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Ben Bernanke wants interest rate shake up

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Former US Federal Reserve chairman Ben Bernanke has called for central banks to consider adopting a radical new interest rate framework that would shake up the monetary policy system that has managed the world economy for the past 25 years.

To deal with the problem of stubbornly weak inflation when interest rates are anchored near zero, as currently experienced in many industrialised economies, Dr Bernanke proposed shifting to a temporary price level target instead of an inflation rate target.

The system would allow inflation to temporarily overshoot after a prolonged inflation shortfall, but might also lead to more rapid rate rises later on and increase volatility.

The technical proposal, which Dr Bernanke emphasised was not a recommendation for current Fed policy but rather for policymakers in the future, could help lift weak inflation during economic downturns, he said.**Bloomberg**

"Inflation targeting is a very inefficient response to the problem of low nominal interest rates," Dr Bernanke said in a speech in Washington.

"A better approach is the price level target idea."

"This is about telling bond markets that when you're in the ZLB [zero lower bound] and inflation is below target we're going to keep rates lower for longer."

As prolonged subdued inflation perplexes economists, central bank heads including Reserve Bank of Australia governor Philip Lowe and Fed chair Janet Yellen are gathering in Washington on Friday and Saturday for the G20 and International Monetary Fund meetings.

Since the 2008 global financial crisis central banks have experimented with negative interest rates, multi-trillion dollar asset purchase programs, assuring investors that rates will stay low for a long time and trying to manipulate yield curves in bond markets.

Despite the unprecedented monetary stimulus, inflation in most of the world has remained weak.

Economists have debated new monetary policy approaches, such as increasing the inflation target, targeting nominal GDP or dumping the inflation target in favour of a price level target.

Existing inflation rate targeting regimes that have existed since the 1990s typically aim for an annual goods and services inflation rate, such as the RBA's 2 to 3 per cent target range or the Fed's 2 per cent target. If inflation misses to the high or low side, central banks typically do not try to "make up" the difference in the future.

Under Dr Bernanke's blueprint that he expanded on in a Brookings Institution blog, the central bank would try to make up for inflation shortfalls.

For example, if 1 per cent inflation was recorded under a 2 per cent target regime, the central bank would aim to hit a 3 per cent inflation rate so that price levels rose 2 per cent on average.

The scheme would be implemented when rates were at or near zero, before reverting back to a conventional inflation targeting regime after inflation had jumped higher.

Fed governor John Williams in May expressed support for the proposed system so "any surges or drops in the inflation rate need to be made up in the future".

Dr Bernanke spoke at the Peterson Institute for International Economics in the presence of European Central Bank president Mario Draghi, Fed governor Lael Brainard, Bank of England chief economist Andrew Haldane, former US Treasury secretaries Larry Summers and Robert Rubin and former IMF chief economist Olivier Blanchard.

Dr Brainard, a dovish Fed policymaker who has argued to keep rates low, said Dr Bernanke's "substantial departure" from existing monetary policy frameworks was "very practical" for when conventional monetary policy was constrained by zero interest rates.

"By pre-committing to implementing the 'make-up' principle based on the actual observed performance of inflation, the framework proposed by Ben could guard against such premature [interest rate] liftoff and help prevent the erosion of inflation expectations," she said.

However, Dr Brainard cautioned that a possible risk was the public doubting the central bank's commitment to ultimately tame inflation if there was an inflation "overshoot" that was too big.

"One additional challenge as I see it in the proposed framework is navigating a path for the policy rate immediately following lift off that smoothly and gradually eases inflation back down to target and facilitates a gradual adjustment of the labour market," she said.

"History suggests this is no easy task."

Dr Bernanke acknowledged there were problems with permanent price level targets. An oil price surge or other supply shocks could force central banks to tighten policy rapidly and not ignore the temporary price rises as they currently do.

Hence, a temporary – not a permanent – price level target was desirable, he said.

Tate Lacey, a monetary policy analyst at the libertarian Cato Institute, said shifting towards a more rules-based system would be welcomed, but periodically swapping between a price level target and an inflation target was problematic.

"Going back and forth between operating frameworks is overly complicated," he said.

A nominal GDP target was superior at handling supply shocks, such as an oil shortage, that drive up prices, Mr Lacey said.