



Beware the Monetary Cliff

By John H. Makin

Unlike the US fiscal cliff, which was largely defused by congressional action, the US monetary cliff—which will be reached if US inflation rates turn negative—cannot be easily circumvented. Over the past two years, US, European, and Chinese inflation rates have drifted steadily lower, and Japan’s “end-deflation” initiatives have produced only modest relief from 15 years of negative inflation (deflation). Once an economy slips into deflation, the risk of falling into a self-reinforcing deflationary spiral rises. And as deflation increases, investment, spending, lending, and employment growth suffer. Because the United States is the largest economy in the world, US deflation would be exported to the rest of the world. Federal Reserve Chairman Ben Bernanke and his recently nominated successor Janet Yellen can prevent the United States from falling off the monetary cliff by making deflation avoidance a more clearly stated Fed objective and by setting a new range for inflation that has a hard lower bound.

The end of quantitative easing (QE), its prospect and realization, is the monetary equivalent of the fiscal cliff. The US monetary cliff—the dangerous plunge from disinflation (falling inflation) to deflation (negative inflation or falling prices)—lies in the future. Talking about it unnerves global markets. Breaching it will cause substantial economic and market disruption. The US fiscal cliff had a set date and was largely defused by congressional action. The monetary cliff, on the other hand, has no set date. It is data-dependent, to use the Federal Reserve’s terminology.

There is no way to smooth out a monetary cliff. The first attempt at easing away from the tapering that was suggested in June created shock and dismay after the September 17 Federal Open Market Committee (FOMC) meeting. Tapering suggests a fear of inflation or hopes for faster growth. Chairman Ben Bernanke’s announcement that the economy was too weak to manage any rescission of QE support and the market’s shock at the implied reversal of tapering represented a

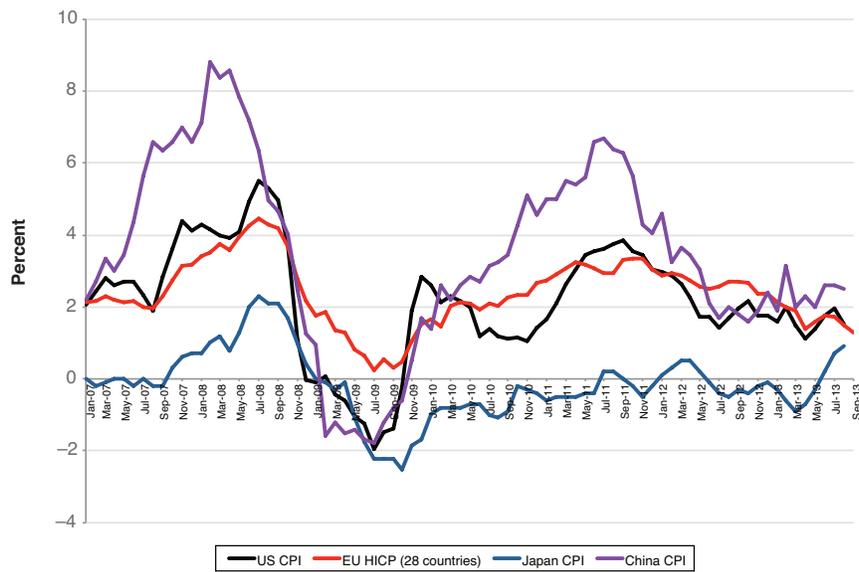
policy failure, both of the Fed’s forecasting ability and of the Fed’s ability to clearly communicate its policy intentions to markets.

Key points in this Outlook:

- The monetary cliff—the US potential to slip into a period of negative inflation (deflation) at the end of quantitative easing—is a more threatening precipice than the fiscal cliff the United States faced earlier this year.
- Major economies should be wary of deflation because of its potential to drive down investment, spending, lending, and employment growth.
- Current Federal Reserve Chairman Ben Bernanke and soon-to-be chairman Janet Yellen should make deflation avoidance a more clearly stated Fed objective by setting a hard lower bound for inflation.

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FIGURE 1
YEAR-OVER-YEAR CHANGE IN MONTHLY CONSUMER PRICE INDEXES



Sources: US Department of Labor, Bureau of Labor Statistics; Eurostat; and Organisation for Economic Co-operation and Development

The High-Stakes Monetary Cliff

A great deal is at stake as the Fed tries to navigate a path that avoids the monetary cliff. With interest rates at the zero bound and the exchange rate unable to provide any real relief in a world of excess supply, the Fed's QE policies have, so far, largely inflated asset prices. Goods and services inflation has continued to drift lower while GDP growth has remained stuck at just below 2 percent.

