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Stock declines just one of the challenges Powell may face as Fed chairman

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Federal Reserve Chairman Jerome Powell faced a sharp drop in the equities market as he was sworn in Feb. 5, highlighting one of the possible challenges he may encounter as the U.S. central bank looks to continue tightening monetary policy a decade after the financial crisis.

On the whole, the economy appears to show healthy signs, with an unemployment rate of 4.1%, inflation appearing to be rising toward the Fed's 2% goal and the country's largest banks passed the last round of stress testing.

But a recent sell-off in the equities market, driven largely by investors worrying about central bank tightening, reflects the balance that Powell will have to strike as the Fed continues to gradually raise interest rates. Below are some of the challenges that Powell may encounter, according to analysts from the libertarian Cato Institute and the progressive Economic Policy Institute.

Tate Lacey, policy analyst at Cato's Center for Monetary and Financial Alternatives:

***1) Fed turnover* —** Lacey noted the Fed is seeing an "unprecedented level of turnover," with Janet Yellen's exit leaving the Board of Governors at three out of seven members.

The Fed board, whose vacancies include the vice chairman role, last year tweaked its quorum requirements in anticipation of some logistical difficulties, given that it has not dropped down to three members since its current structure started in 1936.

William Dudley, president of the Federal Reserve Bank of New York, is also leaving in the middle of the year, and his successor has not yet been selected. The Federal Open Market Committee also has two relatively new voting members this year in Federal Reserve Bank of Atlanta President Raphael Bostic and Federal Reserve Bank of Richmond President Thomas Barkin.

2) Balance sheet reduction — Last year, the Fed began trimming a balance sheet that peaked at around $4.5 trillion as the central bank tried boosting the economy after the crisis.

Lacey said Yellen's Fed took "great pains" to clearly communicate the plan for those gradual reductions and that the Fed wants the effort to take place in the background, with little effects on the markets. But as the Fed begins trimming off the balance sheet this year, Lacey said, Powell will have to be mindful of whether the roll-offs will have broader effects.

"The Fed does not have a ton of experience in this world," Lacey said. "People have thought a lot about it, but in practice, it's going to entail some new developments."

***3) Excess reserve payments to banks* —** Since 2008, the Fed has been paying depository institutions for their excess reserve balances, and those payments have been going up as the Fed continues raising short-term interest rates.

The Fed, for example, remitted $80.2 billion in profits to the Treasury Department in 2017, dropping by $11.3 billion from 2016 largely due to the payments to banks rising. Some Republicans, such as House Financial Services Committee Chair Jeb Hensarling, R-Texas, have questioned whether those payments amount to a subsidy for banks.

Lacey said those payments will "come under some increased scrutiny" and that it would be helpful if the Fed thought "seriously and publicly" about whether they intend to stick with that system.

Josh Bivens, director of research at Economic Policy Institute

1) Continued weakness in inflation — Bivens noted the Fed has continually missed the explicit 2% inflation target it set in 2012, potentially posing a problem for the Fed's credibility if the misses persist.

Bivens said further rate hikes from the Fed would be unwise because hiking rates "seems to be precisely the wrong thing to do" if the goal is boosting inflation. He also said undershooting the goal limits the Fed's ability to respond to the next downturn because higher inflation gives the Fed more room to push down interest rates.

"If we enter the next recession not even having gotten back to that 2% level, you're essentially entering the next recession with a lot less ammunition for monetary policy to help," he said.

Fed officials are beginning to debate whether they should move away from the 2% target, though former Federal Reserve Chairman Ben Bernanke said last month the debate will likely not heat up until 2019.

2) Market downturns — Bivens, speaking before the recent decline in the equities market, said the stock market was looking "pretty frothy" and could face a downturn.

So far, Fed officials say they are not concerned about the recent developments. But Bivens said if the stock market or another sector were to turn into a bubble in the coming months, Powell would have to lead the Fed in figuring out how to "engineer a deflation of a bubble without causing a recession."

Among the tools Powell could consider, he said, is speaking out consistently when he sees overly high valuations in certain sectors. His predecessor, Janet Yellen, warned about tech sector valuations during a 2014 appearance in Congress that led to temporary drops in that industry, and Bivens said using those warnings more consistently could help.

"There is some evidence there that consistent talk could make a difference. ... Plus, it's free. It doesn't cost anything," he said.

3) Unconventional monetary policy options — The Fed may have to give some thought on the unconventional tools it could implement if there is another severe economic downturn.

Fed officials have made clear that they do not want to see a change in the pace of balance sheet reductions, though they are ready to re-evaluate their plan if needed. Bivens said further quantitative easing could happen during the next recession, though there are several other tools that the Fed could consider, such as setting longer-run interest rate targets.

Another option, Bivens said, is the "helicopter money" approach of the central bank giving money to people directly so their spending can stimulate the economy, though he noted the Fed is "nowhere near" ready to take on that unconventional approach.