

News Release

THE FEDERAL RESERVE BANK *of* KANSAS CITY

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WAS MONETARY POLICY OPTIMAL DURING PAST DEFLATION SCARES?

As economies around the world struggled with one of the deepest recessions since the Great Depression, one of the challenges for policymakers has been to respond to the possibility that deflation could take hold. Such an episode, in which the prices of goods and services fall drastically, would worsen an already fragile economic and financial environment.

In the article “Was Monetary Policy Optimal During Past Deflation Scares?” economist Roberto Billi of the Federal Reserve Bank of Kansas City analyzes the success of policymakers’ responses in fending off deflation in previous crises. The article appears in the third quarter edition of the Bank’s *Economic Review*.

Billi’s analysis uses Taylor rules—guidelines that prescribe a setting for a central bank’s policy rate based on output and inflation—to evaluate past monetary policy decisions. The article compares actual policy during Japanese and U.S. deflationary scares to how policy would have been conducted using Taylor rules.

He finds evidence that suggests Japan’s response to its deflation scare in the 1990s might have been too weak, while U.S. monetary policy in the early 2000s following a stock market bubble collapse and the Sept. 11 terrorist attacks may have been too accommodative as policymakers kept rates at historic lows in order to avoid deflation.

The article is available on the Bank’s website at www.KansasCityFed.org.

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