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In a Shift, Fed Signals Concern Over Deflation

Central Bank Leaves Rates Unchanged, but It Cites Possible 'Fall in Inflation'

By GREG IP

WASHINGTON—The Federal Reserve left interest rates unchanged. But in a profound shift from half a century of preoccupation with fighting inflation, the central bank signaled that it may cut interest rates later to ward off even the possibility of deflation.

Over the next few quarters, the Fed said in a statement, "the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level."

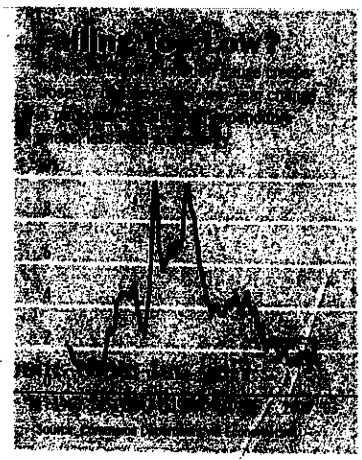
The words suggest that even if the Fed doesn't cut interest rates soon, it will keep them low for a long time. That realization helped send bond yields sharply lower and drove the dollar to a multiyear low against the euro. Stocks initially sold off but ended the day higher. Futures markets—which can provide an indication of what investors believe will occur weeks, or even months, from now—put the odds of a quarter-percentage point cut by August at about 75%.

The Fed statement, termed "masterful" by Goldman Sachs economists, cheered the bond market by suggesting that the central bank is a long way from raising rates, without spooking the stock market.

The central bank kept its target for the federal-funds rate, charged on overnight loans between banks, at 1.25%, as widely expected.

The Fed's statement marks a significant change in the Fed's concern about prices—away from inflation and toward deflation, or falling prices, which would weaken economic growth. Since the end of World War II, Fed officials' primary goal has always been avoiding inflation or reining it in since inflation interferes with the smooth working of the economy and undermines confidence in the government.

Even in the 1950s, when inflation was generally lower than it is today, policy makers worried that it would shoot up. "When you become a central banker you



are inoculated with anti-inflation serum," said Carnegie Mellon University economist Allan Meltzer, who has written a history of the Fed. Most of the terms of Fed Chairman Alan Greenspan and of his predecessor, Paul Volcker, were devoted to dragging the U.S. back to "price stability," a zone where inflation is imperceptible.

But in the past few years, as underlying inflation fell below 2% for the first time since the 1960s, Fed officials began to realize that it could go too low. In the past six months, underlying inflation has been running at just 1% based on the Fed's preferred measure, the price index of personal consumption excluding food and energy.

When inflation is close to zero, an unexpected shock or prolonged period of economic weakness could push the economy into outright deflation, that is, generally declining prices. Deflation weakens the Fed's ability to boost spending because interest rates can't go below zero. Deflation also makes it harder for businesses and individuals to repay debts because their incomes fall while their debts are fixed.

Most Fed officials think deflation is

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highly unlikely, but they have been sensitized to its dangers by Japan's battle with deflation, which has crippled its economy and weakened its banking system. Federal Reserve Bank of San Francisco President Robert Parry, for years an anti-inflation "hawk," said last fall that in part because of Japan's experience, his views had changed and now he felt "the zero inflation objective is not desirable for the U.S. economy."

Though the Fed has no explicit inflation target, officials broadly agree that measured inflation ought to be kept above zero to maintain a buffer against deflation. Fed governor Ben Bernanke, an advocate of adopting an explicit inflation target, told a German newspaper last week that a range of about 1% to 2.5% would be appropriate.

Many officials, including Mr. Greenspan, have previously said they see no risk of inflation heading higher. But yesterday for the first time the central bank went the added step of saying that there is a risk, however small, of it going too low. Former Fed governor Laurence Meyer said the Fed sees two problems: Inflation is "below where they'd like it to be, and it's falling." Indeed, it has dropped a full percentage point in the past few years by almost any measure.

Any further signs of falling inflation—or a failure of the hoped-for economic pickup to arrive—could prompt the Fed to cut short-term interest rates as early as its next meeting, in late June. "Central banks need to be particularly aggressive when there's a risk of deflation," Mr. Meyer said.

The economy has been stalled for months. Payrolls have declined by 525,000 over the past three months. Fed officials are divided on the cause: temporary uncertainty related to the Iraq war or more profound economic problems. Yesterday, the Fed acknowledged that reports on employment and production have been "disappointing," but indicated that falling oil prices and corporate bond yields and rising stock prices and consumer confidence signal a brisk recovery ahead.

All 12 policy makers voted at a regularly scheduled meeting of the Fed's Open Market Committee to hold rates steady and to support of the statement that risks are tilted towards economic weakness. The wording of the Fed's end-of-meeting statement has been controversial inside the Fed since it began disclosing its view on the risks to the economy three years ago. The new refinement, which separates discussion of economic growth and inflation, emphasizes that developments on either front could trigger a Fed move.

If the Fed does cut rates further, it will be a more momentous decision than any of the 12 cuts that brought the federal-funds rate from 6.5% at the beginning of 2001 down to its current, 42-year low of 1.25%. Once the funds rate is below 1%, the Fed will have to consider other tools for boosting the economy. Staff at the Federal Reserve Board in Washington and the New York Fed have been studying alternative monetary policy tools, specifically how the Fed might pull down long-term interest rates by buying bonds or changing its rhetoric.

Policy makers haven't yet decided exactly what they would do if they "ran out of ammo," as Fed insiders put it, and hope they never have to. But they need to be prepared because they likely would need alternatives before the federal-funds rate hits zero, a development that would disrupt the functioning of the money markets.

Mr. Greenspan told Congress last week he expects a healthy economic rebound later this year. If economic reports in the next month or two suggest that the economy is pulling out of its current stall, the Fed will see that as evidence that the expected recovery is materializing, and stay on hold.

More pessimistic officials, such as Federal Reserve Bank of New York President William McDonough, have worried that the lingering effects of the burst stock-market bubble and corporate-governance scandals have been more important than war as burdens on business investment and thus recovery.

Even if the Fed doesn't cut rates soon, analysts said it is unlikely to raise them for a long time—probably until well into next year.

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