Financial Times (London,England)

February 20, 2003 Thursday
USA Edition 2

SECTION: COMMENT & ANALYSIS ; Pg. 13

LENGTH: 799 words

HEADLINE: America must tame inflation before it roars: WILLIAM SILBER:

BYLINE: By WILLIAM **SILBER**

BODY:

How can we expect to fight two wars - one against terrorism and one against Saddam Hussein – without a tax increase, much less with a tax decrease? Vietnam is only the most recent example of the fact that inflation swells from wars that are not accompanied by higher taxation.

The obvious answer is that we can have guns, and butter too, while working our way out of recession. In fact, some economists have recently prescribed fiscal stimulus to avoid deflation, rather than fretting over the inflationary consequences of wartime spending. Perhaps worrying about inflation now is like putting the proverbial cart before the horse.

The problem is that countercyclical fiscal policy is a dangerous prescription. Expenditure is not easily reversed as the recession fades. No one believes the terrorist threat will disappear even if the war in Iraq goes well. Government and private spending on homeland security will strain our resources for the foreseeable future. Therefore, inflation will be our main concern once the economy has turned the corner. Planning to tame inflation only when it roars is a mistake that would threaten a 1970s cycle of inflation and recession.

Alan Greenspan, chairman of the Federal Reserve, confirmed the clear and present danger of fiscal stimulus in his testimony before Congress on February 11, when he said: "We are all too aware that government spending and tax preferences can be easy to initiate or expand but extraordinarily difficult to trim or shut down." He could not mention inflation, at least in part because central bankers cannot use that word without upsetting the financial markets. Instead he warned that deficits are dangerous: "Contrary to what some have said, (the deficit) does affect long-term interest rates and it does have an impact on the economy."

Long-term interest rates increase with deficits either directly because government borrowing expands the demand for credit or because inflationary expectations work their way into the markets if central banks hesitate to shift gears once the economy picks up. The Fed has earned great credibility as an inflation-fighter, but down the road it might delay a necessary increase in interest rate targets. The natural blur of information at turning points in the economy fosters such delays, no matter how vigilant the central bank. And that is precisely when bond market participants drive up yields with inflationary expectations.

Support for fiscal stimulus has grown in part because the Fed's low interest rate policy has yet to jump-start the economy. But expansionary monetary policy often works slowly, so it is still early. The monetary stimulus already in the pipeline does not guarantee a recovery but it has certainly shifted the balance of risks. There is a time to act and a time to wait. Now is the time for waiting.

There is concern that we are on the brink of a deflationary decade like Japan's, but that ignores how quickly our central bank eased compared with theirs. It took the Bank of Japan more than three years to lower its discount rate by 4.25 percentage points in the early 1990s - in response to the explosion of a property-driven stock market bubble. By contrast, it took the Fed half that time to lower the target Federal funds rate by 4.75 per cent - from a high of 6.5 per cent in May 2000 to 1.75 per cent in December 2001.

Fed officials have shown us that they are not afraid to use more ammunition. They lowered the Federal funds rate to 1.25 per cent in November 2002. Moreover, they have indicated a willingness to purchase longer-term Treasury securities directly in the open market if long-term interest rates need another nudge down. The drop in the 30-year bond yield in 2000, caused by the Treasury's buy-back programme, shows that policymakers can effectively target specific maturities if that is what is needed. The Fed has an enviable record of flexibility under Mr Greenspan. Theirs is a work in progress that should proceed with the help of, at most, a temporary fiscal stimulus.

The implication is clear: this is not the time to enact President George W. Bush's tax cuts as currently proposed. Ending the double taxation of dividends rightly belongs as part of a broad reform that addresses other inequities and biases in the tax code. It should not be presented under the rubric of a stimulus package to restore full employment, when its long-lasting effects will be to raise competition for scarce resources.

We cannot afford to let inflation sap our strength the way it did during the 1970s. The war against terrorism is too important to lose because our capacity is stretched thin. It will be far more costly to repeat that mistake now.

The writer is professor of finance and economics at the Stern School of Business, New York University

LOAD-DATE: February 19, 2003