Escaping from deflation and a liquidity trap

Lars E.O. Svensson
www.princeton.edu/∼svensson

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- Avoiding deflation
- Escaping from deflation and liquidity trap
- The foolproof way of escaping from a liquidity trap
- Comparison with other proposals

Avoiding deflation

- Positive credible inflation target
  - Margin for deflation
- Inflation-forecast targeting
  - Looking ahead, responding in time, preemption
- Price-level targeting vs. inflation targeting
  - Unanticipated fall in price level below target: Automatic increase in inflation expectations, fall in real interest rate

Escaping from deflation and liquidity trap

- Deflation and recession: Expansionary stabilization policy
- Expansionary fiscal policy
  - Increase aggregate demand: Fiscal expansion (money financed, Ricardian equivalence)
  - Lower "effective" real interest rate: Time-varying VAT/investment credits (Stiglitz, Feldstein)

- Expansionary monetary policy (exchange-rate policy)
  - Create inflation expectations, lower real interest rate (short and long)
  - Currency depreciation (net export, UIP: lower real interest rate)
  - Increase other asset prices (long bonds, equity, property)

  Means

  - Positive inflation target (Krugman, Posen)
  - Monetary base expansion (Meltzer)
  - Tax on money (Goodfriend, Buiter)
  - Currency peg (McKinnon)

  - Currency depreciation
    - Monetary-base expansion, FX interventions, portfolio-balance (PB) effect (Meltzer, Bernanke, Orphanides-Wieland)
    - Exchange-rate rule (McCallum)
    - The foolproof way (FPW): Price-level target, temporary depreciation/peg, exit strategy (Svensson)

The foolproof way of escaping from a liquidity trap

- Academic article, *Monetary and Economic Studies* 19(S-1), February 2001, 277-312: "The Zero Bound in an Open-Economy: A Foolproof Way of Escaping from a Liquidity Trap"
- Non-technical summary of Graham Lecture, Princeton University, April 5, 2001: "The Foolproof Way of Escaping from a Liquidity Trap: Is It Really, and Can It Help Japan?"
- FT Personal View, Sep 25, 2001: "How Japan Can Recover"
- FT editorial, Oct 1, 2001: "Let the Yen Fall"
- www.princeton.edu/∼svensson/japan/japan.htm

1. Announce price-level target path, upward slope = inflation target
   - Best nominal anchor: Avoid run-away inflation
   - Undo "price-level gap"
   - Provides exit strategy from exchange-rate peg
2. Announce depreciation and temporary exchange rate peg
   - Jump-start economy, increase output and price level
   - Sizeable initial real depreciation
     - Feasible (initial excess demand for currency)
   - Expected real appreciation
   - Inflation expectations
   - Lower real interest rate
3. Announce exit strategy: When price-level target path reached, shift to float and inflation/price-level targeting

Comparison with other proposals

- Krugman: Announce inflation target, future monetary expansion
  - Why credible?
  - Price-level target path better anchor than inflation target
    - Accumulated inflation: Avoid run-away inflation
    - Long-run inflation expectations independent of timing
    - Price gap to undo
  - Devaluation and exchange-rate peg demonstrates commitment
    - Do, not just say
    - Induces expectations of real appreciation and inflation

- Meltzer, McCallum, Bernanke: FX interventions/open-market operations to depreciate currency
  - Temporary peg more structure, benchmark
  - Portfolio-balance effects (endogenous risk premia) not needed
  - McCallum reaction function

$$\tilde{s}_t = s_{t-1} + \nu_0 - \nu_1(\pi_{t,t-1} - \pi^*) - \nu_2(x_{t,t-1})$$

    - Time-varying exchange-rate target/instrument $\tilde{s}_t$: Commitment to buy/sell unlimited amounts of FX at time-varying rate $\tilde{s}_t$
    - More complex commitment and benchmark, less verifiable
    - Parameter values?
    - Interest-rate setting?
    - Exit strategy?

- McKinnon: Permanent bilateral peg
  - Would escape liquidity trap by $i_t = i_t^*$
  - No real depreciation to jump-start economy
  - No price gap to undo
  - Sustainable?
  - Optimal?
  - Temporary peg, exit strategy
  - Unilateral

- Quantitative easing (Meltzer, Nakahara, current BOJ, Orphanides-Wieland)
  - Money and T-bills (close to) perfect substitutes
  - Volumes, targets?
  - Exit strategy?

- Coenen-Wieland C-R 2002: 3-region model, deflation/liquidity trap in Japan, comparison of 3 proposals,
  - Orphanides-Wieland: Monetary base expansion
  - McCallum: Exchange-rate rule
  - Svensson: The foolproof way
  - All work
  - FPW works even if it starts 11 qtrs into deflation/recession
    - Especially if crawling peg
  - Relatively small international effects on inflation and output gaps
- FPW not just direct stimulus of net export and direct effect on CPI

Political problems (Japan, region, US)

- Beggar thy neighbor? Regional and US reactions?
  - Lower long-run real interest rate requires real depreciation
  - Current-account effects of real depreciation ambiguous
  - Region, U.S. and world gain in long run
- Other policy changes/reforms needed for Japan
  - Financial-sector clean-up (Swedish way)

Summary

- Avoiding deflation/liquidity trap feasible
- Escaping deflation/liquidity trap feasible: There is a foolproof way
- It can help Japan (but is not enough alone)
- Any political problems can be solved