EDITORIAL

The Fed at the Crossroads

By The Editorial Board

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Barring unexpected bad economic news in the next several days, the Federal Reserve will finish its bond-buying program at the end of this month. In all, the program has pumped $3.5 trillion into the economy since 2008, helping to revive financial markets and stabilize the economy.

Now comes the hard part.

In its effort to wean the economy off of extraordinary monetary support, the Fed's next task is to decide when to raise interest rates from their prolonged ultralow levels.

Technically, the decision is straightforward. It is appropriate to raise rates when the economy shows signs of overheating, as measured by inflation in wages and prices. Currently, there are no such signs. Wages have long stagnated, even for college-educated workers. As for prices, the Fed's preferred annual inflation measure was recently 1.5 percent, well below its 2 percent target.

Politically, however, the decision is fraught. The Fed is not supposed to be swayed by elected officials or special interests. But bond holders — a powerful political constituency that includes financial firms, investment funds and wealthy individuals — generally want the Fed to raise rates sooner rather than later, and they have ample opportunity to dominate public discourse. Their aim is to pre-emptively attack inflation, which diminishes the value of their bonds.

But it is not the Fed's job to protect investors' bond portfolios. Its job is to foster both stable inflation and full employment. With the American economy still operating below par, low interest rates would pose an inflation threat only after they had succeeded in spurring credit, strong growth and robust employment. Since those results have not yet been achieved, there is no inflationary pressure and no reason to raise rates in the near term.

In fact, inflation has been so low for so long that the economy would not be in danger of overheating even if there were a period of inflation above the 2 percent target. That target is an average that the Fed would like to maintain over time, not a level that necessarily signals the need for a rate increase.

Similarly, wages can rise at a rate well above inflation without pushing up prices. That's because wage increases do not even begin to pose an inflation threat until they exceed the rate of inflation plus the rate of labor-productivity growth, roughly 3.5 percent currently.

Fed officials have indicated that they plan to start raising rates in mid-2015. They have stuck to that timetable, even as wage-and-price increases have failed to materialize. That policy consistency is understandable on one level: With many months to go before it has to either raise rates or admit that the economy is too weak to warrant an increase, the Fed rightly wants to project optimism.

It is crucial, however, for the Fed to keep rates low as long as inflation is in check. If rates are raised too soon, growth would be slowed before pay raises and adequate credit are restored to workers and consumers.

If that happens, the Fed effort to rescue the economy would, in the end, only further entrench inequality.

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