Analysts see danger in Fed's focus on growth
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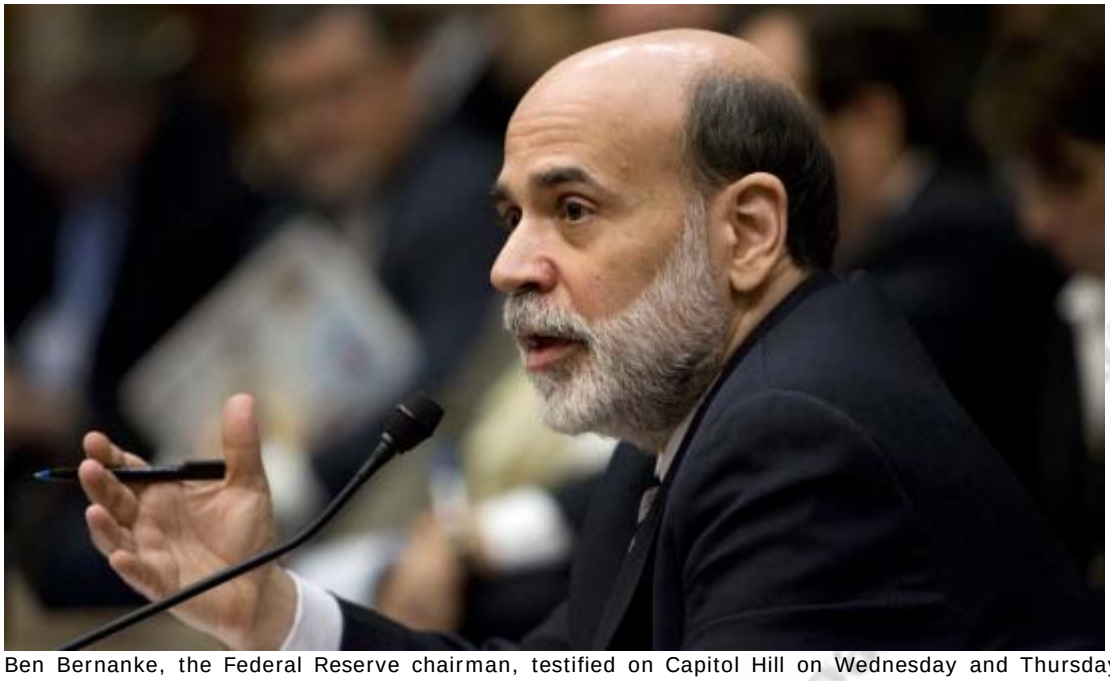

Ben Bernanke, the Federal Reserve chairman, testified on Capitol Hill on Wednesday and Thursday. Bernanke has signaled his readiness to bolster the economy with cheaper money. (J. Scott Applewhite/The Associated Press)

The U.S. Federal Reserve's decision to err on the side of faster growth instead of curbing inflation poses risks to the world's largest economy.

Ever since the wrenching experience with stagflation in the late 1970s, the rule of thumb in monetary policy has been that revving up a slow economy is far easier than slowing down inflation once it becomes entrenched.

"They're doing the same stupid things they did in the 1970s," said Allan Meltzer, a professor of economics at Carnegie Mellon University and the leading historian of Fed policy. "They were always saying that we're not going to let inflation get out of hand, that we're going to tackle it once the economy starts growing, but they never did it."

The hope is that lower interest rates will encourage consumers and businesses to spend more. Ben Bernanke, chairman of the Fed, signaled his readiness Wednesday to bolster the economy with cheaper money even though inflation is picking up speed.

The Fed chairman acknowledged that the central bank faced increasingly contradictory pressures of slowing growth and rising consumer prices. But his bottom line was that, for now, the top priority would be fighting a recession rather than fighting inflation.

