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The Fed Makes History

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On December 16, 2008, Federal Reserve chairman Ben Bernanke exercised decisive leadership at a watershed meeting of the Federal Open Market Committee (FOMC). In its official statement after the meeting, the committee pledged to "employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability."[1] The pledge to preserve price stability was not a commitment to fight inflation, as is typical, but a highly unusual commitment to fight deflation.

By cutting the federal funds rate virtually to zero, the Fed specifically acknowledged that it would have to transition to open market operations (measures other than adjusting the fed funds rate) to increase the supply of money. Specifically, the Fed's December 16 statement said that "the focus of the [Open Market] Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level." The Federal Reserve will achieve these ends primarily by printing money.

Fighting Both Deflation and Inflation

Usually when central bankers talk about price stability and measures to achieve it, they are talking about controlling inflation. Most central banks aim for a low inflation rate—between 1 and 2 percent—because low levels of inflation tend to be stable and conducive to more efficient resource allocation and faster growth. In principle, a fully predictable higher inflation rate—say, 5 percent—could be feasible because economic agents could simply incorporate a stable 5 percent inflation rate into their planning. But in practice, high inflation rates tend to be less stable and to move higher as central banks are tempted to stimulate the economy at a time when, say, unemployment rises while the inflation rate is 5 percent. Therefore, low, stable inflation targets are the norm.

It is necessary for central banks to sharply reorient thinking when deflation threatens. First, it is important to remember that for a central bank seeking price stability—say, a low inflation rate of 1 percent—a claim that 1 percent inflation is better than 5 percent does not mean that –1 percent inflation is better than 1 percent inflation. Beyond that, 5 percent deflation is more than five times worse than 1 percent deflation because the risk of depression rises exponentially as deflation accelerates. The faster prices fall, the less firms and consumers spend as they wait for lower prices. The more spending that is put off now, the more prices fall and the greater the incentive to postpone spending further—and so on. A deflationary spiral is a dynamically unstable, self-reinforcing downward move in the overall price level that causes aggregate demand to collapse, thereby inducing further deflation. Note that I am not talking here about the effect of a benign movement down along a demand curve to a lower price for a single commodity, but rather about a pervasive and accelerating downward move in the overall level of prices.

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December 16, the Federal Reserve took the first decisive step away from the risk of depression that has been overhanging markets, lowering prices of risky assets, and freezing credit. The Fed's pledge to fight deflation is a necessary, but not a sufficient, condition to avoid deflation. The sufficient condition will be implementation of the Fed's commitment to expand its balance sheet rapidly enough to convince households and firms that the price level of most goods and services a year from now will be at or above its current level. If the pledge is for a higher price level two or more years from now, the Fed is giving itself more time to contain and reverse deflation. The time horizon over which the price level target is sought is an important policy variable.

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The arrival of deflation raises an important issue for central bankers: is it better to target a given, low level of inflation or to target a given future overall price level for goods and services? If the target is a price level—say, a price level that is the same five years from now as it is today, or slightly higher—then movements of inflation above or below the path implied by the price level target must be reversed. If the inflation rate rises above its implied stable path in year two of the five-year price level timetable, then just moving back to the target stable inflation path thereafter will still leave the price level above its target in five years' time. Alternatively, if a period of deflation drops the inflation rate below its implied stable path, then a period of inflation above that path must follow in order to achieve the target price level.

Three additional points arise with price level targeting. First, the future price level target can be set slightly higher to imply a modest—say, 1 percent—inflation rate. Second, the time frame over which price stability is sought can be adjusted to avoid having to make abrupt transitions back to the implied target paths for the price level. And third, if deviations from the target line are to be corrected promptly, inflation requirements subsequent to deflation (or vice versa) have to be more pronounced.

The discussion of price level targeting illuminates a fundamental truth concerning deflation. The Fed, or any central bank, has to be willing to risk a period of above-target inflation in order to fight deflation. That is problematic inasmuch as most central banks have, in the process of fulfilling their mandate to promote price stability, had to spend most of their time engaged in the opposite pursuit—fighting inflation. The major exceptions occurred in the United States in the 1930s and in Japan in the 1990s through 2001.

