SHADOW OPEN MARKET COMMITTEE
Policy Statement
April 30, 2001

Outlook and Monetary Policy Recommendations

Since January 2001 the Federal Reserve's aggressive actions to counter decelerating economic growth suggest that it has lost sight of its long-run objective of price stability. The Fed's explanations of these actions vary with each announcement of an interest rate cut, referring alternatively to the stock market, the IT sector, business investment, consumer confidence, and the California electricity crisis. These explanations, and the interest rate cuts between scheduled FOMC meetings, highlight a renewed attempt to over-manage the economy. This lack of focus and unpredictable behavior jeopardize the Fed's hard-won credibility. Monetary over-management and attempts at fine-tuning create poor and erratic economic performance and raise the danger of a return to the "stop-go" policies that produced the stagflation of the 1970s.

We believe that Milton Friedman's caution regarding the power of monetary policy that he delivered over 30 years ago in his 1968 Presidential Address to the American Economic Association is especially relevant today:

> "We are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making."

We recommend that the Federal Reserve maintain its primary focus on ensuring a stable price level as the best foundation for sustained, healthy economic expansion. This requires that the Fed hold to a 3 to 5 percent steady growth rate of the monetary base, given recent velocity trends. While recent base growth is within this range, other aggregates are growing very rapidly, and inflation is rising. Thus the Fed must pay particular attention to the aggregates. The costs of rising inflation far exceed the illusory benefits of attempts to fine-tune the real economy. We urge the Fed to follow transparent and predictable policies. Inter-meeting policy actions and constantly-changing explanations are destabilizing and inconsistent with such policies.

Real GDP grew 2 percent annualized in the first quarter of 2001, even with a dramatic inventory adjustment. Real consumption grew 3 percent, and housing was strong. Business fixed investment has flattened following its earlier boom. This retrenchment in investment was not caused by excessive monetary restraint nor can it be reinvigorated with aggressive monetary stimulus.

It is a common, yet mistaken, view that inflation is dead. During the first quarter of this year, the CPI grew at a 4.0 percent annual rate—up from 3.2 percent in 2000, 2.7 percent in 1999 and 1.6 percent in 1998. Even excluding food and energy the rate was 3.5 percent—again, up from 2.6 percent in 2000, 1.9 percent in 1999 and 2.4 percent in 1998. The first quarter estimate of the GDP chain-weighted index was 3.2 percent—up from 2.1 percent in 2000, 1.5 percent in 1999 and 1.3 percent in 1998. The trend in inflation is up by almost every measure. The recent declines in the value of the dollar, the rise in longer-term bond yields, and the steepening yield curve, accentuated by the Fed's last rate reduction, confirm the market's concern over rising inflation.

Fiscal Policy

The current public debate over the impact of role of tax cuts is tragically confused and obscures the most important issues. Tax receipts as a share of GDP are at a peacetime record high. The increase in personal Federal income taxes has been the driving force behind the boom in tax receipts, with personal income taxes rising from 8 percent to over 10 percent of GDP since 1993. Returning the income tax to its historically normal share of GDP would require a tax cut of at least $200 billion per year. Over a ten-year period this would correspond to an approximate $2.5 trillion tax cut.

While the argument that a tax cut is needed to stimulate aggregate demand is convenient politically, it is not economically compelling and distracts attention from the most important issues. The true case for tax cuts is based on the long-run benefits of improved economic growth, not the promise of averting a further short-term economic slowdown. The tax code has become increasingly complex with hidden taxes in the form of phase-outs of deductions and the rising burden of the alternative minimum tax (AMT). This complexity discourages work, decreases saving, and reduces both economic efficiency and economic growth. The Bush Administration's proposed tax cuts are too small and do too little to reduce complexity and to reduce the taxation of saving and investment.

The argument that it is better to reduce the debt than to cut taxes to increase savings is dubious and inconsistent with recent experience. Since 1993, the debt to GDP ratio has declined from over 50 percent to 35 percent, yet during this period private saving declined. Cutting marginal tax rates is a more effective way to stimulate growth and improve our economic future.

Monetary Policy Changes in Japan

The Japanese economy has been stagnant for nearly a decade. We have argued on several occasions that deflationary monetary policy has contributed to this stagnation. We have recommended that the Bank of Japan (BoJ) adopt a more expansionary monetary policy to reverse its long-term deflationary stance of the past. Recently the BoJ announced several important changes in monetary procedures that are intended to reverse the restrictive policies of the past.

In particular the BoJ announced a change in its main operating target from the overnight call rate to something that closely resembles bank reserves. The bank also stressed the importance of achieving a core inflation rate that is, at least, not negative. It increased the target on reserve accounts by about 25 percent on a one-time basis and agreed to consider increases in BoJ monthly purchases of long-term government bonds.

While we recognize the important step these initiatives represent for the BoJ, we believe that the BoJ could and should go farther. It should specify a target inflation rate of 1-2 percent and should back up that target with a commitment to maintain reserve growth rather than be satisfied with a one-time injection. Finally, the BoJ should resolve not to tighten policy to support the yen, should it begin to depreciate. Just as important, U.S. policy makers should not try to persuade the Japanese to resist a depreciating yen on the ground that it is bad for U.S. exports. Japanese monetary policy, like U.S. monetary policy, should have as its long-term objective a stable domestic price level. Attempts to achieve other objectives, especially at the behest of other countries, are poor policy.

The problems in Japan, however, will not be solved by monetary policy alone. Unless Japan begins to make real progress on clearly needed structural reforms it will never achieve its economic potential.

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