits a loophole designed for a 10-year transition to zero inflation.

If Congress had wanted to give the Fed perpetual discretion on inflation, it could have directed the Fed to secure the greatest possible price stability consistent with 3% unemployment. Instead, Congress gave the Fed a precise number (zero), a source from which the data should come (the Bureau of Labor Statistics) and a target date (1988). Moreover, the 1978 bill gave the president—not the Fed—explicit, perpetual authority to propose alternative targets for inflation and unemployment to Congress.

The legal basis for central bankers to chant the 2%-inflation mantra is even murkier outside the U.S. The European Central Bank has never had an unemployment mandate. The 1999 law that made the Swedish central bank independent mandated "price stability," not steadily increasing prices. And the 2% rate the Riksbank has relentlessly pursued at the risk of stoking a real-estate bubble isn't price stability: Prices double at that rate in a generation, as Mr. Volcker points out.

The legal niceties apart, central bankers are ill-equipped to choose inflation targets. Formal training in economics is now regarded as essential for monetary policy-making. Ben Bernanke and Janet Yellen were distinguished professors of economics before they became Fed chairs. As an academic discipline, economics seeks the status of an objective science. Economists tend to focus on value-free questions of “means” to the exclusion of value-laden considerations of “ends.” Yet inflation targeting requires choosing winners and losers: zero inflation protects the savings of retirees, while 2% lightens the debts of borrowers.

Appointing ethicists to the Fed Board wouldn’t solve the difficulty of choosing ends. Delegating control over means to technical experts can work well in many public and private spheres. Allowing politicians to meddle in day-to-day bank examination or enforcement of money laundering rules does great harm. But granting experts unchecked authority over ends corrodes crucial checks and balances and makes accountability a farce. Like it or not, messy political direction, ratification and oversight provide crucial legitimacy to administrators. And that’s what the Fed should be: a competent administrator, not a law unto itself.

In an ideal world, Congress would scrap the Fed’s inflation and employment mandates. Both constructs are nebulous and, in a dynamic economy constantly buffeted by myriad cross currents, impossible for central bankers to control. Lawmakers should instead hold Fed officials responsible for prudent banking, as envisioned by Congress when it established the Federal Reserve System in 1913. More or less stable prices and low joblessness were regarded as desirable byproducts of a resilient banking system, not the explicit goal. The more expansive mandate established in 1978 likely has distracted the Fed from its foundational mission.

If that’s too great a leap back, Congress should reaffirm the Fed’s legal responsibility for zero inflation or at least require the Fed to seek explicit legislative permission for sustained deviations from that goal. The Constitution requires elected officials to approve budget appropriations, trade treaties and declarations of war. Why not inflation targets?

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