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Insiders seek radical policy review under new Fed Chief

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Federal Reserve officials are pushing for a potentially radical revamp of the playbook for guiding U.S. monetary policy, hoping to seize a moment of economic calm and leadership change to prepare for the next storm.

While the country is enjoying its third-longest expansion on record, inflation and interest rates are still low, meaning the central bank has little room to ease policy in a downturn before hitting zero again.

With Jerome Powell nominated to take over as Fed chairman in February, influential officials including San Francisco Fed chief John Williams and the Chicago Fed's Charles Evans have taken the lead in calling for reconsidering policy maker's 2 percent inflation target.

"It's a good time given the shift in leadership," Atlanta Fed President Raphael Bostic told reporters on Tuesday in Montgomery, Alabama. "The new guy comes in and they are able to really think about, how should this work, how do I think this should work, and is it compatible with where we've been and where we are trying to get to?"

Formalized Policy

The Fed in 2012 officially settled on 2 percent inflation as an explicit target for the price stability half of its dual mandate from Congress. The other goal is maximum sustainable employment.

The move formalized a policy they'd been following in practice for several years, and it was backed by careful logic: 2 percent is high enough to ensure that workers continue to get raises and to give the Fed some cushion against deflation. Other advanced economies aim for a similar level.

Yet Fed officials have been urging the policy-setting Federal Open Market Committee to revisit that approach.

"I do think that's a very important thing that we should all be starting to think about, to prepare ourselves and evaluating," Cleveland Fed President Loretta Mester told a monetary policy conference at the Cato Institute Thursday in Washington. "The Bank of Canada rethinks its framework every five years. It seems to me that's not a bad thing."

The reason? The target was settled at a time when officials thought they'd have no problem in lifting interest rates to 2 percent or higher without choking off growth. But fundamentals in the economy have changed since the crisis. Growth and productivity have been tepid.

As a result, the so-called neutral level of interest rates -- which neither speeds up or slows the economy -- is very low by historic standards, leaving the Fed with less wiggle room.

Allowing prices to rise slightly higher would give the Fed more scope to ease in the next downturn. The federal funds rate is quoted in nominal terms, or not adjusted for inflation. So if neutral stands at 0.5 percent, in real terms, and prices are rising at a 3 percent pace, the Fed can get rates as high as 3.5 percent before policy would be restrictive. If inflation were only 2 percent, that level in nominal terms would be 2.5 percent.

Williams told reporters in early November that he favors discussing a new framework now, though he doesn't want to tie the talks to near-term strategy.

"It would be optimal to have a decision around what's the best framework that we should be using well before the next recession," he said, because it will "take some time" for officials to hammer out such an important policy.

Possible Options

In a speech Thursday, Williams added that policy makers around the world should be thinking together about how to grapple with lower interest rates, since their policy choices are likely to be muted or exacerbated by spillover effects.

"I'm not calling for a coordinated global strategy, but I do think we should all be talking to each other," he said. The Bank of Canada's practice of reviewing its inflation target every five years is something other central banks would benefit from, he suggested.

Alternative approaches could include allowing prices to overshoot for the same amount of time they undershot -- commonly called price-level targeting -- or even raising the desired inflation goal to 3 percent.

Less radically, Fed officials could make their willingness to overshoot the inflation goal more formal by forecasting above-two-percent inflation in their quarterly economic projections, Bank of America Merrill Lynch economist Ethan Harris suggests.

"There's a host of possible options, and I have not settled on any one of those yet," but it merits a discussion "now," Philadelphia Fed President Patrick Harker said in an interview with Bloomberg News earlier this month. "This is a discussion we're going to have to have within the Fed, and within the broad economic community."

There's good reason to discuss the future of monetary policy now. The unemployment rate is low and growth is humming along steadily, and though inflation remains below target, officials expect it to pick up in coming months. In this period of economic calm, economists can debate the merits of different approaches slowly and carefully.

"Developing a new framework prior to the next zero-lower bound episode allows time for a shift in the nature of forward guidance -- and communications more generally," Evans said Tuesday in Frankfurt. The policies would then be better understood, better refined, and "therefore, likely be more effective," he said.