https://www.ft.com/content/b07f7354-1165-11ea-a7e6-62bf4f9e548a

US Inflation

US Federal Reserve considers letting inflation run above target

Bid to avoid weak price growth would be biggest policy revamp since 2012

Federal Reserve Bank of Boston president Eric Rosengren, left, with Fed chairman Jay Powell © AP

Brendan Greeley in Washington YESTERDAY

The Federal Reserve is considering introducing a rule that would let inflation run above its 2 per cent target, a potentially significant shift in its interest rate policy.

The Fed's year-long review of its monetary policy tools is due to conclude next year and, according to interviews with current and former policymakers, the central bank is considering a promise that when it misses its inflation target, it will then temporarily raise that target, to make up for lost inflation.

The idea would be to avoid entrenching low US price growth which has consistently undershot its goal.

If the Fed adopts this so-called "make-up strategy", it would mark the biggest shift in how it carries out its interest rate policy since it began to target 2 per cent inflation in 2012.

Policymakers are frustrated by the failure of prices to hit their target even as US unemployment has plumbed 50-year lows.

The new policy would require “making it clear that it's acceptable that to average 2 per cent, you can't have only observations that are below 2 per cent,” Eric Rosengren, president of the Federal Reserve Bank of Boston, said in an interview with the Financial Times last week.

Consumer and investor expectations for what inflation will be in the future play a crucial role in determining the rate of price increases. In their meetings and speeches, Fed officials have expressed concern that their interest rate policy will become less effective if inflation expectations become anchored permanently lower, as they have in Japan and Europe.

Fed researchers first looked into make-up strategies in the early 2000s, but at the time, with its policy rate around 6 per cent, it was an academic question. Now, by comparison, interest rates are much lower, at 1.5 to 1.75 per cent. That leaves the Fed little room to drop them further in a downturn, given it does not intend to pursue negative rates.

And policymakers, having been forced to tinker with their policy tools after the last recession, are now inclined to consider other changes before the next downturn takes hold.

Janet Yellen, former chair of the Fed, said the discussion was “a worthwhile thing” and the policy would be similar to the “forward guidance” the Fed used during the recovery, when it signalled to markets that it intended to keep short-term interest rates low well into the future. That drove down longer-term rates as well.

An explicit make-up strategy would be “more aggressive”, Ms Yellen said — if it were explained to markets effectively, investors would know at the start of a downturn that the Fed was already committed to keeping rates lower for longer during the recovery.

In September when Fed staff economists presented make-up strategy options to the central bank’s Federal Open Market Committee, several policymakers were concerned that a rigid, mathematical rule might restrict the Fed from being flexible as new economic data came in.

Some Fed members are worried that a make-up rule would rely too much on the as-yet unknown will of future policy committees.

“Future committees might not be as comfortable with that formulaic approach,” said Mr Rosengren. “Which is why I prefer something that is a little bit more flexible, maybe not as constraining, but makes it a little clearer that we should be having [some inflation readings] over 2 per cent.”

Fed governor Lael Brainard, speaking to reporters last week, said that a strict make-up rule would be too hard to explain to the public. Like Mr Rosengren, she preferred a more flexible approach, such as suggesting a target range of 2 to 2.5 per cent inflation after a period of misses.

“That’s a fairly simple thing to communicate to the public,” she said. “It’s very important, obviously, for those rules to work effectively that financial market participants, households and businesses all understand what you’re doing.”