The steps toward risking inflation in order to exit U.S. deflation during the Depression came during 1933 and early 1934 when the new Roosevelt administration raised the price of gold from $22 an ounce to $35 an ounce. Since the world was operating on a gold standard, a higher price of gold in the U.S. caused money to flow into the United States, boosted the monetary base, and boosted the money supply enough to contain deflation by 1935. That was the gold-standard-era equivalent of the Fed's move on December 16 to quantitative easing.

In Japan's deflation-fighting episode, the central bank cut interest rates virtually to zero by 1999 and in 2001 pledged aggressive quantitative easing by injecting large amounts of money into Japan's commercial banking system—its major supplier of credit. The results were not successful at first because the Bank of Japan continued to insist it was concerned about a possible outbreak of inflation—when under a price-level-targeting regime it ought to have been openly hoping for inflation. In a recent interview with the *Financial Times*, the current governor of the Bank of Japan, Masaaki Shirakawa, characterized the period following the Bank of Japan's 2001 quantitative easing as follows: "The massive increase in reserves was effective in maintaining financial system stability when the financial system was in a delicate and unstable situation *but was not that effective in boosting demand*."[2]

The collapses of the housing and stock markets, both in the United States and abroad, have erased about one-third of global wealth. So far, efforts to contain the consequent damage to the U.S. economy have been largely unsuccessful. Demand has continued to collapse. Most policy measures have been directed at sharply increasing the liquidity available to banks in the hope that the banks would begin to provide credit to households and firms. Credit markets, however, remain largely frozen because banks are still deleveraging, given their

heavy exposure to risky assets. If the Fed takes steps, as promised in the FOMC's December 16 statement, to provide funds directly to credit markets by "purchas[ing] large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets," the availability of credit in those markets will improve while the cost of credit falls irrespective of the activities of banks. Still, however, many Fed spokesmen and FOMC members, like their Japanese counterparts earlier in this decade, have continued to express concerns about the risk of inflation.

Will It Work?

The Fed and other central banks have their work cut out for them if they are to succeed in promoting "the resumption of sustainable economic growth and [preserving] price stability." Deflation psychology is even more dangerous to the economy than inflation psychology because of the "zero-bound problem"—interest rates cannot be cut below zero. To put the same thing another way, central banks can fight accelerating inflation more readily than they can fight accelerating deflation. In a period of accelerating inflation, the central bank can simply refuse to print money and allow interest rates to rise without limit until spending growth slows and inflation comes back down. This is essentially the procedure Paul Volcker followed between late 1979 and mid-1982, when short-term interest rates had to rise above 20 percent in order to bring double-digit inflation back down to more normal levels, around 3 percent and below.

In a deflationary environment, however, once the Fed's target interest rate gets to zero, then the Fed has to resort to aggressive money expansion measures in order to convince the public that the price level in the future will be higher than it is today. Central banks are, of course, in the habit of equating a pledge of price stability with a pledge to fight inflation. It requires a change in thinking to articulate a pledge of price stability that involves fighting deflation because that means making a pledge that the price level will rise along the way.

Most central banks, including the European Central Bank, still think of a pledge of price stability as a pledge to fight inflation. The behavior of the price level in the United States, however, has reversed so rapidly that the Fed is transitioning to a pledge to fight deflation. In mid-summer, the three-month annualized inflation rate measured by the Consumer Price Index (CPI) was about 11 percent. By November, the three-month annualized inflation rate measured by the CPI was –10.2 percent. Of course, the energy sector was a major contributor to the move from inflation to deflation, but so were transportation equipment and information services. Even excluding volatile food and energy components, the core inflation rate, which averaged 2.3 percent over the last five years, fell close to zero at 0.4 percent over the three months ending in November. The core inflation rate, excluding the slow-moving imputed measure of the cost of shelter, actually went negative at –0.8 percent over the three months ending in November.

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It is important that prior to further intensification of the disinflationary and deflationary tendencies emerging in the U.S. and the global economy, the Fed has pledged to maintain price stability—that is, to fight deflation. In coming months, those disinflationary and deflationary tendencies will intensify, and without a firm pledge in place to fight them, the risk is that deflation will pick up speed. A pledge by the Fed and other central banks to achieve a price level target, say, five years from now, that implies an interim annual inflation rate of at least 1 percent implies a pledge to follow any episode of deflation with an episode of inflation that is temporarily above the 1 percent underlying price level path. The realization that prices will stop falling and then rise for a time at an above-trend inflation rate is an important component of the Fed's ability to boost aggregate demand by printing money to achieve a preordained target price level.

