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Financial Stability, Deflation, and Monetary Policy

FRB Richmond Working Paper No. 01-1

33 Pages
Posted: 29 Nov 2012

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Date Written: January 1, 2001

Abstract

The paper explores the relationship between financial stability, deflation, and monetary policy. A discussion of narrow liquidity, broad liquidity, market liquidity, and financial distress provides the foundation for the analysis. There are two preliminary conclusions. Equity prices are a misleading guide for interest rate policy. Monetary policy tactics protect market liquidity while maximizing the central bank's leverage over longer-term interest rates and aggregate demand.

Monetary policy is a fundamental source of deflation and stagnation risk when price stability is fully credible. A central bank can be fooled by its own credibility for low inflation into being insufficiently preemptive in a business expansion. Then monetary policy can be constrained by the zero bound from reducing real interest rates enough in the subsequent contraction. The chain of events that leads to deflation and stagnation can be weakened or broken in a number of places. Monetary policy has the power to preempt deflation and the power to overcome the zero bound to restore prosperity after a deflationary shock. Fiscal policy is likely to be relatively ineffective at best and counterproductive at worst.

Keywords: banking policy, deflation, financial distress, financial stability, liquidity, monetary policy, zero bound on interest rates

JEL Classification: E3, E5, E6, G3

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