Deflation: Are We Still Sure "It" Cannot Happen Here?

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In November 2002, as a recently-appointed governor of the Federal Reserve System, Ben Bernanke gave a talk to the National Economists Club entitled "Deflation: Making Sure 'It' Doesn't Happen Here." "Fortunately," he concluded, "for the foreseeable future, the chances of a serious deflation in the United States appear remote indeed."

Bernanke's talk has been widely cited by those who think a protracted, Japanese-style deflationary episode simply cannot happen in the United States. How well do Bernanke's arguments of 2002 stand up in light of recent events?

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Bernanke makes two kinds of arguments in his talk. First, he emphasizes certain differences between the United States and Japan. Second, he lists a number of instruments, ranging from the conventional to the highly aggressive, that the Fed could use to stop deflation before it starts, and reverse it in the unlikely case it did start. Let's look at some of his specific points.

WHY THE UNITED STATES IS DIFFERENT

Bernanke begins his case with the observation that "Over the years, the U.S. economy has shown a remarkable ability to absorb shocks of all kinds, to recover, and to continue to grow… A particularly important protective factor in the current environment is the strength of our financial system: Despite the adverse shocks of the past year [2001-2002], our banking system remains healthy and well-regulated, and firm and household balance sheets are for the most part in good shape."

That was then, this is now. Bernanke, of course, was right about the critical importance of healthy balance sheets in the financial, business, and household sectors. He cites Irving Fisher, who pointed out, as early as 1933, "the potential connections between violent financial crises, which lead to 'fire sales' of assets and falling asset prices, with general declines in aggregate demand and the price level."

In order for monetary policy to do its job, there must be a smooth transmission mechanism from the operating targets that the Fed can directly control—chiefly short-term interest rates and bank reserves—to the money stock, to credit, and on to aggregate demand. When asset values are falling and balance sheets are

over-leveraged, the transmission mechanism breaks down. The Fed pumps reserves into the banking system, but banks remain reluctant to lend because there is inadequate dependable collateral to support the needed level of credit.

Even when banks are willing to lend, firms and households are reluctant to borrow because they are uncertain of cash flows from sales and wages. As everyone piles up liquid assets, the central bank finds itself "pushing on a string." Data from Japan in the late 1990s show this clearly. The monetary base, composed of bank reserves and currency, soars. As it does so, the money multiplier falls, so the quantity of money rises only sluggishly. And, as the non-bank public accumulates liquid balances, velocity decreases, so that nominal GDP actually falls.

THE ANTI-DEFLATION ARSENAL

Even so, Bernanke argues, the Fed has nearly limitless powers to push on the string, and if it uses them, the real economy must budge sooner or later. He outlines a sequence of policy actions that begins with conventional open-market operations at the short-term end of the government securities market, moves on to purchases of longer-term government securities, then progresses to indirect operations with private securities through swaps or in cooperation with the Treasury. It culminates with "helicopter drops" of money that are executed through expansionary fiscal policy, backed by central bank purchases of government bonds to keep the growing deficit from pushing up interest rates.

The list of potential weapons must have been impressive to Bernanke's 2002 audience. Today, the sobering thing is how far down that list the Fed has already moved.

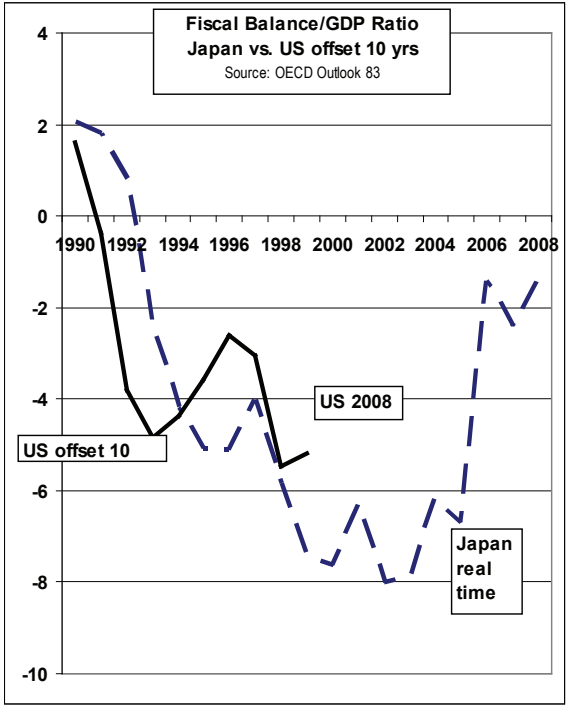
Under Bernanke's leadership, the Fed began aggressively lowering the federal funds target in mid–2007, within weeks after the government's housing price index crossed the line from increase to decrease. True to the spirit of the 2002 blueprint, as the target rate fell, the gap between it and the discount rate, at which banks borrow from the Fed, was narrowed first to 50 and then to 25 basis points. Together with earlier relaxation of administrative restrictions on discount borrowing, the Fed was almost begging banks to borrow reserves. It was still not enough.

The Fed quickly moved on down the list, lengthening the term of its lender-of-last-resort operations, broadening the range and lowering the quality of acceptable collateral, and reaching beyond commercial banks, deep into the financial sector. It was hard to keep up with the new terminology—Term Auction Facility, Section 13(3) loans to non-bank companies, Primary Dealer Credit Facility, Term Securities Lending Facility (TSLF), even auctions of options on TSLF loans. The Fed could certainly not be accused of sitting on its hands, but it still was not enough.