Bernanke's view of the state of the economy, part of his semiannual appearance before Congress, came as the dollar sank to a historic low against other major currencies, introducing a possible third dimension to the economic problems the Fed chairman must tackle all at once.

Having already cut short-term interest rates by almost half since September, Bernanke painted a grim picture of consumers reluctant to spend, businesses reluctant to invest and banks reluctant to lend. On top of it all, housing prices keep falling.

"The economic situation has become distinctly less favorable" since last summer, he told the House Financial Services Committee. In words that investors immediately recognized as a hint of lower rates, he vowed to "act in a timely manner" and "provide adequate insurance against downside risks."

But the success or failure of the Fed's strategy could depend on something outside Bernanke's immediate control: foreign confidence in the U.S. dollar and foreign willingness to keep financing the United States's huge external debt.

The dollar has plunged 24 percent against a basket of six major currencies in the last four years, and on Wednesday it slipped to its lowest level yet since the United States let the dollar float freely in 1973.

A weak dollar can be both good and bad for the U.S. economy. It tends to bolster American exports by making them cheaper in foreign markets, but it also pushes up inflation by raising the cost of foreign imports. And while the United States pays for foreign oil in dollars, analysts contend that part of the recent run-up in oil prices was tied to the steadily declining value of the dollar.

Over the long haul, the bigger worry for Bernanke may not be import prices as much as interest rates and the dollar's value. Huge inflows of cheap foreign capital helped keep interest rates for mortgages and businesses low even as the Fed raised its benchmark overnight rates from 2004 to 2006.

If foreign investors become more wary, in part because of the dollar's declining value, economists worry they will not invest in the United States unless they get higher long-term interest rates - even as the Fed lowers its overnight rate.

"I don't think there is any great danger of hitting a trigger point where people cut and run from the dollar," said Kenneth Rogoff, a professor of economics at Harvard and a former director of research at the International Monetary Fund. "But there are hidden costs. The dollar's pre-eminence in the international financial system provides a huge bonanza to the United States. We pay lower interest rates than we would otherwise. We can probably borrow money on short notice more easily than we could otherwise."

Bernanke did not mention the dollar's falling value on Wednesday, but he has said on previous occasions that he saw no sign that the dollar was in danger of losing its status as the world's leading reserve currency.

On Wednesday, Bernanke carefully acknowledged that inflation had accelerated in recent months and would make the Fed's job much more difficult if it became ingrained in public expectations.

"Any tendency of inflation expectations to become unmoored or for the Federal Reserve's inflation-fighting credibility to be eroded would greatly complicate the task of sustaining price stability and could reduce the flexibility of the FOMC," Bernanke warned, referring to the Federal Open Market Committee, which sets interest rates.

"Accordingly, in the months ahead, the Federal Reserve will continue to closely monitor inflation and inflation expectations," Bernanke said.

But Bernanke made it clear that Fed officials were more worried about a sharp slowdown and rising unemployment than they were about inflation.

The Fed's assumption is that slower economic growth will reduce inflationary pressure in the months ahead, because debt-laden consumers will be far more wary of spending money and businesses will be more cautious about investing in plant and equipment.

Though the Fed is still predicting that the economy will narrowly escape a recession, policymakers have sharply cut their forecasts for growth in 2008 to less than 2 percent and expect almost no expansion during the first six months of this year.

At the hearing on Wednesday, Bernanke cautioned that even the newer, bleaker forecast could prove optimistic. He predicted that the housing downturn would continue to slow the economy

"in the coming quarters," noting that financial markets are still in turmoil and that credit had become more difficult to get.

Consumer spending had "slowed significantly," he said, in part because of rising gasoline prices, slowing job growth and the decline in household wealth as a result of falling home prices.

On Wall Street, investors and analysts expressed relief that the Fed was ready to lower rates again. It has already reduced the Fed funds rate to 3 percent from 5.25 percent since September, and investors had already been betting that Fed officials would lower it to 2.5 percent at its next meeting on March 18.

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