Can Fiscal Stimulus Help?

As the Fed is moving to maintain price stability by fighting deflation, the new Obama administration is discussing aggressive fiscal measures to further boost aggregate demand. While specifics are lacking, estimates of a trillion-dollar fiscal stimulus package over the next two years (to be announced in January) are common. The new magic word when it comes to "stimulative" fiscal policy is infrastructure spending or, better yet, "green" infrastructure spending. Democrats seem to get as excited about green infrastructure spending as Republicans do about tax cuts to boost capital formation or

spending for defense. Whenever politicians articulate cure-all spending measures, taxpayers are advised to hold on to their wallets.

There are a number of things to bear in mind about stimulus packages, especially those tied to infrastructure spending. Infrastructure spending packages lend themselves to large, headline numbers—and to great disappointment. Japan's experience during the 1990s is a classic example that has been widely discussed elsewhere. It teaches three lessons for evaluating the impact of a stimulus package on aggregate demand. First, are the items included in the stimulus package really new or merely relabeled items that would have been undertaken anyway? Second, how many years will it take to implement the outlays proposed in the stimulus package? Finally, how much of the stimulus package consists of tax cuts, which put spending power directly into the hands of households and businesses, and how much consists of tax incentives that may or may not be employed?

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A good rule of thumb for evaluating stimulus packages is, first, to annualize the number—that is, to adjust for the amount of proposed outlays or tax cuts per year—and second, to cut in half the gross incentive and spending proposals. Finally, add in the direct tax cuts for households and businesses. Suppose, for example, that in January the Obama administration announces a headline trillion-dollar stimulus package to be implemented over two years. Suppose that during the first year the total package is $600 billion, consisting of, say, $500 billion in infrastructure and other spending measures and $100 billion in tax cuts. A rough rule of thumb for estimating the real value of the stimulus would be to cut in half the $500 billion headline number for spending on infrastructure and other measures while classifying most of the $100 billion in tax cuts as stimulative. That would leave $350 billion of real stimulus in the first year, or about 2.5 percent of GDP. That constitutes a large but not overwhelming stimulus package.

A far simpler approach to stimulus, one that I proposed last month, would be to eliminate the Social Security portion of the payroll tax for a year.[3] That measure, which would be quite simple to implement, would add to household cash flow by $350 billion, with the same amount added to corporate cash flow. The measure would also have the advantage of reducing a tax on employing and retaining labor and thereby would help improve the employment picture while providing stimulus to aggregate demand worth nearly 5 percent of GDP, or about $700 billion. If only half of that amount were spent, the net stimulus would still be 2.5 percent of GDP—the equivalent of the first year of a headline $1 trillion stimulus package that concentrates on infrastructure spending. Moreover, infrastructure spending tends not to be labor-intensive and so would provide less of a boost to employment than would a lower payroll tax. The latter measure has the added advantage of being targeted at people in lower-income households, who are more likely to spend it, because the payroll tax is the only federal tax most of those people pay. (More than half of households do not currently pay any income tax.) That feature would probably result in spending of 60–70 percent of the payroll tax relief—a substantial additional benefit relative to a high headline number stimulus package that does not include generous tax provisions.

The Fed Still Has Work to Do

The Fed has made history by actively initiating a battle against deflation through quantitative easing. Neither the Fed during the Great Depression of the 1930s nor the Bank of Japan after 2001—having initiated such a battle—scored a clean, consistent victory over deflation. Let us hope the Fed truly makes history this time with a clear victory over deflation—and that its leaders realize that a period of inflation above the target level will be required for success should deflation gain a hold on the U.S. economy.

Notes

1. The full statement is available at www.federalreserve.gov/newsevents/press/monetary/20081216b.htm (accessed December 29, 2008).

2. A transcript of the interview is available at www.ft.com/cms/s/0/18086fba-ca0c-11dd-93e5-000077b07658.html (accessed December 29, 2008). Emphasis added.

3. John H. Makin, "Print Money and Cut the Payroll Tax," *Economic Outlook* (December 2008), available at www.aei.org/publication28990/.

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