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Within the Fed, Worries of Deflation

By SEWELL CHAN

WASHINGTON — A subtle but significant shift appears to be occurring within the Federal Reserve over the course of monetary policy as the economic recovery is weakening.

On Thursday, James Bullard, president of the Federal Reserve Bank of St. Louis, warned that the Fed's policies were putting the economy at risk of becoming "enmeshed in a Japanese-style deflationary outcome within the next several years."

The warning by Mr. Bullard, who is a voting member of the Fed committee that determines interest rates, came days after Ben S. Bernanke, the Fed chairman, said the central bank was prepared to do more to stimulate the economy if needed, though it had no immediate plans to do so. On Friday, the government will release its estimate of gross domestic product for the second quarter of this year.

At the Fed, Mr. Bullard had been associated with the camp that sees inflation, the central bank's traditional enemy, as a greater threat than deflation brought on by anemic growth. Until now he had not been an advocate for large-scale asset purchases to reinvigorate the economy.

But with inflation very low, about half of the Fed's implicit target of 2 percent, and with the European debt crisis having roiled the markets, even self-described inflation hawks like Mr. Bullard have gotten worried about the economy's trajectory.

With his remarks on Thursday, Mr. Bullard appeared to join other Fed officials already seen as sympathetic to the view that damage from long-term unemployment and the threat of deflation are the greatest challenges facing the economy. They include the Fed bank presidents Eric S. Rosengren of Boston and William C. Dudley of New York.

Those so-called inflation doves are likely to be joined soon by three new members of the Fed's board of governors.

President Obama has nominated Peter A. Diamond, an economist, and Sarah Bloom Raskin, a bank regulator, to the Fed's board, along with Janet L. Yellen, president of the San Francisco Fed, to be vice chairwoman of the board. All have also expressed serious concerns about unemployment.

Whether the Fed should take additional measures to support the economy is certain to be the top item when the Federal Open Market Committee, which shapes monetary policy, meets on Aug. 10. The committee includes the Fed's board of governors, along with the president of the New York Fed and a rotating group of the other bank presidents.

Of 10 current members on the committee, two are openly concerned about inflationary risks; three, now including Mr. Bullard, are somewhat worried about deflation; and five centrists, including Mr. Bernanke, have not expressed a firm leaning either way.

Mr. Bullard, in an conference call with reporters on Thursday, said that if any new "negative shocks" roiled the economy, the Fed should alter its position that interest rates would remain exceptionally low for "an extended period," or resume buying long-term Treasury securities to stimulate the economy. He emphasized that he was not calling on the committee to act right now, but wanted to "try to get a debate going." And he expressed hope his fears would not come to pass, saying, "The most likely possibility is that the recovery will continue into the fall, inflation will start to move up and this issue will all go away."

Laurence H. Meyer, a former Fed governor, said of Mr. Bullard's new position: "This is very significant.

He has been one of the most hawkish members, but he is now calling for the Fed to ease aggressively."

Until now, Mr. Rosengren had been perhaps the Fed official most outspoken on the prospect of the economy getting stuck in a deflationary cycle.

"While I am not anticipating we will be in a deflationary period, it's a risk that I do take seriously, and we should continue to monitor what's happening with prices," Mr. Rosengren said in an interview last week. "A heightened risk of deflation is something that we should react to."

That view is not universally held, however.

Thomas M. Hoenig, president of the Kansas City Fed and an inflation hawk, said in an interview Thursday that the comparisons to Japan were overstated. He likened the debate to the situation in mid-2003, when a sluggish recovery from the 2001 recession prompted predictions of deflation that did not come to pass. "I don't think we should find ourselves picking up every piece of short-term data and jumping to conclusions," he said.

Two others associated with the hawkish camp, which is focused on continued vigilance on inflation, offered similar perspectives in separate interviews.

"I think the fear of deflation in and of itself is probably overblown," Charles I. Plosser, president of the Philadelphia Fed, said last week. He said that inflation expectations were "well anchored" and noted that $1 trillion in bank reserves was sitting at the Fed. "It's hard to imagine with that much money sitting around, you would have a prolonged period of deflation," he said. And Richard W. Fisher, president of the Dallas Fed, said this week, "Reasonable people can argue that there's a risk of deflation, but we haven't seen it in the numbers yet."

Starting in 2007, the Fed lowered the benchmark short-term interest rate to zero and pumped some $2 trillion into the economy with an array of emergency loans and purchases of government debts and mortgage bonds.

Those purchases were phased out in March, but there is now talk of resuming them. Doing so would further enlarge the central bank's balance sheet, which has more than doubled, to $2.3 trillion.

The Fed has been saying since May 2008 that it would keep interest rates "exceptionally low" for an "extended period." The markets have over time interpreted that phrase to mean that the Fed will probably keep the federal funds rate at its current level — a target of zero to 0.25 percent — through 2011.

But in his article, Mr. Bullard wrote, "Promising to remain at zero for a long time is a double-edged sword."

Mr. Bullard said that inflation expectations had fallen from about 2 percent earlier this year to about 1.4 percent now, as judged by one measure, five-year Treasury inflation-protected securities.

The outcome could be an "unintended steady state" like Japan's slow-growth economy. "The U.S. is closer to a Japan-style outcome today than at any time in recent history," he wrote.

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