

## **SHADOW OPEN MARKET COMMITTEE**

### **Policy Statement**

**March 16, 1998**

Much recent discussion of the economy's prospects in 1998, following Asia's problems, suggests that (1) real growth (GDP) will slow as imports increase, and (2) lower import prices will reduce inflation. Both statements are misleading. Rising imports would affect real output (GDP) much more than real domestic demand. Domestic demand continues to grow at a rate far above the sustainable rate of growth of real GDP.

Typically, growth rates of real GDP and domestic demand move closely together. However, a large decrease in net exports in 1998 would drive a wedge between the two. (\$200 billion of net imports is about 2.5 percent of GDP.) Reductions in the administration's forecast for real GDP growth to 2 percent, and the Federal Reserve's central tendency forecast to 2 to 2 ¾ percent, therefore, should not be misinterpreted as evidence of substantially slower growth of domestic aggregate demand.

Similarly, reported rates of inflation will be misleading in the near term. Reduction in oil prices or a decline in import prices are one-time events that mask the underlying rate of inflation. Readjustments of the consumer price index (CPI) to reflect new benchmarks and correction of the CPI to remove distortions will hold reported inflation below the actual rate of inflation in 1998. Estimates of the size of these latter effects vary, but commonly used estimates are about ¼ to 1 percent. The much larger, and more misleading, change is the one-time drop in oil prices, a 40 percent reduction from the peak oil prices of 1997. These one-time changes have no bearing on the medium- to long-term prospects for inflation. The Federal Reserve's responsibility is to contain the pressures for inflation that will be reported after the one-time adjustments have been made.

For the past several years, our Committee has forecast slower inflation based on moderating rates of money growth. The Committee's correct forecast stands in contrast to forecasts of higher inflation based on Phillips curves. This disinflationary progress is now in jeopardy.

## **Monetary Policy**

Current Federal Reserve policy is inconsistent with its slated long-term objectives. Money growth rates are higher than at any time since early 1994. With high domestic demand and high utilization of labor and capital, recent monetary policy will lead to higher inflation. Declines in oil prices and other one-time changes may mask the increase for a time. It is shortsighted both to rely on these short-term changes and to reverse progress toward price stability achieved by the proper monetary policies of the last several years.

One of the supposed justifications for current monetary policy is that Asian economies have suffered a severe shock. By holding short-term interest rates constant (or in some proposals reducing them), the Federal Reserve would seek to maintain economic growth in the face of increased imports, reduced exports, and rising trade deficits.

This argument reveals confusion between aggregate supply (real GDP) and aggregate (domestic) demand. Increased money growth increases aggregate demand, adding to pressures for higher prices and wages. Imports supply part of the increased demand. But part of the increased demand will be reflected in higher prices. Sooner or later, the Federal Reserve must reduce money growth to reduce spending and inflation.

We have no special ability to forecast precisely when inflation will start to rise. We are convinced that others cannot forecast accurately either, so it is a mistake to scrutinize current data for clues. Monthly and quarterly changes are mainly random, with no reliable information about the future. Policymakers who rely on these data or try to discern patterns in them waste their time.

It is enough to know that the seeds of higher inflation have been and are being sown. It is irresponsible to ignore the increased money growth of the past six months. A prudent policy would lower money growth now. A wise policy would aim for price stability—zero inflation.

We urge the Federal Reserve to reduce the growth rate of monetary aggregates by reducing growth of the monetary base by two percentage points to an annual rate of 4 percent.

## **Deflation**

Recent forecasts of deflation—a falling price level—show the low quality of many forecasts and the inchoate arguments based on them. The argument is that falling import prices will lower the U.S. price level.

This argument makes three errors. First it confuses individual commodity prices with the aggregate price level, a serious elementary error that every economist is taught to avoid in the first course in economics. Second, it overlooks the fact that the U.S. price level is determined mainly by U.S. monetary policy, not by events in Asia or elsewhere. Third, as noted, it neglects the difference between one-time changes to fixed-weight index and persistent changes in a broad-based index. Inflation or deflation refers only to the latter.

Just as inflation is generated by excess growth of money and aggregate demand relative to productive capacity, deflation—a persistent decline in the general price level—is generated by insufficient growth of money and aggregate demand relative to productive capacity. Deflation will not occur if recent money growth continues.

Some economists find evidence of deflation in the producer price index. This is a serious mistake. The producer price index (PPI) includes only a small subset of the many prices that affect the consumer's market basket. Chart 1 shows that the producer price index has fallen several times in recent years with little or no effect on the consumer price index (CPI).

The Federal Reserve's responsibility is to keep the broad-based index from rising or falling persistently. It should try to offset real shocks to individual commodities by pushing the price index up or down.

## **Gold and Inflation**

The *Wall Street Journal* frequently uses changes in the gold price as an indicator of inflation. Chart 2, with almost thirty years of data, shows how poorly gold movements have predicted inflation. Any positive relation arises mainly from the common influence of oil price shocks in the 1970s on both gold prices and the consumer price level. After 1980, the two series generally have no relation. Gold prices rose during the U.S.

disinflation of the mid-1980s, and gold prices fell despite rising inflation from 1987 to 1991.

### **The Budget Surplus**

Projections of sustained budget surpluses are illusory and misleading. They include Social Security taxes as current receipts but exclude unfunded liabilities for future Social Security payments.

The President sees “budget surplus as far as the eye can see.” He must be shortsighted. First, the economy is at or near full employment. The administration projects that high employment will continue indefinitely. A moderate recession would eliminate some of the projected surplus. Second, the surpluses are achieved by using current revenues of the government trust funds that record future commitments for highways, Social Security and other entitlements. This is the way the government keeps its accounts; it allows the government to include current trust funds as revenues, while ignoring future liabilities for these entitlements in the current budget.

