

To: SOMC Members
From: Lee Hoskins
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The attacks of September 11 have prompted a number of changes in economic policy and proposals for even more. Sorting out appropriate policy actions in times of crisis requires the delineation of what is needed immediately to stabilize the situation and what is best for the long term. The problem that arises is that many short-term policy actions can have a negative impact on the economy over the long haul, particularly when they become permanent.

Monetary Policy. The job of a central bank when major disruptions to financial markets occur is to provide the liquidity needed to restore the markets to normal. When the added liquidity is no longer needed for markets to function it should be removed. The Fed responded to the short-term challenge swiftly and appropriately. However, subsequent actions by the FOMC to lower the federal funds rate to respond to recession raises the risk of doing long term harm to the economy. Monetary policy can not produce real growth in the economy. It controls the price level. By responding to fluctuations in economic growth with an activist policy the FOMC runs the risk of creating inflation down the road. What was good monetary policy before the crisis is good policy after the crisis and that policy is zero inflation.

Fiscal Policy. Federal aid to those directly damaged in the attacks is an appropriate short-term policy. A major fiscal package aimed at stimulating the economy is not. There is no evidence that an activist fiscal policy can produced real growth in the economy. The appropriate fiscal policy is the one that provides the environment for the maximum growth in the economy over time. Such a policy would require overhauling the tax code to reduce marginal tax rates and eliminate the corporate income tax as well as the capital gain tax.

Nationalization policy. Using the National Guard to provide security at airports and other public places is an appropriate short-term response to this crisis. Nationalizing airport security for the long haul is bad policy. Government agencies lack the incentive to innovate in response to changing conditions or substitute capital for labor when appropriate. A strong case can be made for Federal government standards and even funding for anti-terrorist security with the private and local public sectors free to produce the required security. Long term loans and loan guarantees for corporations impacted by the attacks is an invitation to nationalize troubled industries and creates an endless moral hazard problem for the economy.