Then it became harder to move farther down the 2002 list. There were a couple of big guns left to fire, but no one wanted to pull the trigger.

One of the big guns would be foreign exchange operations. Bernanke noted the awesome impact of Roosevelt's 1933 decision to take the country off the gold standard, which reversed deflation in a matter of months. But already in 2002, Bernanke recognized that this was an area where the Fed needed to tread carefully. It was not just that international monetary policy, in the United States, is Treasury turf. More importantly, there was a risk of unintended consequences. If it was right in 2002 to be cautious about driving the dollar down to stimulate domestic demand, it is doubly right to be cautious today, when the dollar is already weak relative to the euro, and when even a hint of intervention

Chart 1



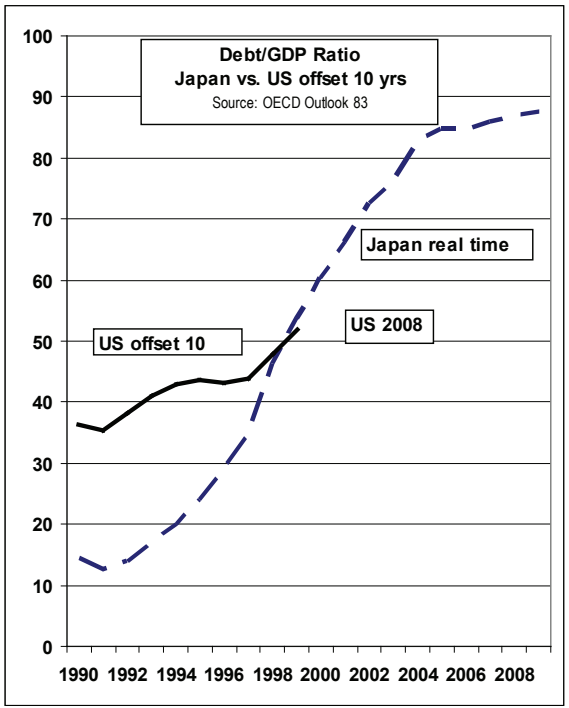
by the Fed could set off a stampede of divestment of dollar assets by foreign central banks. So that gun remains in the holster.

However, there was still the fiscal policy gun. "A broad-based tax cut," Bernanke told his 2002 audience, "accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices."

Bernanke saw the availability of the fiscal policy weapon as one of the key differences between Japan and the United States. "Japan's economy faces some significant barriers to growth besides deflation," he wrote, "including massive financial problems in the banking and corporate sectors and a large overhang of government debt. Plausibly, private-sector financial problems have muted the effects of the monetary policies that have been tried in Japan, even as the heavy overhang of government debt has made Japanese policymakers more reluctant to use aggressive fiscal policies."

Unfortunately, although U.S. government finance in 2002 was much healthier than that of Japan in the same year, the comparison is no longer as favorable to the United States. Chart 1 superimposes a plot of the U.S. government surplus or deficit over the same data for Japan. The U.S. series is offset by ten years, so that the data for 2008 in the U.S. coincide with the data for Japan in 1998, the first year of Japan's long deflation. The similarity of the two plots is startling. The same thing is true of chart 2, which shows government debt as a percentage of GDP. (The data used for this exercise came from the Annex of the OECD's Economic Outlook 83.)

Chart 2



THE SECRET WEAPON

The more one looks at the situation, the more it is clear that many of the safeguards that made deflation a remote danger in 2002 have since eroded. It is true that survey data on inflation expectations for the United States are still safely positive, but in Japan, they remained positive as late as 1999, when deflation was already well underway. Deflation seems to have a way of sneaking up on its victims.

It may be that HR 1424, the Emergency Economic Stabilization Act of 2008, will save us. Although Bernanke, in 2002, did not envision the need for such a massive operation, the $700 billion Troubled Asset Relief Plan is in the spirit of his talk, which advocated quick, decisive action before "it" started. So is the Fed's recently announced Commercial Paper Funding Facility.

In addition to TARP, there is a secret weapon buried in Section 128 of HR 1424 that may prove to be helpful. Unnoticed by anyone but specialists, and without ever mentioning the Federal Reserve, banks, or interest rates, Section 128 gives the Fed immediate authority to pay interest on the reserve deposits of commercial banks. In fact, as much interest as it likes.

A recent paper by Todd Keister, Antoine Martin, and James McAndrews of the New York Fed explains why this interest is potentially important. If the Fed can pay interest on reserves, it can inject unlimited quantities of reserves into the banking system without pushing the federal funds rate all the way to zero. Such a policy is called *quantitative easing*. As implemented in Japan, it had mixed results, but still, it provides an additional weapon against deflation. The Fed wasted no time making use of its new authority and announced that it would begin paying interest on reserves immediately.

When all is said and done, I still doubt that the U.S. economy will succumb to a prolonged deflation. But the possibility is no longer as remote as it was.

There is at least the comforting thought that we have a chairman of the Federal Reserve who knows what the risks are, knows what weapons are in the arsenal, has already proved his willingness to use many of the instruments listed in his 2002 talk, and, not stopping there, is prepared to improvise new ones as the need arises.

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REFERENCES AND FURTHER READING

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