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How to Deflate Overblown Fears of Deflation

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There's been a lot of hand-wringing of late over the possibility that the U.S. economy is headed for the deflationary doldrums. Deflation -- a persistent decline in the price level -- weakens borrowers' balance sheets, and reduces consumption and especially business-investment spending. In other words, deflation is costly -- potentially much more so than modest rates of inflation. This Great Depression foe for the U.S. economy is a present disease in Japan. Are we once again at risk?

I don't think so. Nonetheless, the doomsday scenario goes something like this: The end of the stock-market boom leads to a drop in consumer spending and collapse of business investment. The subsequent decline in aggregate demand relative to our potential output puts downward pressure on prices. (With high structural productivity growth in the U.S., this gap is substantial.) Once deflation begins, the real burden of debt increases, so borrowers must cut their spending to pay off the real value of their debts and the cycle continues.

Additional twists to the deflation fear in recent months include concerns that a soon-to-burst housing bubble will exacerbate deflationary pressures and that the declining dollar will further reduce U.S. asset values, as foreign investors rush for the exits.

These worst-case scenarios are entirely overblown. High housing values have indeed cushioned the effects of the sharp fall in stock prices and have supported consumption. A bubble? Not likely. Aggressive expansionary policy by the Fed lowered the user cost of housing, raising the fundamentals for housing. The surge in immigration during the 1990s and the lack of land suitable for new housing in some cities with harsh zoning restrictions contribute as well. Finally, a key factor in any "bubble" story is the hope or prayer that a buyer can purchase the asset for one price (even if high) and sell it quickly for a higher price. High transactions costs in the housing market make this easy liquidity story unlikely.

And the dollar? The dollar has declined by more than 24% against the euro since the start of 2002. This decline need not presage another round of asset-price declines in the U.S. Recall that equity prices rose when the dollar's value fell from 1985 through 1987. Recall also that the correction in the U.S. current account does not have to be accompanied by economic contraction. Between 1985 and 1991, the U.S. current-account deficit declined from 2.8% of GDP to essentially zero -- while real imports actually rose by almost 30%.

The dollar's near-term woes reflect the Fed's aggressive actions to reflate the U.S. economy, decreasing the federal funds rate from 6.5% to 1.25% since early 2001. The European Central Bank's policy, by contrast, has been less focused on asserting the eurozone's recovery and avoiding deflationary pressures.

Deflation is avoidable in the U.S., particularly if the economic recovery gains steam in the coming months. In an environment in which nominal interest rates are low and deflation fears persist, tax policy should play an important role. In deflation-suffering Japan, fiscal policy has acquired a bad name. Inefficient spending projects and temporary tax changes have offered little to a viable long-term recovery, while piling up government debt -- a lesson for politicians here who offer the siren song of "temporary tax cuts" and "aid to states."

President Bush's bold proposal to eliminate the double taxation of corporate income, by contrast, would have significantly cut the cost of capital for investment, raise corporate asset values, and strengthen household and business balance sheets. Acceleration of the phased-in 2001 tax cuts will

shore up consumer spending. These tax changes will reduce and likely eliminate the gap between current output and potential output in the short term -- reducing deflation fears -- and increase potential output for the long term. By raising the desirability of U.S. assets and promoting economic growth, these effects would also strengthen the dollar, thus reducing fears of capital flight. The Congress failed to deliver the full pro-growth punch of the president's proposal, though the tax compromise is hopefully a step toward longer-term tax reform.

What of monetary policy, the domain of the Fed, an unsung hero of pro-investment "tax cuts" in the 1980s and 1990s? While there can be no doubt that the Fed's aggressive actions over the past two years have cushioned adverse shocks to current output, the central bank's current stance on deflation blurs the distinction between a genuine present fear of deflation and a reassurance that deflation is unlikely because of a swift Fed response. Senior officials continue to stress that the economy's recovery is on track. Hence the Fed's Open Market Committee appears to be aiming at reassurance. That being the case, the Fed's objectives would be better served by identifying an acceptable range of inflation and setting a floor beneath it, which would trigger corrective expansion. Given measurement problems in price indexes, broad inflation in the 2% range is consistent with price stability.

During the battle against inflation in the 1980s and 1990s, the public instinctively understood that inflation was a "problem." Still, Fed discussion of acceptable ranges for inflation -- accompanied by an explanation of the costs of inflation -- would have been constructive.

Calming the present fears over deflation -- exaggerated, in my view -- requires a greater emphasis on clear communication from the Fed. Explaining the costs of deflation requires more subtlety than explaining the costs of inflation. A perhaps greater challenge is that the Fed would have to reduce its discretion somewhat in favor of discussion of, and action to achieve, an articulated low and stable rate of inflation.

As a senior Fed official rightly put it: "Having won the war, we need to win the peace."

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