THE WALL STREET JOURNAL.
OPINION WEDNESDAY, SEPTEMBER 25, 2002

The Fed's Moment of Weakness

By David Malpass

Three major debates over monetary policy are in full swing—how to combat deflation, the central bank's role in controlling asset-price extremes, and the proper response to fiscal deficits. How these questions are resolved will have a dramatic effect on global growth in coming decades. At the moment the debates are headed in the wrong direction. They don't offer an explanation for the deflation of the 1990s, let alone a policy bridge to price stability, economic growth and tax reform in the 2000s.

Yesterday's Federal Reserve Board decision again left it unclear how monetary policy will transition from deflation and very low interest rates to a more normal environment. The weakness of the stock market and the economy continue to reflect uncertainty about how the Fed will stop deflation without starting inflation and restraining growth. Yesterday's message didn't help.

Weak Moves

The Fed continues to describe monetary policy as "accommodative," yet at the same time warn of economic weakness. This suggests that the Fed isn't very powerful, that it can't improve the economy.

This isn't a new tune for Fed Chairman Alan Greenspan, who explained at an Aug. 30 speech in Jackson Hole, Wyo., that the Fed can't anticipate bubbles and can only hope to soften the blow when they pop. "If low-cost, incremental policy tightening appears incapable of deflating bubbles, do other options exist that can at least effectively limit the size of bubbles without doing substantial damage in the process? To date, we have not been able to identify such policies," Mr. Greenspan said.

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Mr. Greenspan is letting himself off the hook here. Instead of the tight-money, strong-dollar response to "irrational exuberance" in the late 1990s, a Fed commitment to currency stability and proper regulation would have allowed market forces to operate better, softening the boom. The momentum-based capital inflow to the U.S. would have been smaller. The result would have been less of a U.S. boom, but also less of a bust and a better economy going forward. Global growth would have been more balanced.

Yes, the money supply grew rapidly leading into Y2K at the end of 1999, allowing some to argue that the Fed was too loose. This way of thinking says that asset price booms are, by definition, evidence of excess credit. But the dollar was very strong during this period and inflation was falling, suggesting a scarcity of dollars, not an excess of credit.

As such, the debate is simple enough. Should the tightness of monetary policy be measured by the growth in the money supply, credit and asset prices? Or should it be measured by the strength or weakness of the dollar? And which indicator will better guide policy toward low inflation while avoiding deflation?

I think the answers are clear. Changes in the value of money are the primary cause of inflation and deflation. In the late 1990s, money grew fast but inflation fell fast. The only explanation is that the growth in the money supply was not fast enough to keep up with the growth in the demand for ever-strengthening dollars. In other words, despite fast money-supply growth, monetary policy was tight because the dollar appreciated. As the dollar strengthened, it put downward pressure on prices, causing deflation.

To create the monetary policy bridge to normal interest rates, the Fed should be in "neutral" all the time, neither accommodative nor restrictive. This means a commitment to dollar stability in both the short- and long-term.

With a neutral monetary policy, the Fed's focus should be on low inflation, not economic growth, asset prices or fiscal deficits. To avoid inflation and deflation, the Fed should use the value of the dollar as a principal guidepost for monetary policy. Given a globalized economy with relatively free capital flows, it is hard to conceive of a harmful inflation or deflation if the dollar's value is stable. And conversely, wild changes in the value of the dollar, as we saw in the 1970s and again in the late 1990s, seem guaranteed to lead to inflation or deflation.

Unfortunately, earlier this month, Mr. Greenspan told Congress that bigger fiscal deficits may lead to higher interest rates. Mr. Greenspan's argument and sterling reputation will be used to block much-needed tax rate cuts. Washington's jabberwocky computers already assume tax cuts have no positive impact on the economy and instead simply increase the fiscal deficit. Add to the computer model the expectation of higher interest rates, and the result is that the 2001 and 2002 tax cuts may be the last for a decade.

Furthermore, Mr. Greenspan's deficit warning seems to provide a justification for activist Fed rate increases even in the absence of inflation or growth. This threatens a lasting deflationary bias at the Fed.

Yet the evidence is clear that there isn't a connection between budget deficits and interest rates. In the 1980s, the U.S. saw fiscal deficits skyrocket, yet both interest rates and bond yields fell. In the late 1990s, the U.S. budget surplus was growing rapidly, yet interest rates and bond yields were rising. In 2001, estimates of the fiscal balance shifted from massive surplus to massive deficit, yet interest rates had their biggest decline on record.

Boom and Bust Cycles

The monetary policy debates are important. If the argument prevails that deflation is caused by private sector mistakes and too much production (rather than too strong a currency), then limits to growth would be justified. If the value of the dollar is allowed to fluctuate as wildly in the future, then momentum will dominate the global economy as it did in the 1990s, creating constant boom/bust cycles. And if fiscal deficits are thought to cause higher interest rates, constructive tax reform will be impossible.

The Fed should change direction. It may not need to lower the 1.75% Fed funds rate, but it should make a clearer commitment to price stability (neither inflation nor deflation). This would create a neutral monetary policy that would strengthen the economic recovery.

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