



A Two-Headed Dragon for Monetary Policy

James Bullard

President and CEO

Roundtable Discussion: Long-Run Economic Challenges: A Federal Reserve Perspective

American Economic Association Meeting, NABE

January 3, 2009



A Two Headed Dragon for Monetary Policy

- I will emphasize two medium-term issues for the Federal Reserve.
 - Looking a few years ahead.
 - I hope that qualifies as long-term challenges.

- I will not touch on regulatory reform in these opening remarks even though that is an important issue.
 - A near-term challenge?



Introduction

- Let me begin by recalling the Volcker Fed of 1979.
 - 70s economy was characterized by dramatically high interest rates and inflation by U.S. standards.
 - Real economy also very volatile by later standards.
 - The “monetarist experiment” of 1979-82 set up the Fed to “slay the inflation dragon.”
- An important moment in American Economic History.
- Set the stage for long booms punctuated by relatively mild recessions.



Introduction

- Today's situation is not 1979.
 - Inflation is low, for instance.
- But the drama is similar.
 - Aggressive actions have been taken by the Fed.
- One similarity: Dropping nominal interest rate targeting as the primary focus of monetary policy.
 - That was the thrust of October 1979.
 - This time, forced on the Fed by events and the zero bound on nominal interest rates.



Main Concern

- My concern: How to keep medium- and longer-term inflation expectations anchored in this new reality
 - Private sector completely accustomed to thinking in terms of nominal interest rate movements as the very definition of monetary policy.
 - Normal times: Nominal interest rate targeting as espoused by Taylor and Woodford works well.
 - Exceptional times like today: Ability to signal to the private sector via nominal interest rate movements is lost.
 - Medium run expectations for inflation can begin to drift.



The Two-Headed Dragon We Face

- The risk of a deflationary trap a la Japan.
- The risk of a 70s-style inflation stemming from a failure to control monetary base growth.



The Risk of Deflation

- In this discussion, let's not be too bothered by the facts:
 - Core inflation measured from one year ago is about 2 percent.
 - It would take a lot to drag a measure like this down to negative levels.
 - So we are far from deflation today.
 - But the spirit of the discussion is to focus on the medium term.
- If deflationary expectations become entrenched, then deflation could become a reality
 - So this is a serious risk.



The Risk of Deflation

- We also have the Japanese experience
 - Clear problems in their banking sector in the 1990s, not unlike the U.S. today.
 - Deflation in year-over-year core numbers for much of the time since the mid-1990s.

- Why worry about deflation?
 - Nominal contracts, especially in housing.
 - Unexpected deflation would worsen the situation.
 - Also, Japan appears to be in a “steady state,” which I will now turn to.



The Risk of Deflation

- I have been influenced by Benhabib, Schmitt-Grohé and Uribe on this issue:
 - “The Perils of Taylor Rules.” *Journal of Economic Theory*. 2001
 - Also much subsequent work.



The Risk of Deflation: Benhabib, Schmitt-Grohé and Uribe

- The idea in a nutshell:
Any model with:
 1. A Fisher relation $R = r + \pi^e$
 2. A continuous Taylor rule
 $R = R(\pi)$
 $R'(\pi) > 1$
which is “active.”
 3. A zero bound on nominal interest rates.
Will possess a second “trap” steady state.



The Risk of Deflation: Benhabib, Schmitt-Grohé and Uribe

- The trap steady state is characterized by:
 - Very low or zero nominal interest rates.
 - Very low or negative inflation rates.
- The trap steady state co-exists with the target steady state.
 - Inflation is at target or near target.
 - Nominal interest rates are positive.



The Risk of Deflation

- I like the two steady states idea as a way to conceptualize:
 - The Bank of Japan policy rate has not been above 1% since 1994 –14 years!
 - *And, it's headed back down.*
 - This sounds more like a steady state outcome.
 - *Not just a temporary visit.*
- The risk is falling into the deflationary trap steady state:
 - We do not know much about the dynamics.
 - Just a way to think about possible outcomes.
 - A long-run issue.



The Risk of Deflation

- How to slay this part of the dragon?
 - In the literature, “eliminate the bad equilibrium.”
 - Adopt policies that change the set of long-run outcomes.
 - With that in mind ...
- The paper was called “The Perils of Taylor Rules.”
 - In the model, the policymaker is a slavish devotee of Taylor.
 - The devotion works well at the target steady state.
 - The rule is credible and is not abandoned at any point.
 - But, this devotion creates the trap steady state.
 - Logic: inflation is too low, but nominal interest rates cannot be lowered.
 - This keeps the economy in the trap.



The Risk of Deflation

- Volcker 1979 idea: Switch policy rules at a key juncture.
 - This is something like what the FOMC did at the December meeting.
 - De-emphasize nominal interest rates.
 - Emphasis is on quantitative policy measures going forward.
 - This emphasis should help to control expectations and guide inflation toward target.
 - I am hopeful that the deflationary outcome can be avoided this way.



Too much of a Good Thing?

- It's possible.
- This leads to the second dragon head:
 - Possibility of 70s style inflation as a medium term outcome.



The Risk of Inflation

- Orthodox economics a la Milton Friedman: it is essential to think about money when thinking about policies to control inflation.
 - The monetary base has increased dramatically in the U.S. since September 2008.
 - Deficit spending is increasing dramatically.
 - These would normally be considered inflationary developments –medium term.
 - How to stop this?



The Risk of Inflation: How to stop this?

- Two Ideas:
 - Reversibility of liquidity programs.
 - Set an inflation target.



The Risk of Inflation: How to stop this?

- Times of Crisis and Lender of Last Resort.
 - Central Banks often flood the system with reserves in times of crisis.
 - Once the crisis passes, the action is reversed.
 - The inflationary consequences of this type of action are minimal.



The Risk of Inflation: How to stop this?

● Reversibility

- Many of the newly introduced programs are temporary.
- Some have explicit termination dates.
- Others are under 13(3) authority which has to end.
“Emergency.”
- All involve collateralized lending.
- It seems the reverse build up could be reversed quickly and easily.



The Risk of Inflation: How to stop this?

- Questions about Reversibility
 1. Crisis is often a short event measured in “weeks.”
 - This one is 13 months and promises to go on for a long time.
 - A problem? No good news for 6 months?
 2. What will the criteria be for exiting programs?
 - Normal functioning of markets?
 3. Scale of programs is very large.
 - Large scale needed to have an impact.
 - Might size hamper reversibility?



The Risk of Inflation: How to stop this?

- The second idea, other than reversibility would be to set an explicit inflation target.
 - Help focus expectations.
 - Has to be backed by action.
 - Would help fight the two-headed dragon.



Conclusions

- A time of very fluid, volatile expectations.
 - We know expectations are a major factor in macroeconomic performance.
 - How the Fed acts in 2009 may have important consequences fro the longer run.
- I emphasized two risks.
 - A Japanese-style deflation trap risk.
 - Inflation risk as in the 1970s.
 - Both very real medium-term risks.
- An explicit inflation target would help mitigate these risks.



Long-Run Economic Challenges: A Federal Reserve Perspective

James Bullard

President and CEO

American Economic Association Meeting, NABE

January 3, 2009



A Two-Headed Dragon for Monetary Policy

James Bullard

President and CEO

Roundtable Discussion: Long-Run Economic Challenges: A Federal Reserve Perspective

American Economic Association Meeting, NABE

January 3, 2009