

Wall Street Journal Commentary

The 'I' Word: Dollar stability is the best way to control inflation

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One of the most important challenges in economics is to understand the causes of inflation and deflation, and then to avoid both. The problem is far from trivial -- inflations and deflations have become relatively common and are damaging when they occur. Thus, monetary policy presents a huge opportunity for faster U.S. and global growth.

Until just a few months ago, many thought the U.S. still had a deflation problem -- not to mention a jobs problem and even a growth problem. Now, the concern has flip-flopped to inflation, causing wide fluctuations in bond yields, mortgage rates, interest rate expectations and currencies.

In monetary policy terms, these are exciting times. At 1%, the Fed-funds rate is stunningly low. The economy is actually accelerating from a fast growth rate, as shown by recent employment reports and Wednesday's jump in industrial production. I expect a mild burst of inflation just ahead, the result of the weaker dollar in 2002 and 2003.

Interest rate futures have priced in significantly higher rates over the next two years. This helped the dollar recover some in April and May. These market-based indicators argue that the expected interest rate hikes may be enough to stop further dollar weakness, allowing the inflation burst to come and go.

In looking back at the huge swings between inflation and deflation, two key conclusions jump out. First, changes in the value of the dollar had a major impact on the price level. When the dollar was weaker than its 10-year trend, there was upward pressure on prices, and vice versa. The pattern was predictable. Dollar weakness in the 1970s brought inflation and the recessions of 1974, 1980 and 1982. Dollar strength in 1998-2000 caused deflation pressures that showed up first in gold and commodity prices, then in the broader inflation indices. Dollar weakness in 2002-2003 is now putting upward pressure on prices, again starting with gold and commodities and working its way through the general price level in a piece-by-piece fashion. Second, the standard model -- trying to measure the slack in the economy -- simply didn't work in anticipating deflation or inflation pressures. For one, the "output gap" was very hard to measure, given the economy's dynamism. More importantly, changes in the value of the dollar were so large that they dominated other factors.

It should also be clear that inflation and deflation rates themselves have not been suitable for managing monetary policy because they have such a long lag from past monetary policy. Even monitoring inflation expectations is not helpful since the near-term inflation outlook is the result of past events. The analogy of driving

a slow-to-turn supertanker is apt. If the pilot directs the rudder based on the past course (historical inflation) or even the current course (inflation expectations), the ship will zig-zag, wasting fuel and risking shoals.

The growth-maximizing course is for the Fed to raise interest rates fast enough to keep the dollar stable, while explicitly recognizing that there may be a material bulge in the inflation rate over the next two years due to past dollar weakness. As inflation bubbles up in coming months, some will want to raise interest rates even faster to get ahead of it, just as they wanted to cut rates below 1% in 2003 to get ahead of the fading deflation pressures already addressed by 2002's dollar weakness. This won't stop the inflation bulge or maximize growth.

It is comforting that increases in interest rate expectations have caused strength in the dollar, confirming that markets are confident in the Fed and the U.S. economy; just not in the 1% interest rate. While interest rates are far below neutral, it looks as if the distortions haven't accumulated to the point of causing serious damage, meaning rate hikes will have a positive effect on the economic outlook. However, in the absence of clear guidance from the Fed, the market will likely assume the worst -- that the Fed will push rates up as long as extra inflation persists, even if it causes an overshoot on the high side. Just as markets worried their way into deflation psychology after the fact in 2003, they may worry themselves into a deeper inflation psychology in 2005. The Fed can avoid this by explaining that the upward pressure on prices is the result of dollar weakness in 2003 and will pass.

In the '90s, Alan Greenspan achieved ever-lower inflation amid fast economic growth. The U.S. has an opportunity to make another great monetary leap forward by creating a conceptual bridge to a stable price environment, one that achieves low, relatively steady CPI inflation. Only dollar stability offers that bridge. If the dollar is stable, neither inflation nor deflation can be substantial. In the alternative, dollar instability, inflation and interest rates will continue to fluctuate over a wide range, the costly zig-zag process we have been experiencing.

The starting point for a dollar stability standard is to recognize that sustained currency weakness is inflationary while sustained currency strength is deflationary. The connection is somehow still controversial in economics. It shouldn't be. If an item is priced in dollars and the dollar weakens, it makes sense that the dollar price will rise at some point. Likewise, yen prices had to fall in the '90s due to the yen's strength, causing a deflation spiral. It would be a major pro-growth change in economics if this currency stability logic were accepted and incorporated into monetary policy.

The market is clearly prepared to welcome a dollar stability standard under which the Fed would watch market-based indicators, especially the value of the dollar, to set interest rates and help avoid harmful inflation and deflation. The Fed and

particularly its current chairman have immense credibility in fighting inflation. The dollar's value changes instantly when the Fed alters its monetary policy direction, giving clear feedback. This provides an easy path in which the Fed uses dollar stability to combat inflation.

The market implications of a change to a dollar stability standard would be particularly favorable. As recently as March 25, the heavily traded futures contract for the December Fed-funds rate stood at 1.26%. This indicated that the bond market accepted the Fed's then-held view that deflation was a slightly higher risk than inflation and that the Fed would "be patient in removing its policy accommodation" as stated in the Fed's March 15 statement. By June 16, billions of dollars had evaporated as bond yields rose. The December contract had jumped over a full percent, to 2.3%, based on new data and new Fed signals.

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Going forward, the proper level of interest rates depends heavily on whether the coming inflation bulge is perceived as temporary or lasting. If the Fed were using forward-looking indicators, particularly the value of the dollar, to set interest rates and pursue price stability, it would add substantially to non-inflationary U.S. growth. This would be quickly reflected in stock prices, just as the pro-growth 2003 tax cut was.

The debate is straightforward -- do changes in the value of the dollar affect the price level? They clearly do, so dollar stability provides a bridge to price stability and a useful guide in combating the coming inflation pressures.

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