

The legacy of Powell at the Fed

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Central bank's outgoing chair made mistakes but his decision to stand up to the president was heroic



Jay Powell is an honourable and intelligent man. He has handled the political side of being Federal Reserve chair – particularly relations with Congress – with skill and impartiality. Above all, he has stood up to vindictive abuse from Donald Trump, the man who appointed him, only to label him a “moron” for the crime of doing his job.

The president's poodles at the Department of Justice even opened an absurd criminal investigation into Powell. He is indeed one of the few people to emerge from the experience of working with Trump untaunted. The fact that he plans to remain on the Fed's board under his successor, Kevin Warsh, is encouraging, since the next few years are likely to be challenging indeed for US monetary stability.

Unlike Arthur Burns, Fed chair under Richard Nixon, Powell stood up to the bully. That is admirable. Unfortunately, he has faced other challenges that have, arguably, not been handled quite so well. The most important was the disruption caused by the Covid-19 pandemic. The Fed, like other central banks, failed to keep inflation at 2 per cent a year. Some argue that, given the scale of that disruption, what happened was the least bad outcome. But in March 2026 the US personal consumption expenditures price index was 10.4 per cent higher than it would have been if the Fed had hit its 2 per cent annual target from January 2020 onwards. This was rightly hated by voters.

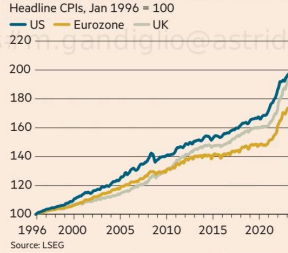
From this experience, it is rational for people to conclude that over time the 2 per cent target will be exceeded. That is because central banks will allow prices to rise permanently above the levels implied by the inflation target in response to a big shock. But they will work far harder to prevent it from falling consistently below that level.

The Fed also made its job harder by moving to a new regime, in which bygones would no longer be bygones. In August 2020, the Fed said that it “seeks to achieve inflation that averages 2 per cent over time”. Thus, “following periods when inflation has been running persistently below 2 per cent, appropriate monetary policy will probably aim to achieve inflation moderately above 2 per cent for some time”. This was both a bad idea and a badly mistimed idea, since it was followed by a period of very high inflation.

This episode also raises questions about the Fed's economics. I have long considered it a mistake to jump from the naive monetarism of the 1980s to the conviction that money never matters at all. The experience of the 2020s shows it still does, as I suggested back in May 2021. Indeed, it is a test case.

Monetarists would argue that a big jump in a relevant measure of the money supply would lead to a corresponding jump in the price level. In the short run, the ratio of money to nominal GDP would soar, but, as the price level responded, nominal GDP would itself jump, returning the ratio of the two

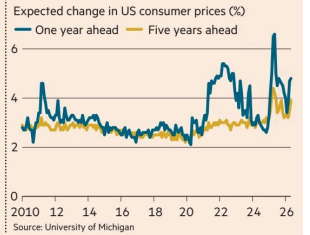
Price levels suddenly jumped after Covid



The broad money to nominal GDP ratio rose and then fell as inflation drove the latter up



US inflation expectations have not yet gone securely back to target



roughly back to where it started. This is almost exactly what happened: the ratio of broad money to US nominal GDP jumped in early 2020, from 70 per cent in the last quarter of 2019 to 91 per cent in the second quarter of 2020, and then fell back to 71 per cent as the price level (and money GDP) jumped. (See charts.)

Some would argue that the apparent precision of the forecast is a false positive for monetarism. Others would argue that, given the scale of the negative supply shock during and after

Covid, temporarily above-target inflation and a permanently higher price level were a small price to pay, particularly since the disinflation did not require the jump in unemployment some feared. Moreover, if monetary policy had not been so loose, the Covid and post-Covid experience would have been more traumatic. Maybe so. But what is certain is that the Fed and other central banks did not expect the soaring inflation and, in my view at the time, ended up tightening policy far too late.

It is always difficult to debate over counterfactuals. Thus, we do not know what would have happened if monetary (and fiscal) policy had been less expansionary during and after the pandemic. But taking the view that money has no effect on people's behaviour, other than via short-term interest rates, is foolish.

Another mistake was not to insist that the large regional banks have resolution plans. The failure of Silicon Valley Bank and the rescue of uninsured depositors were an example of moral hazard incarnate. The pressure to deregulate banking usually ends badly.

Judge Powell to have passed through the fires of the pandemic and Trump no more than sinned, particularly since, as a non-economist, he had to rely on his technicians. He also, rightly, stuck to the core tasks of the Fed and avoided getting mired in vexed climate politics. It will be no easy task for Warsh to do as well. He has already suggested that AI will be disinflationary. Given the huge investment spending, this view is premature. The balance between the effects on demand and supply is unknown.

Similarly premature is the view that

the Fed's balance sheet must be shrunk. No pressing reason exists for doing so. It would surely tend to raise long-term interest rates. Doing that might demonstrate independence from Trump. But that is hardly a good enough reason.

The immediate challenge will be the Hormuz crisis. In that context, higher rates might indeed be necessary. But standard monetary policy would be more flexible than reductions in the balance sheet. Apart from all of this, Warsh has to ensure that free-market ideology does not lead swiftly to another huge financial crisis. As Powell knows, Fed chairs are not guaranteed popularity with either the people or the president. Warsh must prepare himself for tough times ahead.

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His successor has to ensure that free-market ideology does not lead swiftly to another financial crisis