



# A Two-Headed Dragon for Monetary Policy

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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.



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