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Central Banks

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Jackson Hole: Researchers See Low Deflation Odds in US, Europe

By Steven K. Beckner

JACKSON HOLE, Wyoming (MNI) - Although Japan seems doomed to continue to struggle with deflation, the odds that the United States and Europe will find themselves in the same situation are fairly low, central bankers were told Saturday.

The Federal Reserve, unlike the Bank of Japan, did well in "reassuring" the public and the markets that it intended to sustain a positive rate of inflation when it cut short-term interest rates to near zero in 2008, two academic economists told the Kansas City Federal Reserve Bank's annual symposium.

University of Maryland Professor Boragon Aruoba and University of Pennsylvania Professor Frank Schorfheide find "important qualitative differences" between the experiences of the United States, Japan and the Euro Area at the zero lower bound.

They note that in Japan, which has been at the zero lower bound ever since 1999 except for two brief stints, "inflation has been negative, long-run inflation expectations demonstrate significant fluctuations, and the real interest rate has remained positive."

By contrast, in the United States, where the Fed has held the federal funds rate near zero since December 2008, "inflation has been positive but real rates have been consistently negative."

"Inflation and real rates in the Euro Area have behaved qualitatively similar to the U.S.," they add.

"Another crucial difference between the U.S. and Europe on the one hand, and Japan on the other, is the remarkable stability of long-run inflation expectations in the former two economies despite fairly large swings in actual inflation," Aruoba and Schorfheide write.

According to their inflation forecasting model, the two researchers project "a substantial probability of deflation for Japan over the next five years, while for the U.S. and Europe these probabilities are no more than 20%."

Aruoba and Schorfheide contend that, following adverse shocks that hit Japan in the late 1990s, the BOJ "made the public doubt the central bank's commitment to a positive inflation target and caused a switch in inflation expectations."

"This lower (and negative) expectations then meant that the economy started fluctuating around the (deflationary) steady state," they say.

By contrast, the economists maintain, "the actions of the Fed following the 2008 financial crisis reassured the public that the positive inflation target is alive and well, and the economy continued to fluctuate around the (targeted inflation) steady state."

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