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Hard Money - In trying to prevent inflation and deflation, Ben Bernanke treads a perilous path

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The U.S. economy is at risk of falling into either an inflationary or a deflationary spiral, which is a consequence of the Federal Reserve's having been either too loose or too tight. The only point of consensus among economists and financial journalists seems to be that Fed policy is dangerously wrong.

Federal Reserve chairman Ben Bernanke has been on both sides of the debate within the last few months. In late August he said that "falling into deflation is not a significant risk for the United States at this time." In mid-October he said that "the risk of deflation is higher than desirable." The Fed is expected to engage in another round of "quantitative easing": creating money and using it to buy assets from banks. The banks will then use their increased reserves to lend more, thus stimulating the economy and easing deflationary pressures. That's Bernanke's plan, anyway. Executing it -- and then beating a retreat before inflation begins, as the Fed also promises to do -- will require the technocrat to exercise a kind of statesmanship.

Bernanke's shift probably reflects a change in economic indicators, but may also be a response to pressures from inside and outside the Fed. Several members of the Fed board believe that the economy needs easier money. Charles Evans, head of the Chicago Fed, believes that the inflation rate should average 2 percent per year over time. Since we have undershot that mark recently, we should have a higher inflation rate for a while to catch up. William Dudley, Tim Geithner's successor at the New York Fed, says that "very low interest rates can help smooth the adjustment process by supporting asset valuations, including making housing more affordable and by allowing some borrowers to reduce debt interest payments."

Many academic and journalistic commentators agree. Columbia University economist Michael Woodford backs Evans's contention. Paul Krugman is looking for stimulus anywhere he can get it. Martin Wolf, an influential columnist at the Financial Times, is worried about deflation.

Debates over monetary policy typically have a left-right dimension. Conservatives have traditionally worried that an excessively loose Fed policy would generate inflation, while liberals have been more concerned that overly tight policy would increase unemployment. (Congress has given the Fed the dual mandate of pursuing price stability and fighting unemployment.) That pattern is evident in this debate as well. The Wall Street Journal's editorial page is regularly running commentary critical of the Fed for debasing the dollar, and Fox News is running plenty of ads encouraging people to buy gold as a hedge against inflation.

But some analysts are playing against type. John Makin, an economist at the conservative American Enterprise Institute, is worried about deflation. Greg Mankiw, who chaired President Bush's Council of Economic Advisers, has called for "significant" inflation so as to create negative real interest rates and thus spur borrowing. But Joseph Stiglitz, a Nobel Prize-winning economist who has been a favorite of the Left over the last decade, joins with supply-sider Lawrence Kudlow in thinking that the chief effect of quantitative easing will be to cause "chaos" (Stiglitz's word) in foreign-exchange markets.

Different people make different arguments for a looser monetary policy. For some of them, fear of deflation is the primary concern. The Treasury sells five-year bonds both with and without inflation protections. Comparing their yields results in one measure of the market's expectations of inflation over the period. Those expectations have been low and dropping for most of the year, although they have started to bounce back now that quantitative easing is under discussion.

Fear of deflation is rooted in the experience of the early years of the Great Depression, when the money supply cratered. A falling price level increases the burden of debt and discourages spending (since a dollar will buy more tomorrow than it does today). Thus it can make recovery difficult, or even impossible. Bernanke is a student of the Depression and agrees with the late Milton Friedman that the Fed's excessive tightness caused it. He has vowed that the Fed will not make the same mistake again, even if it means printing money and tossing it out of helicopters.

Inflation, on the other hand, reduces the real value of fixed-interest debt. (With enough inflation, a lot of homeowners could find themselves above water again.) It encourages spending, since unspent cash burns a little of its value every day. By reducing real wages, it makes it possible for employers to keep more people on payroll. (People suffer from "money illusion": They'll balk at wage cuts but acquiesce in wage freezes that, with inflation, have the same effect.) Bernanke has also suggested that it might promote long-term economic stability if the Fed made up for periods of lower-than-expected inflation with a temporary increase.