There are risks attached to the QE experiment. If the Fed pushes QE too far, then inflation will result and the Fed will be forced to tighten its monetary policy, thereby risking bursting an asset bubble. If the Fed is too conservative and tightens too soon, then the risk of deflation jumps and the Fed faces serious problems tied to a deflationary spiral and slower growth, both of which would also burst an asset bubble. The safe, no-bubble-burst path is narrow.

Even as deflation threatens, widespread inflation fears persist, for some members of the FOMC and for markets. Inflation expectations have remained steady to high even in the face of gradually falling inflation. Sticky inflation expectations mean the Fed may be slow to spot and react to the onset of deflation.

After falling into deflation in 2009, right after the 2008 Lehman Brothers crisis, most inflation rates in major

economies recovered by 2011 to normal, positive levels. (See figure 1.) Over the past two years, however, inflation rates in the United States, Europe, and China have drifted steadily lower while Japan's inflation rate has recovered only modestly under the Abenomics "end-deflation" initiatives introduced at the end of 2012. Core inflation rates, which filter out the noise from food and fuel prices, have fallen even more ominously close to zero than broader Consumer Price Index (CPI) inflation rates. European core inflation is close to a 1.0 percent year-over-year rate while US core inflation hovers around 1.5 percent. (See figure 2.)

Even Abenomics has only managed to push Japan's core deflation rate back to zero and, as is evident from figure 2, it remains

too early for Japan to declare victory over deflation. Just before the 2008 financial crisis, Japan's core inflation grew modestly above zero to about 0.4 percent on a year-over-year basis, but thereafter collapsed to a negative 1.5 percent pace. Subsequently, Japanese deflation has recovered to zero, but only after substantial QE from the Bank of Japan.

The dangers of falling off the monetary cliff, or deflation, are not widely understood. Although Fed Chairman Bernanke and his successor Janet Yellen recognize them, their deflation warnings have been largely ignored. Once an economy slips into deflation, the risk of a self-reinforcing deflationary spiral rises. Persistent deflation has four primary negative, self-reinforcing effects on an economy.

First, with nominal interest rates held at zero, the real interest rate—the nominal interest rate minus inflation—rises as inflation decreases and deflation increases. The increase in the real interest rate discourages investment and other spending.

Second, as deflation accelerates, the demand for cash rises. Deflation measures the real return on cash, a largely riskless asset. In Japan, during periods of 1.5 to 2.0 percent deflation, holders of cash and other highly liquid assets were earning a 2.0 percent real return. Faster deflation means that demand for cash keeps increasing. The rise

in the demand for cash pushes down the demand for goods, accelerating the deflation. As resulting deflation expectations become embedded in the minds of households, the central bank faces the formidable task of reversing such expectations. Left alone, a drop in deflation leads only to further deflation.

Third, the real burden of debt rises for households, firms, and the federal government when deflation occurs. Falling prices mean that the cost of paying back debt rises. For example, a borrower paying 4 percent interest on a \$100,000 loan must still pay \$4,000 per year even though the purchasing power of that \$4,000 is rising with persistent deflation. The rising real burden of debt leads to a higher incidence of default, which depletes lender assets, lender ability, and willingness to keep lending.

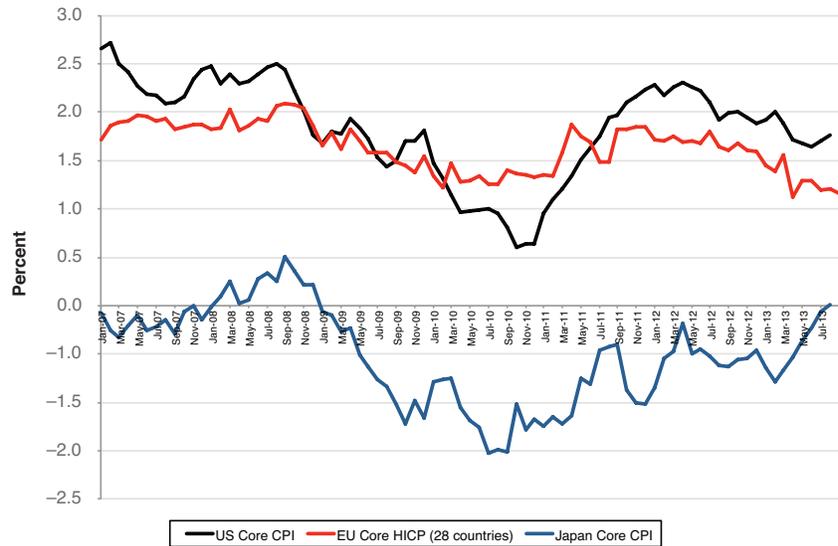
Fourth, labor markets suffer in deflationary periods. During deflation, wages tend to fall more slowly than prices, similar to nominal interest rates at the zero bound. A faster fall in prices pushes up real wages and reduces the demand for labor, boosting unemployment, further depressing demand, and accelerating deflation. Real wage growth in the United States has been steadily increasing toward zero since mid-2011 (see figure 3), due largely to the inflation slowdown shown in figures 1 and 2. At the same time, employment growth has been tepid. If deflation occurs, real wages will rise even faster and employment growth will be weaker.

