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The Paradox of Profligacy

The recently passed tax cut with its seemingly clever sunset provisions appears to some observers the height of budget profligacy. Even a sound money man like Alan Greenspan has been heard to worry about the Federal Government's inability to control spending. This has led him to worry about the longer term implications for interest rates of an expanding government deficit. For such an adept economist, it is hard to understand how Greenspan could confuse structural and cyclical policy issues. We think he knows, but is afraid to tell the Congress how to distinguish between the long run and the short run effects of monetary increases. In doing this, he moves from the role of Central Banker to Religious Leader. That is a real risk to the economy!

If, in fact, the steady pace of recent disinflation is threatening to take the U.S. economy down the slippery slope into outright deflation, Greenspan should be willing to tell the Congress and the public exactly how the Central Bank will fight the war. The antidote for deflation is a rapid and continuous expansion of high powered money…In short, if the budget deficit represents 'fiscal policy,' then it is the monetization of that fiscal excess that points the way out of the deflationary nightmare. What Greenspan should recognize, if not applaud, is the very "profligacy" that will give the Fed plenty of leeway to issue reserves for Treasury paper. Surely, he knows that. Just as we asked the President to tell us how he intended to fight the War against Terrorism, maybe we need to ask the Chairman of the Fed, how he intends to fight the War against Deflation.

One can only believe that he has another agenda. Greenspan was and probably still is an Objectivist. That means he is dedicated to restraining the size of Government. Given a choice, he always wants to be seen as a good soldier in that war. It is a long-run goal for Greenspan. In this instance, however, the potential costs to the nation of a slide into deflation far outweigh the costs of excessive government that can be downsized later. The problem is that what he knows, he cannot say in public. In a Christian country, Profligacy is sin, and a Central Banker can never be for Sin. The Chairman of the Fed has to be like Calpurnia---"above suspicion." This involves a huge, macroeconomic risk---that the public will begin to worry that the Fed has the tools and the will for the battle. That will make the public more risk averse and that is definitely what is to be avoided.

How important the issue of profligacy can become is illustrated by recent Japanese history. During the Hayami era, the Bank of Japan often saw itself as the last redoubt against a profligate Diet. We believe it confused the issues that face a Central Bank when deflation is a real risk. This is the central truth about the relationship between money and prices. It got lost in Japan during the early period of the post-Bubble era and Japan was plunged into a Hayekian Liquidation from which they have not recovered. In that liquidation, major pieces of the financial network of Japan were destroyed and the fear that destruction engendered turned the Japanese into extreme Risk Averters. Ultimately, with risk aversion on the march, the connection between money and prices was adumbrated. The lesson Greenspan needs to draw from the Japanese experience is to avoid teaching the public that Risk is a bad and Risk Aversion is a good! In this, as in much else in a complex, macroeconomic world, timing is everything.

Now, the Fed has to stand up and be counted as the biggest gun in Dodge City. It's time to put an end to the evil-doers. The key is to identify the source of evil. In this case, it is to shrink from an expansionary course. The right course is to keep on pumping until the war on deflation is won. The way around risk aversion is to give no cause to the alarmists that the Central Bank will pull back from its responsibility---no matter what the size of the Government deficit.

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Currently, the Bond Vigilante's are pushing the yield curve down into fantasy-land---low and flattening! It can only stay there if deflation spreads an ugly message that the Central Bank has weak knees and monetary measures have no punch. A profligate Treasury will depreciate both the dollar and the currency at home---Sooner than we think, prices will in fact rise. If inflation is fundamentally a monetary matter, so is deflation. Never forget that truth no matter how the mythology of 'globalization' spreads. The key is to make sure that asset holders do not become increasingly risk-averse, as they have in Japan. That can substantially weaken the link between money and prices because with high risk aversion, the money goes into the mattress.

The ECB is also risking a great deal in its mindless pursuit of disinflation when the world as a whole is on a threatening course toward deflation. There is a difference, however, in the ECB's madness. They don't believe that a Central Bank should waver from its 'rule,' and they are willing to sit through fiscal madness in the respective States of the EU to prove their point. Their problem is not about being above suspicion. Their problem is that they have taken the Thuycidideean maxim about the need to study history to an extreme. They indeed study their history and realize that the Weimar Republic repudiated the Mark in an effort to get out from underneath World War I reparations. That was true, and it may indeed have contributed to the Hitlerian nightmare. But, the ECB has no reparations problem today with which to deal, and it should not turn the Growth and Stability Pact into an equivalent. The ECB merely needs to be consistently expansionary until the public gains confidence that nominal income will begin to grow at a healthy rate. The danger comes when the public loses faith in their Central Bank. The ECB can create a self-fulfilling prophecy by thinking that it is promoting another virtue. Nothing could be more foolish.

It is of course true that structural rigidities in Europe will make the re-allocation of labor and capital difficult and it will make full employment and modest inflation a difficult goal to achieve simultaneously. Indeed it may condemn Europe to a permanently higher rate of inflation in order that real wages are lowered sufficiently to expand employment and output. But, asking the politicians of Europe to practice 'structural reform,' is like asking an alcoholic to refuse a free drink. Wonderful to imagine, but hard to believe! If we have learned anything about the practice of Central Banking, it is that Central Bankers not being elected, gives them the power to do the right thing somewhat independently of crass political considerations. Sometimes, however, they get confused and think the right thing is the restraint of government profligacy and promotion of political virtue. Wonderful to imagine, but an unrealistic hope for a Central Banker. The right thing for Central Bankers is to steer a reasonable course between deflation and inflation, and not to get tied up in other issues or a belief that profligacy is a sin to be punished by the Central Banker It may be a sin, but they do not have that responsibility. The taxpayers will take care of it in their own time.

Taxpayers need their Central Bankers to worry about both inflation and deflation. That is a big enough job and the Central Bankers should get busy and do their job in a timely way. Timeliness is essential and the time is now.

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