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Unlike Japan, U.S. and Europe Probably Will Dodge Deflation: Fed Conference Paper

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By Bloomberg (http://www.ibloomberg.net/author/thanhcong/)


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Inflation has remained stubbornly low in the U.S., Japan and the eurozone for years. But while Japan faces a serious possibility of deflation, the risk is far lower for the U.S. and Europe, according to research presented Saturday at the Federal Reserve Bank of Kansas City’s economic symposium in Jackson Hole, Wyo.

University of Maryland economist S. Boragan Aruoba and University of Pennsylvania economist Frank Schorfheide wrote in a paper that their model shows that “the risk of experiencing deflation over the next five years remains close to 50% for Japan,” while “for the U.S. it increases from essentially zero in the short-run to about 15% in five years from now.” For the eurozone, they wrote, “in the short-run the risk of deflation is about 5% and it increases to about 20% over the next five years.”

Deflation, a broad and sustained decline in consumer prices, worries economic policy makers because it is often associated with deep economic downturns like the Great Depression, and it can be difficult to combat with traditional policy tools.

Japan has struggled to escape slow economic growth and deflation for two decades. Europe and the U.S. have confronted persistently low price growth in the years since the 2008 financial crisis. In all three advanced economies, central banks have kept their policy rates near zero for years.

But there are key differences, according to Messrs. Aruoba and Schorfheide. Annual inflation rates have generally been negative in Japan and positive in the U.S., while “the verdict on the euro area is still out,” they wrote. Inflation expectations have been “remarkably stable” in the U.S. and eurozone, they added.

Importantly, the economists wrote, a standard economic model appears to suggest no single policy playbook exists when interest rates are near zero.

“Multiplicity of equilibria is both a blessing and a curse,” they wrote. “As we demonstrate, it is a blessing for empirical researchers who are trying to explain very different macroeconomic experiences, say in the U.S. and Japan, with a single economic model. Unfortunately, it may turn out to be a curse for policy makers, because the same monetary policy action of, say, changing interest rates or making announcements about targeted inflation rates, may have very different effects, depending on the equilibrium.”

They analyzed one policy proposal, that the U.S. central bank target 4% annual inflation to reduce the risk that rates will reach zero. The Fed currently has a 2% annual inflation target.

Messrs. Aruoba and Schorfheide wrote in their paper that, were the Fed to switch to a 4% inflation target now, deflation would remain a risk for several years. Their analysis “suggests that if the central bank raises the inflation target now, even if it is able to communicate and convince the public about the credibility of this new policy, there does not seem to be much real effects of this policy change to make it desirable,” they concluded.

The paper, “Inflation During and After the Zero Lower Bound,” was prepared for the Kansas City Fed’s Jackson Hole conference, which ends Saturday.

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