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REVIEW & OUTLOOK

The Fed at Ease

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The Federal Reserve stayed true to its recent news leaks yesterday and held its target interest rate at 2%. In lieu of action, Chairman Ben Bernanke and his mates decided merely to talk tougher about inflation, signaling that they may lack the will to tighten money in an election year.

As the nearby chart shows, the Fed continues to run a highly accommodative monetary policy. The consumer price index is rising at a rate roughly double the fed funds rate, and the CPI is a lagging indicator. Producer prices in May were up 7.2% on an annual basis, and that's before soaring oil and food prices have made their way through the economy. The dollar remains weak against gold, oil, the euro, you name it.

Every American who drives or shops for groceries understands this, except at the Fed, where they bow before something called "core inflation." This is a way of measuring prices without including food and energy, and so we are supposed to take comfort that "core inflation" is rising at only a 2.3% annual rate. Yet it is the Fed-induced price spike in food and energy since last August that has Americans in an uproar and Congress in a panic that may yet produce major policy blunders.

But don't worry: Yesterday's Fed statement averred that it "expects inflation to moderate later this year and next year." That's good to know, though the Fed Governors will have to do some evangelizing because this isn't what the public thinks. According to the Conference Board's June survey of consumer sentiment, Americans believe inflation over the next 12 months will be 7.7%. That's up from 6.8% in April, 5.4% in February, 5% last September, and the highest in the last 20 years.

It was only a couple of months ago that Frederic Mishkin, Donald Kohn and other Fed Governors were asserting that "inflationary expectations" were "anchored." In fact, those expectations are soaring, which means that they will soon begin to show up in wage demands.
and price increases throughout the economy. The more deeply those expectations become embedded, the harder they are to change and the more the Fed will have to tighten money to uproot them.

Meanwhile, inflation continues to rise around the world, especially in what the Paul Volcker Fed understood was the "dollar bloc." Headlines like this one have become routine: "Chinese agree [to] 96% rise in iron ore prices." Mexico's CPI has leapt above 5%, and Brazil's overall inflation rate is nearly 6%.

All of this is evidence that the Bernanke Fed has failed in its main responsibility of maintaining price stability and a stable dollar. In its defense, the Governors would say they have acted to prevent the credit crisis from becoming a global recession. But in the process they have ignited a global spike in commodity prices that amounts to a huge tax increase on much of the world. It is crushing the airlines, may well break the U.S. car companies that rely on SUVs for their profits, and is sapping the purchasing power of the American middle class.

It has been an historic blunder, and the damage will only increase the longer the Fed takes to correct it.

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