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FED SHADOW

Better Late Than Never

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Fed minutes show policymakers grappling with the specter of deflation risk.

It doesn't take much reading between the lines of the September **FOMC** minutes released yesterday to reach an inescapable conclusion: **the Fed** is finally coming to terms with the reality of deflation risk, and is exploring its options to find a way to deal with it. To be sure, the word "deflation" does not appear in the document, and the central bank's diagnosis of the problem is obscured by the cause-and-effect confusion of the demand-based "output gap" model. But make no mistake. **Alan Greenspan** has seen the whites of the eyes of deflation, and that could be the best indication yet that he is prepared to confront the risk, even if it requires that he resort to "unconventional" means to do it.

"[C]urrent forecasts continued to point to quite low and perhaps declining inflation over the next several quarters," the minutes state. Rising healthcare and insurance costs and the "lagged passthrough" of higher oil prices would tend to maintain upward price pressures, the FOMC says. But opposing these forces "were the effects on resource use of an extended period of economic activity below the economy's potential…declining inflation expectations, and the persistent absence of pricing power in highly competitive markets." This mish-mash of Keynesian logic suggests that the downward price pressures are the consequence of below-potential growth, when in fact it was the accumulation of Fed deflation errors at the root of the economy's sharp decline beginning in mid-2000.

In any case, the minutes go on to say that "members did not rule out the emergence of appreciably lower inflation. In this regard, some observed that a significant decline in inflation from current levels could imply an unwelcome tightening in monetary policy in real terms." A further decline in inflation, in other words, would cause the "real," inflation-adjusted overnight rate to rise, even if the nominal funds rate were held steady. With the PCE deflator currently rising at a rate around 1.8%, that could offer an explanation for the Fed's surprisingly aggressive move to 1.25% this week. But the minutes then observe that "further sizable disinflation that resulted in a nominal inflation rate near zero could create problems for the implementation of monetary policy through conventional means in the event of an adverse shock to the economy that called for negative real policy interest rates."

Here, we have the most clear-cut acknowledgement of the predicament potentially facing monetary policy. From the Fed's perspective, whether the sign on a "nominal inflation rate near zero" is positive or negative doesn't make much difference. In the realm of interest-rate targeting, the capacity to push the real rate below zero is the ultimate weapon. But inasmuch as zero is the downside limit to a nominal rate target, it would be impossible to establish a negative real rate with inflation near or below zero. That the **Bank of Japan** became ensnared in that trap appears to be the primary lesson Fed officials have drawn from the Japanese experience. By the time its nominal rate target finally reached zero, the Japanese price level was already falling.

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In raising the possibility of eventually being similarly hamstrung in the "implementation of monetary policy through conventional means," the Fed here clearly seems to be entertaining the idea of adopting unconventional measures. Indeed, a former Fed official familiar with the process of assembling the FOMC minutes suggested to me that such language amounts to an acknowledgement that consideration is being given to jettisoning rate-targeting procedures. Thus it now may be less far fetched to suggest that adoption of a commodity price-rule orientation, in which the Fed's operational objective would shift to stabilizing a representative sampling of sensitive market prices rather than an interest rate, could be in the offing.

There is some irony here in that the central bank's *de facto* recognition of deflation risk comes with the most sensitive monetary indicators showing that deflationary pressures have subsided significantly since early this year. It has now been more than five years since I began to warn of the deflationary tendencies seen in the dollar's rise against foreign exchange, gold and broader commodity groupings. Those tendencies went almost entirely unchecked from 1997 to 2001, producing an appreciation of more than 30% in the real value of the unit of account. Over time, a sustained rise of that magnitude in the currency's purchasing power inevitably pulls down the prices of all things valued in terms of the currency. The decline of profits, revenues and asset values seen the last two years was the result.

Over the past year, though, the dollar has reflated by some 15% against gold, and has fallen more than 13% against the G-6 trade-weighted index of major foreign currencies since early this year. The CRB Spot Index (non-petroleum) is up 16% from its lows a year ago. The worst, in other words, is past, and to the extent the earlier decline of the most sensitive market prices had yet to feed through the full universe of dollar prices, the full magnitude of the deflation will likely be avoided. We have suggested, however, that deflation *risk* remains a prominent concern, owing in no small measure to a paucity of evidence that the Fed has been cognizant of the danger and is prepared to take the steps required to overcome it. Publication yesterday of the September FOMC minutes goes some distance toward beginning to subdue that risk. TM