Deflation Remedy

The remedy for deflation, and for disinflation that could degenerate into deflation, is antithetical to the thinking of many central bankers. A necessary condition to end deflation is for the central bank to promise inflation. A sufficient condition to end deflation is, of course, achieving an inflation rate consistent with the stated goal of the central bank.

The Bank of Japan struggled unsuccessfully to end deflation during the 15 years following its 1998 plunge into deflation, which came after a sharp increase in its

FIGURE 2
YEAR-OVER-YEAR CHANGE IN MONTHLY CORE
CONSUMER PRICE INDEXES



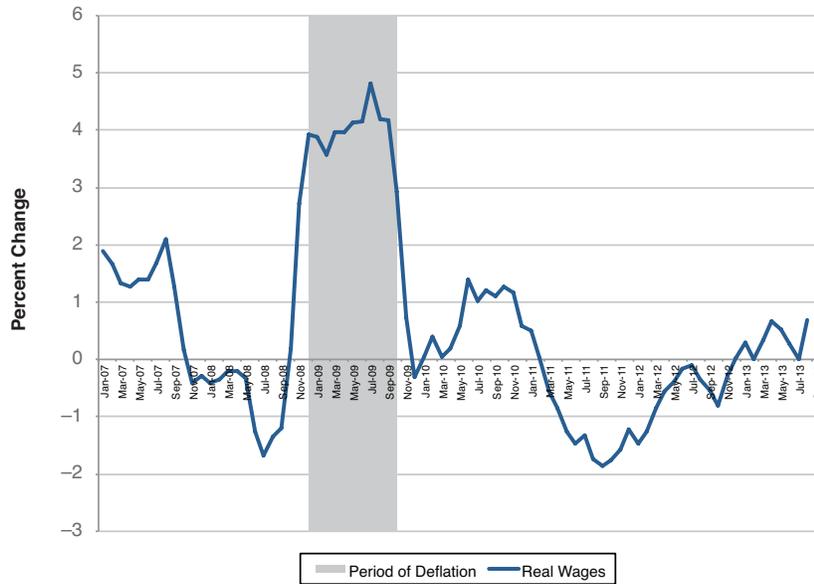
Sources: US Department of Labor, Bureau of Labor Statistics; Eurostat; and Organisation for Economic Co-operation and Development

consumption tax. The consumption tax acted as a drag on expenditure and ended a nascent recovery. During the sharp deflation following the 2008 financial crisis, the Bank of Japan began indicating that it might target inflation. However, it did so with little conviction and continued to express fears of deflation, undercutting the credibility of its deflation-ending promise.

This changed radically when the Bank of Japan announced a 2 percent inflation target in March of this year. Now, as we approach the halfway point in the Bank of Japan's first year of its deflation battle, markets are beginning to wonder about the sufficient condition—that is, the Bank of Japan's ability to achieve sustained inflation. Encouraging more doubt about the ultimate success of reflationary Abenomics is the reflation risk implied by Japan's current plan to raise its consumption tax from 7 to 10 percent beginning in April 2014.

Viewed more broadly, Japan is struggling with the zero interest-rate bound that blunts the stimulative impact of easier money. Japan's currency has also strengthened recently, undermining reflation efforts. Countries struggling with deflation aim to weaken their currency because a weaker currency increases exports by lowering their price to foreign buyers. A weaker currency also makes imports more costly at home, so the price level rises.

FIGURE 3
YEAR-OVER-YEAR CHANGE IN REAL AVERAGE EARNINGS OF
PRODUCTION AND NONSUPERVISORY EMPLOYEES
(TOTAL PRIVATE) IN THE UNITED STATES



Source: US Department of Labor, Bureau of Labor Statistics

Japan’s difficulty sustaining reflation efforts mirrors today’s disinflationary world. Major currencies are constrained from weakening by most policymakers’ tendency to push for easier money as fiscal policy is tightened to reduce deficits. Easier money and tighter fiscal policy is a currency-weakening formula, but it cannot work for all countries.