The Fed gets nervous about very low inflation, or deflation, for one additional reason: It loses some of its room to maneuver. It often tries to stimulate the economy by lowering real interest rates. But since nominal interest rates cannot go below zero -- nobody is going to lend at a negative rate -- deflation puts a floor on real interest rates. The Fed can still run an accommodative policy, but it has to use less familiar tools.

On the other side of the argument are those who consider fears of deflation overblown. "There has never been a deflation preceded by rising commodities [prices], a steep yield curve, and a falling dollar," says Alan Reynolds of the Cato Institute. Some observers think the economy is stronger than generally appreciated. Retail sales are up three months in a row, notes Lawrence Kudlow of CNBC. Monetary stimulus might not be necessary.

Allan Meltzer, an economist at Carnegie Mellon's school of business, is one of many critics of quantitative easing who point out that banks are already sitting on large reserves (as are corporations) and therefore question the utility of adding to those reserves. He also argues that the very low interest rates that the Fed has engineered are delaying the housing market's adjustment to reality.

The anti-inflationists argue that inflation has a tendency to get out of control, as in the late 1960s and 1970s, but is hard to vanquish. The Fed spent the 1980s and 1990s making its commitment to price stability credible, they say, and raising inflation targets could squander that inheritance. Most of the anti-inflationists believe that an excessively loose policy contributed to our current troubles by encouraging the housing boom. Thomas Hoenig, the head of the Kansas City Fed and the leading opponent of further loosening there, takes this view. When Bernanke says that the "slack" in the economy makes inflation unlikely, the anti-inflationists shake their heads and wonder if he has forgotten about the possibility of stagflation.

Kudlow cites two other negative effects of looser money. Inflation, he points out, increases the distortions associated with taxes on capital (because those taxes are levied on inflationary as well as real gains). And it weakens the dollar, making investment in the U.S. less attractive and increasing the likelihood of a "currency war" in which countries try to improve their trade balances by competitively devaluing -- another unhappy echo of the 1930s. For a lot of the inflationists, devaluation is part of the point: They think China has already been holding the value of its currency down and that aggressive steps are needed to force it higher against the dollar.

There may be a way to avoid the worst fears of both camps. Economists Scott Sumner of Bentley University and David Beckworth of Texas State University are among those who have suggested that the Fed should move gradually toward a new, more rule-bound and predictable monetary policy. The first step would be to signal to the markets that the Fed is willing to do whatever it takes to reach 2 percent average inflation. Over time the Fed would move to stabilize and then slow the growth of nominal GDP, which is the size of the economy as measured in a given year's dollars. If the nominal GDP target was for 3 percent growth and the economy grew by 2 percent, there would be 1 percent inflation.

That policy would bind the Fed to a rule, thus reducing the uncertainty that recent policy has generated, including the risk that we will get galloping inflation at some point in the future. But it is superior to simply targeting the inflation rate, Beckworth argues, because it incorporates two worthwhile types of flexibility. It allows the price level to move in response to supply shocks: An oil embargo would cause prices to rise, a technological advance would have the opposite effect. And it allows the money supply to move up and down in response to the demand for cash: In periods such as late 2008, when people were holding on to their money, the Fed would have loosened more than it did. But since the rule would have required tighter money during the boom years, the financial crisis

might not have been as severe in the first place.

This policy would, in the short run, increase inflation, but to a low rate; we have averaged higher than 2 percent inflation for each of the last five decades. Eventually it would yield a gentle, long-term deflation: Prices would fall during periods of productivity growth. (George Selgin, an economist at the University of Georgia, has made an elegant case that productivity-driven deflation is not dangerous.) Beckworth cites evidence that both Milton Friedman and Friedrich Hayek favored something like this approach of stabilizing nominal spending.

Moving inflation first up and then down; managing the transition from discretion to rules: The task before the Fed may be likened to performing a complicated operation on a patient in a delicate condition, and with only crude tools. Be glad that you are not in Bernanke's seat.

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