SHADOW OPEN MARKET COMMITTEE
Policy Statement
October 15, 2001

Economic Outlook

The economy and the nation suffered a tremendous shock on September 11. Beyond the devastation of the World Trade Center and the damage to the Pentagon there is a fear of more terrorism. The resulting concerns over national security are causing significant short-run disruptions to consumer and business spending and exacerbating the cyclical slowdown. There appears to be a widespread belief that the economy has entered a recession. The response of policymakers and the general public is to look to Washington to act quickly to revive the economy through the wise use of monetary and fiscal policies.

Sorting out the appropriate policy actions in times of crises requires the delineation of what is needed immediately to stabilize the situation and what is best for the long term. The Federal Reserve responded swiftly and appropriately to the short-term challenges to the soundness of the financial and payments systems. That crisis is now over. Unfortunately, little in the way of policy choices will have a significant impact on consumer or business spending in the very near term. Moreover, many short-term policy actions can be wasteful. They may have a negative impact on the economy over the long term, particularly if they become permanent. We are also now faced with the prospect of significant increases in government spending for defense and national security.

The major long-term policy objectives continue to be price stability and promotion of economic growth. The fundamentals of the economy remain strong. We believe that the economic impact of the disaster will be relatively short-lived.

Monetary Policy

Prior to September 11, the Federal Reserve had supplied substantial monetary stimulus to the economy. In our statement last April, we urged the FOMC to maintain its focus on long-term price stability and avoid the pressures to fine-tune the economy. Fine-tuning is beyond the capability of monetary policy. Since January 1, the Federal Reserve has lowered the Federal funds target in 9 steps from 6 percent to 2.5 percent. Even before the events of September 11, the easing had resulted in growth rates of the monetary aggregates well in excess of that consistent with long-term price stability. From January to early September the monetary base grew at an annual rate of 8.4 percent, MZM grew at 19.8 percent, and M2 grew at 10.3 percent. The growth rates of most of these aggregates were at their highest in over a decade.

Following September 11, facing very real concerns regarding disruptions to the payments system and settlement problems, the Fed appropriately injected liquidity at an unprecedented rate. This is consistent with its role of preserving the orderly functioning of the payments system in times of crises. It is equally important that the liquidity be drained from the system after the threats to the system have passed.

Attempts by the monetary authority to “jump-start” the economy with additional monetary stimulus are likely to have an impact only with a lag and thus be futile in the short term. Moreover, it will run the risk of significantly higher inflation in the future. The Federal Reserve has already injected substantial liquidity into the economy in the last 9 months and risks re-igniting inflation in the future. Through most of the last 12 months, inflation has been on the rise. In the near term, special factors related to the economic turmoil following the terrorist attack, will likely result in some volatility and mitigation of the upward movement in the measured price indexes. These short-term movements should not be interpreted as meaning that inflation is not a danger and thus monetary policy can be even more stimulative. The underlying factors pointing to a continued increase in inflation are still in place. The median CPI, measured by the Federal Reserve Bank of Cleveland, rose at a 4 percent annual average rate from last January to August compared to 3.2 percent during all of 2000 and 2.2 percent in 1999. Given the very rapid rise in the aggregates currently underway, the groundwork is there for higher inflation in the future.

Fiscal Policy

Fighting the war on terrorism will necessitate sustained increases in Federal expenditures, primarily related to defense spending and national security. It is also appropriate to allocate Federal expenditures temporarily as aid to those directly damaged in the attacks of September 11. The resulting disappearance of the budget surplus in fiscal 2002 is a natural and appropriate consequence of the economic slowdown and war. There is a real danger, however, that Congress and the Administration, under the label of security and/or economic stimulus, will attempt to pass wholly inappropriate spending initiatives. Such activist initiatives would be wasteful and ineffective. It is certainly understandable and acceptable for the government to specify standards of performance and even funding for security. It is not necessary that government perform the service directly.

We have long urged a restructuring of the tax code to improve efficiency and promote growth. That calls for permanent reductions in marginal tax rates and lower taxes on saving and investment. Temporary and targeted measures intended to achieve a short-term objective are seldom beneficial and recall the failed policies of the past.

Restructuring the tax code to promote long-term growth also has the benefit of contributing to a solution to the Social Security problem. Raising the real growth rate of the economy in per capita terms will enable the working population to support the baby boomers as they retire.

Japanese Crisis

The Japanese economy seems to be getting worse rather than better. Japan experienced a decline in real GDP in the second quarter, and the third quarter is unlikely to be much stronger. Despite the rhetoric from politicians about fundamental reform, little has been done to date. Deregulation and restructuring of the financial system are necessary if Japan is to achieve sustained growth; monetary policy cannot by itself solve Japan's long lasting economic slump. Nevertheless, monetary policy can reverse nearly three years of outright deflation and help stimulate the nominal spending which is likely to facilitate needed structural reforms.

As we have discussed before, some suggest that since the Bank of Japan (BoJ) has already lowered short-term interest rates to almost zero, there is no more it can do. This view is incorrect and seriously damaging for the Japanese economy. Nominal interest rates will naturally be low when the economy is experiencing deflation and do not indicate that monetary policy is easy. We repeat our recommendation that the BoJ act to inject more liquidity into the system. As an alternative to the purchase of government bills, the BoJ should increase the growth of the monetary base by purchases of foreign exchange. The effect would be to stimulate exports, production, and nominal income in Japan and reverse deflationary pressures. This strategy would involve temporary depreciation of the yen, but that is incidental. The objective should be to conduct monetary policy appropriate for the Japanese economy, which will be good for the world economy.

The BoJ has been reluctant to adopt this type of policy because of a belief that it will be inconsistent with its legal charter. Our reading of that law indicates that there is a difficulty because of the law's failure to recognize the near identity of monetary and exchange rate policy but one that could easily be overcome by a minor level of cooperation with the finance ministry.

IMF Failures Continue

The IMF has apparently ignored the barrage of critical reviews of its practices and proceeded to go about conducting business as usual. Three countries are facing serious crises: Argentina, Brazil and Turkey. The IMF response is essentially no different from what it was during the 1998 and earlier crises: it offers countries in distress money, paid out in installments, subject to certain conditions spelled out in the IMF loan agreement that they have fulfilled or made efforts to fulfill. Given the current environment, these efforts are not likely to be successful. The IMF and World Bank will be under severe pressure to serve U.S. foreign policy interests. Nevertheless, we urge the IMF and World Bank to take seriously the criticisms and constructive suggestions to revamp their policies toward the emerging economies.

The tragic events of September 11 provide a stark reminder that freedom, both political and economic, does not come without risks. Nevertheless, there is no doubt that individuals have prospered more in every dimension imaginable in those countries where economic and political freedoms are most highly valued and protected. It would be a mistake of enormous proportions for mankind to abandon those freedoms or to let them be taken away piece by piece.