

**SHADOW OPEN MARKET COMMITTEE**  
**Policy Statement**  
**March 8, 1999**

The Federal Reserve should act promptly to slow money growth. Failure to act will prove costly; continued delay will add to those costs. The mistaken policies of the last 12 months must be replaced by a policy that reduces money growth. The Federal Reserve will have to be uncharacteristically adept to avoid both recession and higher inflation as it slows money growth.

Forecasters who predicted deflation and recession are busily correcting their errors. Their major error was neglect of the surge in money growth.

A year ago we wrote: "Domestic demand continues to grow at a rate far above the sustainable rate of growth of real GDP." We foresaw a decline in industrial production but continued strong growth of domestic demand. Six months ago, we again urged the Federal Reserve to slow money growth. It ignored this advice.

Current strong demand reflects the rapid growth of aggregate spending in response to rapid money growth. The surge in 4<sup>th</sup> quarter GDP, and continued rapid expansion this quarter should be surprising, it is the normal response of demand after more than a year of rapid money growth. Strong money growth also helps to explain why stock prices surge while profits slow.

Currently the consumer price index and other measures of inflation understate the rate of inflation by 1 percent or more. The principal reason is the fall in energy prices. Omitting food and energy prices, CPI inflation in 1998 was 2.5 percent. The 2.5 percent rate, however, includes one-time adjustments by the Bureau of Labor Statistics to eliminate past biases. The adjustments lower the reported rate of inflation by  $\frac{1}{2}$  percent. Additional adjustments in 1999 will reduce the reported rate by an additional  $\frac{1}{4}$  percent. Because of these adjustments, the costs previously associated with 3 percent inflation now occur when inflation is 2 percent.

Once these adjustments are completed, the reported rate of inflation will rise to reflect more accurately the underlying rate of inflation, currently about 3 percent. A 3

percent rate is much too high; at this rate prices double every 24 years. The Federal Reserve should achieve a zero rate of inflation.

Current monetary policy adds to inflationary pressures. The Federal Reserve should not wait for evidence that inflation has increased. The least costly way to reduce inflation is to keep aggregate demand growing at the sustainable rate of growth of output. While no one can be certain about the precise values of the sustainable rate of real growth, or whether it has increased, the size of the increase is unlikely to be more than  $\frac{1}{2}$  percent, therefore much too small to justify current rates of monetary growth.

In his Humphrey-Hawkins testimony, Alan Greenspan suggested that the third  $\frac{1}{4}$  percent reduction in interest rates last fall might not have been appropriate. This is an understatement. We believe the Federal Reserve responded incorrectly to the financial market disturbances following Russia's default and the problems of Long-Term Capital Management. The proper response was to open the discount window to all financial institutions that could offer marketable collateral. The additions to bank reserves and monetary base could then have been offset. If this policy had been followed, we would not have experienced the very high rates of money growth in the fall and winter.

The Federal Reserve has delayed too long in responding to rapid money growth at high employment. The current open market committee has repeated the mistake of the late 1960s and early 1970s, a mistake that started and sustained the great inflation. Then, as now, the reasons for hesitation and delay, based on near-term events or imprecise forecasts, dominated long-term concerns. In contrast, the Federal Reserve responded more promptly in 1994, thereby sustaining expansion without inflation.

The longer the Federal Reserve delays, the larger will be the losses in output and employment when they occur. Anticipations of inflation appear to be relatively quiescent. Once prices start to rise, anticipations will rise also.

All monetary aggregates have continued to rise well beyond the ranges the Federal Reserve projected. The Federal Reserve should have acted a year ago to reduce money growth, as we urged at the time. The FOMC should act now to reduce growth of the monetary base. By the end of the year, base growth should be brought to 4 percent-5 percent from the current 7 to 8 percent.

## **The President's Budget**

President Clinton's budget is an outrageous and misleading document. It takes advantage of a surge in tax receipts to propose spending 38 percent of the projected surplus. It promises to fix Medicare while increasing the scope of the program, adding new benefits and increasing costs. It promises to save Social Security by using general revenues, but it does nothing to change its receipts or spending. It provides tax subsidies that would reintroduce burdensome complication to an overburdened tax system. Congress should reject the President's program. It should retain the spending caps.

Voters should be skeptical about projected budget surpluses. Five years ago projected surpluses were nowhere in sight. There were only projected deficits. Current projected surpluses may be as ephemeral as past projected deficits. A small decline in growth or a rise in interest rates will substantially lower these projections.

Government at all levels now takes 1/3 of all income in taxes, a 6 percentage point increase in one generation. Nearly half the increase has come in the last five years. And it has come when defense-related spending has been cut drastically.

Properly counted, there is no surplus. The mirage of a surplus ignores the entire unfunded liability for promises that the government has made to current and future Social Security recipients. The government will need more revenue in the future if it is to honor its obligations under current law. Obtaining more revenues and more efficient use of medical resources requires reform of Medicare.

## **Medicare**

President Clinton should listen to his own rhetoric: Save Medicare first, before introducing new benefit programs for prescription drugs and long-term care. Together, Medicare (Parts A and B) will grow from 12 percent of the current Federal budget to 28 percent of the Federal budget by 2008, even under the CBO's most optimistic projections.

