# Seven Faces of "The Peril"
# Executive Summary

In this manuscript, Federal Reserve Bank of St. Louis President James Bullard argues that the Federal Open Market Committee's extended period language may be increasing the probability of a Japanese-style deflationary outcome for the U.S. within the next several years. Bullard concludes that an appropriate quantitative easing policy offers the best hope for avoiding a low nominal interest rate, deflationary outcome.

Bullard frames his discussion in the context of theoretical analysis by Benhabib *et. al.* [1] that emphasizes two possible long-run outcomes for the economy: one which is consistent with monetary policy as it has typically been implemented in the U.S. in recent years, and one which is consistent with the low nominal interest rate, deflationary regime observed in Japan during the same period.

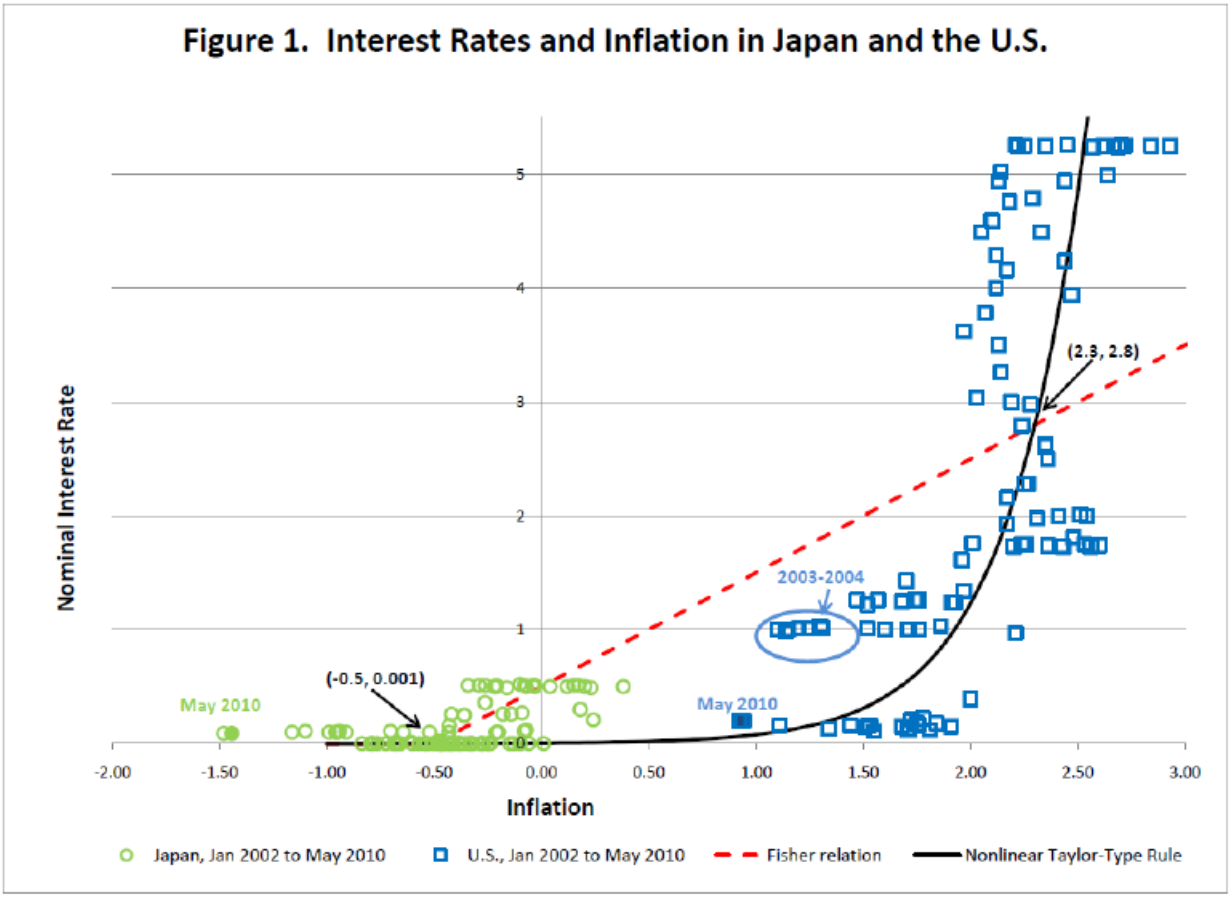


Figure 1: Short-term nominal interest rates and core inflation rates in Japan and the U.S., 2002-2010. OECD data.

[1] Jess Benhabib, Stephanie Schmitt-Grohe, and Martín Uribe, 2001, .The Perils of Taylor Rules, Journal of Economic Theory 96(1-2): 40-69.

Bullard looks at monthly data on nominal interest rates and inflation for both the U.S. and Japan during the period from January 2002 through May 2010[2] (Figure 1). These data seem to corroborate the theoretical argument that the two long-run outcomes exist. Recent data for the U.S. are as close as they've ever been to the low nominal interest rate outcome.

He then critiques seven stories he has encountered in the economics profession concerning this analysis. These stories range from reasons not to worry about the implications of Figure 1, through ways to adjust nominal interest rates to avoid the implications of Figure 1, and on to the uses of unconventional policies as a tool to avoid "the peril."

Bullard argues that promises to keep the policy rate near zero may be increasing the risk of falling into this state where inflation turns negative and remains there. He argues that promising to remain at zero for a long time is a double-edged sword. This policy is consistent with the idea that inflation and inflation expectations should rise in response to the promise, and that this will eventually lead the economy back toward the targeted equilibrium of Figure 1. But it is also consistent with the idea that inflation and inflation expectations will instead fall, and that the economy will settle in the neighborhood of the unintended steady state, as Japan has in recent years.

A key problem in the Figure is that the monetary policymaker only uses nominal interest rate adjustment to implement policy. The policymaker is completely committed to interest rate adjustment as the main tool of monetary policy, even long after it ceases to make sense. Many of the possible responses discussed in Bullard's manuscript attempt to remedy this situation by recommending a switch to some other policy in cases when inflation is far below target. The regime switch required must be sharp and credible. Policymakers have to commit to the new policy and the private sector has to believe the policymaker. Unfortunately, in actual policy discussions, nothing of this sort seems to be happening. Both policymakers and private sector players continue to communicate in terms of interest rate adjustment as the main tool for the implementation of monetary policy. This is increasing the risk of a Japanese-style outcome for the U.S. A better policy response to a negative shock is to expand the quantitative easing program through the purchase of Treasury securities.

The experience in the U.K. seems to suggest that appropriately state-contingent purchases of Treasury securities are a good tool to use when inflation and inflation expectations are "too low." Bullard concludes that the U.S. quantitative easing program may be the best tool to avoid the low nominal interest rate, deflationary outcome.

[2] Source: OECD main economic indicators.