The world’s largest economy, the United States, is confronting the drag from tighter fiscal policies and elevated policy uncertainty.¹ Even as the Fed elects to maintain quantitative easing (easier money), the dollar has weakened only modestly against currencies like the yen and euro. Since a weaker dollar means a stronger yen and a stronger euro, this amounts to an export of deflation from the United States to the rest of the world. A remedy for global deflation that could result from the widespread, persistent deflation shown in figures 1 and 2 would require a commitment from G-7 central banks to combat deflation whereby everybody reflate.

China is also struggling with disinflation. As figure 1 illustrates, China’s overall CPI inflation rate jumped to more than 6 percent during 2011, but has dropped back toward 2 percent during 2013. Simultaneously, China’s currency has been steadily appreciating against the dollar.

Therefore, the Chinese are especially unhappy about the policy uncertainty and persistent quantitative easing emanating from the United States as it exports deflation to China, where growth is slowing.

Notwithstanding China’s efforts to boost domestic demand, it remains heavily dependent on exports. Yet China’s export volumes have dropped sharply into negative territory since mid-year, threatening its tepid recovery. In this context, the strengthening renminbi is a particularly unwelcome deflationary event. It underlies China’s need to commit, along with the G-7, to fighting deflation.

Avoiding the Monetary Cliff

Despite persistent inflation warnings from Fed officials and some economists, the real risk facing the

Fed is a drift into deflation. In fact, an obsession with inflation threatens while approaching a period of deflation is a necessary condition for deflation to occur. Another necessary condition is complacency about the threat of deflation. The Fed has observed weaker-than-expected inflation, not to mention a weaker-than-expected economy during most of 2013, but has persisted in looking for a second half-recovery in the economy and a second half-reversal in the disinflationary trend. Neither has occurred nor is either likely to emerge as fiscal drag and policy uncertainty persist.

The Fed’s complacency about the growth outlook and inflation is best captured in the September 18 FOMC statement:

The Committee expects that, with appropriate policy accommodation, economic growth will pick up from its recent pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. . . . The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, but it anticipates that inflation will move back toward its objective over the medium term.²

The Fed's QE is at best a holding action designed to avoid a further drift down in growth and inflation. As is well known, the Fed made its deflation threat worse by suggesting an early tapering of QE this May, only to reverse the suggestion in September after interest rates rose by more than a full percentage point and economic growth weakened. While the US federal government shutdown will only have a temporary negative impact on the economy in terms of outright spending, the uncertainty drag will persist into next year since the budget battles that shut down the government in October are scheduled to resume in January and February of next year.

The Fed, under Chairman Bernanke and soon-to-be chairman Yellen, can do three things to reduce the risk of going over the deflationary monetary cliff. First, the Fed should temper its complacency about the possibility of further disinflation and deflation. If disinflation persists and the Fed's favorite inflation measure, the core personal consumption expenditures, drops below 1.0 percent (it is currently at 1.2 percent), then the Fed should restate the desirability of boosting inflation and underscore efforts to achieve that goal. Perhaps signaling a possible increase in QE rather than another hint of tapering will be required.

Second, the Fed could underscore its desire to avoid deflation by setting a new target range for inflation with a firmly defined lower bound. Currently, the Fed talks about a 2 percent inflation target, with any significant rise above that level leading to Fed tightening. The Fed would do well to reinforce the symmetry of its goal with respect to the behavior of inflation.

The Fed could highlight its long-run commitment to avoid inflation, along with its desire to avoid deflation, by

specifying a target range of around 0.5 to 1.5 percent for inflation. With that target range, a drift of inflation below the 1 percent level would lead to increasing emphasis by the Fed of its commitment to avoid deflation. While inflation expectations have been sticky, a further drift toward disinflation could cause a sudden change in expectations in the deflationary direction. That would constitute a substantial drag on economic growth and a threat to global economic expansion.

Yellen's elevation to the chairmanship of the Fed, probably during the first quarter of next year, presents the Fed's third opportunity to underscore its commitment to avoid deflation. Yellen should resist the temptation to sound hawkish in view of her, probably unwarranted, reputation as a dove on inflation. She knows the risks of inflation and ways to deal with it. By discussing the risk of deflation at some length and by putting a firm floor on the Fed's willingness to tolerate a drift toward deflation, Yellen could substantially reduce the risks that fears of deflation could produce. Avoiding a self-reinforcing deflationary spiral should be a clearly articulated objective of the Yellen Fed.

Notes

1. John H. Makin, "What Now for Monetary Policy?" *AEI Economic Outlook* (September/October 2013), www.aei.org/outlook/economics/monetary-policy/federal-reserve/what-now-for-monetary-policy/.

2. Federal Open Market Committee, "Press Release," Board of Governors of the Federal Reserve System, September 18, 2013, www.federalreserve.gov/newsevents/press/monetary/20130918a.htm.