

Low rates can lead to deflation: Fed official



President of St. Louis Fed says danger of deflation could grow if 'something else hits' economy

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A key member of the U.S. Federal Reserve says it's time the Fed considered taking action to stimulate the country's economy and head off looming deflation. James Bullard, president of the Federal Reserve Bank of St. Louis, said in a paper released Thursday that the Fed's commitment to keep [interest rates](#) near zero "may be increasing the probability of a Japanese-style deflationary outcome for the U.S. within the next several years." He added that the promise "may be increasing the risk of falling into this state where inflation turns negative and remains there."

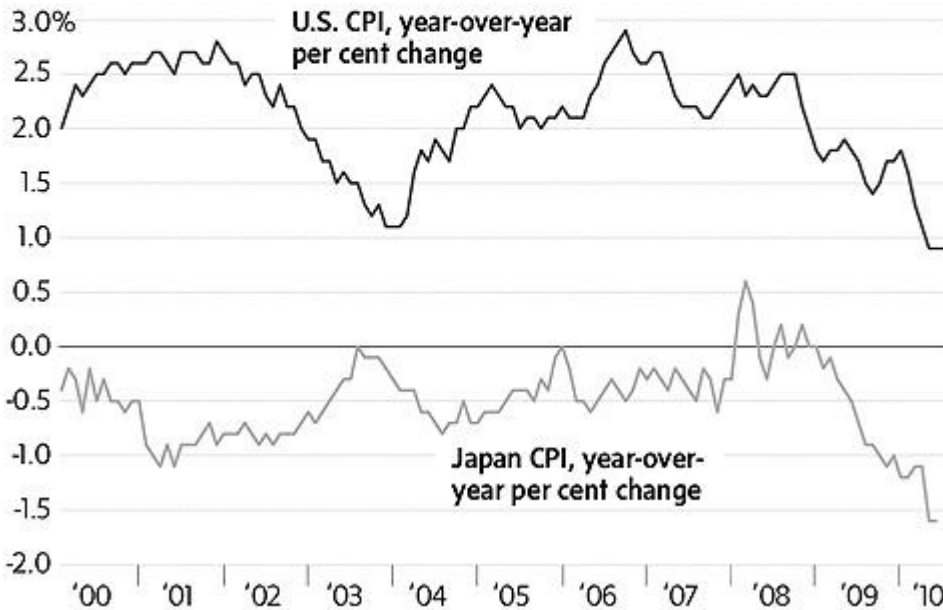
Mr. Bullard argues that a commitment to low rates is a double-edged sword. While the Fed hopes that actual inflation and inflation expectations will rise in response, there is also the possibility both will fall and the U.S. economy will settle into a prolonged period of unintended sluggishness comparable to what happened in Japan. That country went through years of deflation in the 1990s, in which prices dropped and the overall economy slowed, and has yet to fully recover. Mr. Bullard said the Fed should consider resuming "**quantitative easing**," which is a way of injecting money into the economy through the purchase of government debt and mortgage bonds. The Fed pumped more than \$2-trillion (U.S.) into the economy in the last three years through various measures, but it backed off earlier this year in hopes the economy had started to recover.

Mr. Bullard told reporters the risk of deflation is low, but the danger could grow if the economy is hit with a sudden shock. "It pays to think ahead about things that might happen," he said. "This is a matter of being ready, in case something else hits." His comments signal a growing debate inside the Federal Reserve system about what to do in the face of persistent sluggishness in the U.S. economy. Unemployment remains high, bank lending has been relatively stagnant and most

economic growth forecasts have been cut. Inflation has also started tracking downward by some measurements.

Falling and falling

Japan has spent the past decade in a deflationary funk. Worries are growing that the U.S. may be verging on a similar fate as inflation dwindles to its lowest point in years.



THE GLOBE AND MAIL » SOURCE: BLOOMBERG

Federal Reserve Board Chairman Ben Bernanke has not indicated whether he favours a more aggressive approach. But as many as three other Fed bank presidents share the concerns of Mr. Bullard, who is currently a member of the Fed committee that sets interest rates. (The 12-member committee consists of the Fed's seven board of governors, the president of the New York Fed and a rotation of four of the 12 district bank presidents.)

Other Fed officials don't share the same view. "I think the fear of deflation in and of itself is probably overblown, from my perspective," Charles Plosser, president of the Philadelphia Fed, told The New York Times last week.

On Thursday, Richard Fisher, president of the Federal Reserve Bank of Dallas, said he expects the economy to remain slow for a "prolonged period." But he does not believe the Fed should take aggressive steps. Businesses "are increasingly distressed by the lack of consistent direction coming from Washington," Mr. Fisher said. "They are confused and dispirited by random refereeing." It's possible "further monetary accommodation might make the situation worse" if the Fed is seen as "politically pliable" and "prone to substituting such accommodation for fiscal discipline."

Brian Bethune, an economist at IHS Global Insight in Lexington, Mass., said Mr. Bullard raised intriguing points. "He's just saying that there should be some serious consideration of what the Fed should do if we are tracking [a deflationary] economy," Mr. Bethune said in an interview. "I

would say that it's still too early to say at this point that [the Fed] would actually pull the trigger on [quantitative easing]. But I think what he's saying is that in some sense the debate is engaged.”

With files from Bloomberg News
