

SHADOW OPEN MARKET COMMITTEE
Policy Statement
November 18, 2002

Economic Outlook

The economic recovery is intact, although in several key aspects it has been weaker than in prior cycles. The crisis in confidence, associated with the accounting scandals, terrorism, and threats of war, has been a key factor inhibiting a stronger rebound. Many of these current uncertainties constraining the economy will dissipate, and economic growth will reaccelerate in 2003. Monetary policy has not restrained the economic recovery. Nevertheless, the Federal Reserve must avoid excessive monetary stimulation when external factors cause economic shocks. Monetary policy cannot mitigate such shocks. The Federal Reserve should clearly articulate to the public the objectives and rationale for its policy actions – a practice yet to be implemented.

In many respects economic performance has exceeded general perceptions. Real GDP has rebounded above its expansion peak, and labor productivity is rising rapidly. Consumer spending and real disposable income continue to grow. Housing activity is firm. Business investment in equipment and software is now increasing, although it is well below its expansion peak. Investment in structures, telecommunications and transportation, however, is still falling. Employment and hours worked have not rebounded from recession, and inventories remain low. These pockets of weakness stem from shortfalls in business investment, current risks and uncertainties, and the reallocation of resources required to fight the war on terrorism. Further monetary stimulus is an inappropriate policy tool for addressing these issues.

Monetary Policy and Policy Rules

Determining the appropriate stance for monetary policy in uncertain or volatile times is always difficult. The lack of systematic guidelines for the conduct of policy, however,

contributes additional uncertainty to the economic environment. Explicit policy rules are of value because they embody specific objectives and are capable of reducing the potential for serious policy errors such as those witnessed in the past. In addition, rules make monetary policy more transparent and promote accountability of the Federal Reserve. This does not mean that simple rules must be applied mechanistically and without judgment. But the rules should provide a benchmark so that the FOMC has a context within which to explain its actions.

The SOMC has long advocated a more systematic approach to monetary policy. To this end we are initiating the regular reporting of a collection of monetary policy indicators which will be available on our website. We hope that these indicators will contribute to greater understanding of our approach to policy and perhaps to an improved public discussion of Federal Reserve policy. These indicators include two policy rules – one proposed by John Taylor that shows how to set the federal funds rate and another proposed by Bennett McCallum that shows the appropriate growth rate for the monetary base. Both of these rules have the advantage of incorporating an explicit inflation target and also scope for policy to respond to fluctuations in real output.

At present, inflation remains subdued, and the Federal Reserve deserves much credit for its successful commitment to price stability. That commitment should be made more explicit, however, and policy rules provide an appropriate mechanism for doing so.

In the current environment these monetary policy indicators send some mixed signals. The Taylor rule for the federal funds rate indicates that in order to maintain an inflation rate of two percent, the Federal Reserve should be raising, not lowering the federal funds rate – even taking into account the current economic weakness. The monetary base rule, on the other hand, suggests that recent base growth is consistent with a one percent inflation rate. This might

suggest that monetary growth could be slightly more expansive. However, neither rule offers a justification for the recent 50 basis point lowering of the funds rate.

We strongly urge the Fed to adopt more systematic guidelines and explain their decisions in light of the guidelines. The FOMC should be more explicit as to why it believes deviating from the rules is warranted.

Misplaced Fears of Deflation and the Japanese Disease

Some apparent similarities between the United States and Japan have raised widespread concerns that the U.S. economy will, like Japan, experience deflation and a long economic slump. These concerns are misplaced: U.S. conditions differ substantially from Japan's. Japan's banking system is dysfunctional, and its capital markets are inefficient. It has had slow growth and high unemployment for a decade. The similarities are misleading. The U.S. banking system and capital market are strong. Nominal spending has been declining persistently in Japan while it is rising in the U.S. Japan has had deflation since the mid 1990s; the U.S. is experiencing modest inflation. Perhaps most important, Japanese policy-makers lack credibility to make meaningful reform.

Zero interest rates do not render monetary policy impotent, as many have claimed, even if an economy is in a liquidity trap. Expansionary monetary policy does not entail a reduction of nominal interest rates; instead, it can raise aggregate demand by policies to affect monetary aggregates, the foreign exchange rate, and real interest rates. Even in a liquidity trap, in which households simply hold any additional money that central banks create, monetary policy is *not* rendered impotent. Deflation in Japan is not the primary reason for its stalled economy, but it has exacerbated its difficulties. The Bank of Japan should contribute to Japanese recovery by

pursuing a more expansionary policy. The United States does not risk the problems that Japan faces today.

Fiscal Policy

Tax policy should focus on reform that simplifies the tax code and eliminates distortions. In particular, we support the elimination of the double taxation of corporate dividends and the provision of additional incentives to personal saving. Allowing corporations to deduct dividends would help balance the tax treatment of debt and equity. It would eliminate a major source of economic inefficiency and elicit a healthy improvement in corporate finance. Enhancing IRAs and Keoghs would encourage saving and reduce burdensome taxation of savings.

Continuing Problems in Argentina and Brazil

Both Argentina and Brazil accumulated excessive sovereign debt in years when they were recipients of massive IMF bailout funds. Argentina has been in default on its private sector debt since early this year. Last week it defaulted on debt due the World Bank. It has not yet defaulted on debt due the IMF because month after month the IMF has rolled over amounts Argentina should have paid it. Markets rate Brazil's government debt as highly risky partly because its President-elect, who takes office in January 2003, promised during his campaign to increase spending programs to fight poverty, raise the minimum wage, and increase public employee pay. By failing to limit its clients' borrowing from capital markets and international financial institutions, the IMF itself has acted irresponsibly. Instead of addiction to borrowing, Argentina and Brazil need to learn to live within their means and without the IMF crutch.

Risks in Government Sponsored Enterprises

Fannie Mae and Freddie Mac were established as Government Sponsored Enterprises (GSE's) to facilitate liquidity in mortgage markets at times when the U.S. banking system was more regionalized and substantially less capitalized. These characteristics are no longer in place. However, the regulatory and implicit guarantee advantages that the GSEs receive from the Federal government remain. Consequently, Fannie Mae and Freddie Mac hold far less capital than private competitors and make substantial profits by leveraging their portfolios and taking on substantial interest rate risk. This does not enhance housing activity and only raises the risks borne by taxpayers.

The government subsidies provided to the GSEs encourage risk taking and moral hazard. These are inconsistent with an efficient allocation of resources, transparency, accountability and good governance. We recommend eventually fully privatizing of the GSE financial intermediaries. Such a change would not affect the liquidity of mortgage financing or housing activity.