True reform of Medicare starts by recognizing that the government cannot provide healthcare services. Only medical professionals, hospitals, and pharmaceutical companies provide quality health services. All the government can do is redistribute the cost. Efforts to shift costs and benefits, however, raise overall cost, introduce serious

distortions into the pricing and provision of services, and remove incentives to use medical services rationally.

We believe that the present hodge podge arrangements mixing government, HMOs, insurance companies and many others are fundamentally flawed. Instead of piecemeal patches that increase complexity and the role of government, the system should be scrapped completely and replaced with a lower cost, viable system based on four features:

- (1) Mandatory catastrophic health care paid through an actuarially sound insurance program;
- (2) Private insurance coverage for the indigent, with premiums paid partly or wholly from general revenues, in place of Medicaid;
- (3) Separation of medical insurance from employment and wages by eliminating the tax benefit for employer-paid health insurance;
- (4) Application of part of current revenues to compensate people for the loss of the tax benefit when employer paid insurance ends. (Employers could continue to provide insurance, but the payment would be taxed as income.)

These four steps would reduce the role of government, end controversies over HMOs, and return health care to a market good. People would choose their doctor, level of service, quality of care, and amount of insurance. The poor would be protected, and the entire population would be insured against medial catastrophes.

### **Social Security**

The present system is bankrupt. It has large unfunded liabilities and much smaller projected revenues. Its problems mount as the population ages with the passing of time. President Clinton deserves praise for focusing political attention on reform. The administration's proposal, however, has serious flaws.

First, the proposal depends on projection of future budget surpluses that may never materialize. This will be a certainty if Congress adopts the many new spending proposals that President Clinton has proposed.

Second, part of the funds would be invested in the stock market by a government agency. Experience with state pension plans, studied by Roberta Romano and Olivia Mitchell, shows that government management of investment increases risk and lowers returns. The cost to the beneficiaries of public pension funds is billions of dollars in lost returns.

Third, the administration's proposal for Universal Saving Accounts creates another small subsidized program instead of using resources to overhaul the present system.

Fourth, the administration continues the deplorable tradition of double-counting Social Security revenues. Revenues are counted as a receipt of the Social Security trust fund. For years, these revenues have been replaced in the trust fund by the government's promises to pay. The revenue is then spent for general budget purposes. Indeed, current discussion of a budget surplus relies on this arrangement. If the Social Security accounts were separated from the budget, as many have proposed, the budget would show a deficit.

The current "surplus" borrows from the future. It is representative of the way in which government does its accounting that the administration receives praise for dedicating 62 percent of the projected surplus to Social Security. The remaining 38 percent is spent for other purposes, including new spending initiatives. A private corporate that behaved in this way would violate accounting standards and government regulation of pension funds.

Congress should reject the Clinton program. Two-thirds of the public want to permit individuals to invest part of their Social Security in their own accounts. Congress should accede to this request by allowing individuals to manage part of their Social Security funds. As the public gains confidence in private investing, more of the system can be privatized.

True reform of Social Security begins by recognizing that the only way to reduce the net liability we leave to our children and grandchildren is to increase the assets that we leave them. That requires scrapping pay-as-you-go financing, privatizing the system, and allowing individuals to accumulate claims to real assets in their retirement accounts.

The government can contribute most to the solvency of the Social Security program by enacting tax cuts that stimulate capital formation and increase economic efficiency.

## **The Euro**

The praise and euphoria that followed the introduction of the Euro have been followed by second thoughts now that the Euro has fallen 7 percent or more against the dollar. Neither is warranted.

Whether the Euro becomes a stable, durable currency, and a rival for the dollar as a major reserve currency, will not be decided in the first weeks or months. It will happen only if the 11 member states of Euroland, or the 15 members of the European Union, can maintain price stability while adopting policies that promote more flexible, market driven, innovative economies.

The latter has not happened. During the years in which Europe prepared for the Euro, the gap widened between U.S. real GDP and the real GDPs of the principal Euro-countries—France, Germany and Italy. Current governments demand more inflationary policies to finance larger state spending. They seek to restrict the independence of the European Central Bank and to repeal the strong commitment to price stability in its charter.

The future of Europe and the Euro does not depend on these short-term, misguided measures. It depends on the willingness of European governments to reduce the scope of the social welfare state, lowering taxes and social spending, reducing burdensome regulation, and encouraging competition. We see no evidence that the necessary changes are about to be made.

The Euro-system has limited flexibility. Labor does not move from surplus to deficit areas. Wages and prices are inflexible downward. Without greater flexibility in labor and product markets, unemployment will remain high. Continued high unemployment is a political threat to the Euro.

Instead of seeking greater flexibility, the finance ministers of Germany and France recently proposed an exchange rate arrangement with the United States and Japan that would restrict exchange rate adjustment. This is the very opposite of what they should want. The fact that they proposed to limit exchange rate changes is worrisome

because it suggests misunderstanding of the role of price adjustment within and between countries. Failure to permit price and wage adjustment is a major flaw in the Euro economy.

The proposals of the leading Euro countries—to limit exchange rate adjustment internationally and expand money growth within Europe—raise doubts about whether the Euro governments understand Europe's problems.

## **Japan**

We welcome recent initiatives by Japanese officials in the Ministry of Finance and the Bank of Japan to increase money growth even if the exchange rate depreciates. This is the appropriate policy for Japan. We hope they will persist until deflation ends and sustained expansion is underway. The U.S. Treasury should welcome and endorse these steps to strengthen Japan and the world economy.