Estimates by the Congressional Budget Office report the deficit excluding transfers from the trust funds. These estimates do not show surpluses; there are deficits “as far as the eye can see.” For the next fiscal year, President Clinton proposes to borrow \$184 billion from the trust funds. If the budget were in surplus, as Congress and the President claim, the government would not have to borrow. Further, when the government borrows from its trust funds, it is borrowing from itself. It is as misleading for the government as for an individual to talk about budget surpluses under current and prospective conditions.

Third, the administration wants to introduce new entitlements and expand old ones. Using current government accounting, Social Security and Medicare spending will drive the budget into deficit in about ten years. The administration knows this; talk of sustained budget surpluses misleads the public.

The administration’s proposal to use the budget surplus to reduce debt is at best disingenuous, at worst obfuscation. At most, the Treasury will reduce the amount borrowed from the trust funds. Debt will continue to increase. The President is a “policy

wonk.” Almost certainly he knows that his administration does not have a program to secure pensions for people under fifty.

### **The Case for Tax Cuts**

Tax reduction and tax reform would be beneficial. They should not be seen as a way of disposing of a possible budget surplus. A tax cut that increases incentives to save and invest should be welcome as a means of increasing incomes and removing the tax system’s bias in favor of current consumption.

Total tax collections as a percent of GDP are now at the highest level in U.S. history. It is remarkable that members of Congress who claim to be most concerned about the growing spread in the distribution of income and the sluggish growth of median family income express little interest in tax reduction.

A tax cut that increases incentives to save and invest raises income and living standards. This is an excellent way to both raise family income and make future social security payments more secure.

### **Asia and the International Monetary Fund**

The International Monetary Fund (IMF) has become a “lender of first resort.” It lends at rates below the market to keep international banks from accepting the losses they would otherwise sustain.

Investors in stocks, bonds, and businesses have taken very large losses. Residents of the countries lose jobs, income, and wealth. Foreign banks in Europe, Japan, and the United States escape with at most small losses. Many then receive large fees for “restructuring” loans. And they get government guarantees of loans to non-government entities.

Why does the IMF need \$65 billion in new money, \$14 billion from the United States? Why does it plan to follow its current request with a request for an additional \$21 billion for special drawing rights? It must expect more crises, and larger crises, in the future. If that were not so, it could continue operating at its present level, using the money that would be repaid as outstanding loans come due.

IMF lending encourages moral hazard—a large difference between the risks borne by the debtor country and its citizens and the risks borne by the international banks. Experience in Latin America in the 1980s, Mexico in the 1990s, and Asia now shows the enormous difference between social losses and the returns to international banks. Moral hazard will remain as long as the IMF continues to bail out international banks.

The current system is crises-prone. It encourages international banks to lend with little regard for the risk of the loan. In Korea the lenders did not even know the amount of the borrowers' liabilities.

Two major changes are needed. First, domestic banks in most developing countries are too small and too little diversified to avoid serious failures. When the semiconductor or auto industry experienced heavy losses, domestic Korean banks suffered losses. Many became insolvent. More diversification would be achieved if private international banks were permitted to compete fully in foreign markets. These banks would spread local risks over a diversified portfolio of international loans. Members of the World Trade Organization have recently adopted a protocol on financial services that opens financial markets to foreign competition. This is a useful step in the right direction.

Second, in the current Korean crisis the IMF showed unseemly haste, offering to lend money before the Korean government requested it and urging the government to borrow. The IMF offers its loans at below market interest rates. It acts as a lender of first resort.

There may be a modest but useful role for an international lender operating on the principles set out by Walter Bagehot more than a century ago. These principles include loans at a penalty rate against specified collateral. Such lending would be done rarely. The rules requiring collateral and a penalty rate would assure that most of the time the lender would have nothing to do. Insolvent institutions would not have marketable collateral, so they would not be helped. Banks would be encouraged by the rules to hold collateral in case of crisis or emergency. There would be no bailouts of lending banks. Crises would be smaller and less frequent.

The IMF should be abolished; the Bank for International Settlements should assume the responsibility for lending in the rare instances when such lending is useful.

## **Lag Reserve Accounting**

The Federal Reserve proposes to reintroduce lag reserve accounting. The reported reason is to improve control of the Federal Funds rate by reducing short-term variability around reserve settlement dates.

Lag reserve accounting permits banks to calculate required reserves using transaction deposits at an earlier date as the base of the calculation. Banks, therefore, have more time to compute required reserves, so they have less reason to make last-minute adjustments on or near reserve settlement dates. A system of this kind was in effect from September 1968 to February 1984.

The proposal fails to take account of major changes affecting banks' reserve management. Most banks are no longer constrained by reserve requirement ratios, so they do not face an adjustment problem on settlement dates.

There are three main reasons. First, currency held by the banks, called vault cash, has been eligible as bank reserves since 1959. Current levels of vault cash satisfy a large fraction of reserve requirements. Second, many banks reduce required reserves by "sweeping" transactions deposits into money market accounts. Subsequently these transactions are reversed. "Sweeps" substantially reduce required reserves because there are no required reserves against money market accounts. Third, legal reserve ratios were reduced in 1991 and 1992.

Since few banks are bound or restricted by reserve requirements under current conditions, changes in the method of computing required reserves are largely irrelevant. The proposed change is unlikely to have any significant effect on the demand for reserves or the variability of the Federal funds rate.

Concentration on issues such as this is an example of the waste of resources at the Board of Governors. An enormous research department should be capable of understanding this issue and foreseeing the outcome. They could do more and better service by learning to control money more reliably. Perhaps they could start by asking: Why do reserve requirements continue to be necessary?