SHADOW OPEN MARKET COMMITTEE
Policy Statement
April 15, 2002

Economic Outlook

The recovery is well under way, and the risks of higher inflation are growing. Six months ago most economic forecasters could see only a continuing downward spiral or a modest recovery. By contrast, at the October 2001 meeting of the SOMC, we argued that, although the events of September 11 were a significant shock to an already slow economy, they were likely to be short-lived and that the economy would recover relatively quickly. We stressed that monetary and fiscal policies were very stimulative, there was no need for a fiscal stimulus package from Congress, and the Federal Reserve would eventually need to raise short-term interest rates and reverse its aggressive easing. We argued that the fundamentals of the economy were sound and policies should continue to focus on price stability and the promotion of long-run economic growth.

These predictions have been borne out. The recession that officially began in March 2001 likely will go down as the mildest in the post-war era. With only one quarter of declining real GDP and an unemployment rate that has yet to surpass 6 percent, it was a far cry from the wrenching disruptions of the 1970s and 1980s and even mild by the standards of the modest recession in 1991.

The strength of the rebound has surprised many forecasters, eliciting upward revisions to their projections. We believe that the long-run underlying growth rate of the economy remains between 3.0 and 3.5 percent, reflecting productivity growth of about 2.0 to 2.5 percent and employment growth of about 1 percent.

Monetary Policy and Inflation

During 2001 monetary policy was excessively stimulative by any metric. The target funds rate was dropped 11 times during the year to its lowest level in 30 years and now at 1.75

percent is negative in real terms; the monetary base grew at over 8 percent compared to just about 1 percent in 2000; MZM growth accelerated from 8.2 percent to over 20 percent, and M2 increased from just over 6 percent to over 10 percent. Although money growth rates have slowed in recent months, the excess liquidity provided in 2001 raises serious risks of rising inflation.

There is evidence that the underlying rate of inflation is creeping up. Unfortunately, the headline numbers have been dominated by large swings in energy prices. For example, the energy component of the CPI declined 13.8 percent in 2001 and declined at a 9.6 percent annual rate in February 2002 after rising at a 10.8 percent annual rate in January. Meanwhile, the median CPI inflation as computed by the Federal Reserve Bank of Cleveland has risen from 3 percent in 2000 to 3.3 percent in 2001 and during the first 2 months of 2002 stands at almost 4 percent.

The negative real federal funds rate and excess liquidity are incompatible with stable, low inflation and a sustained healthy economic expansion. The monetary rules according to both Taylor and McCallum suggest that the general thrust of monetary policy points toward inflation rates rising to 4 percent. This is unacceptable.

Monetary policy is too accommodative and must be reversed. The Fed must raise its federal funds rate target in order to drain the excess liquidity it provided last year. The extremely low interest rate gives the Fed room to begin to tighten now. As real rates rise with an improving economy, increasing the federal funds rate would not adversely affect the recovery. Delayed tightening runs the risks of escalating inflation and potentially undesired volatility in economic performance.

We repeat our strong recommendation for the Congress and the Federal Reserve to adopt a monetary standard that would establish price stability as the Federal Reserve's primary responsibility. While the 1990s was characterized by generally healthy economic growth and low inflation, institutionalization of clear monetary policy objectives is critical for the future direction and credibility of the Fed. Current guidelines are too vague and would easily permit a return to high and variable rates of inflation under different leadership. Moreover, the current guidelines make the Federal Reserve accountable for everything in general and nothing in particular. Uncertainty regarding actions of the Federal Reserve creates needless volatility in the markets. Volatility could also be reduced by making Federal Reserve actions more transparent. Many central banks around the world have adopted explicit statements regarding their commitment to price stability and we urge the U.S. to do likewise.

Argentina and Exchange Rates

The prospects for Argentina are dismal. Despite the headline attention given to the abandonment of the dollar peg and the financial volatility that has ensued, Argentina's fundamental fiscal and structural problems remain unresolved. The currency board system was successful in ending Argentina's hyperinflation and providing a stable monetary environment for nearly 10 years. Unfortunately, its problems were not addressed and real economic growth could not be sustained. This inevitably led to increased strain on the dollar peg and it was ultimately abandoned.

Argentina's inability to control public spending fuels its large and growing public debt. In 2001, the government deficit was in excess of 5 percent of GDP and growing; furthermore, much of the public debt was owed to foreigners. Rigid employment practices, inflexible wages arising from a very unionized work force, high levels of government employment, and the

central government's responsibility for provincial spending harm economic performance. Ill-conceived policymaking impinges upon property rights, hampers export growth via direct taxes, and has bankrupted the banking system. Until Argentina addresses these problems in a serious and credible manner, regaining the stability it once enjoyed is doubtful. The IMF should continue to hold off making further loans until such a time has clearly arrived.

The debate over responses to the currency crisis in Argentina has once again brought to light the long standing issue of the relative desirability of fixed and floating exchange rate regimes. In some corners it is taken as almost axiomatic that fixed rate regimes are universally to be preferred. This, we contend, is incorrect. The optimal currency area type of analysis indicates that there is a tradeoff, i.e., that an increase in the size of an area over which one currency prevails entails costs as well as benefits. This approach, however, does not imply that the optimal number of currencies in the world is one. For some economies, especially large and less-open ones, the best arrangement will be a monetary policy rule that entails floating exchange rates. This rule's objective would be to achieve a very low rate of inflation by means of some clearly specified instrument adjustments; examples include inflation targeting rules, Taylor-style rules, monetary base growth rules, etc. In addition, we would argue that there is no special role for gold; a widely defined price index dominates the price of gold as a policy criterion and is equally workable.

Governance of the Federal Reserve

Excesses in the private sector are policed and ultimately corrected by market forces—just ask Enron and Arthur Andersen. The Federal Reserve is largely immune to such self-corrective forces. Therefore, it is appropriate for the Fed to examine periodically their practices with an eye to improving transparency and public understanding of Fed operations. The

Greenspan Fed has had substantial success in pursuing an objective of low inflation in order to achieve long-term sustainable growth in the economy.

In addition to working with Congress to establish a clear objective of price stability, the Fed should continue its thrust of making monetary policy more transparent. They should be congratulated for their decision to release FOMC decisions immediately, for dropping the "bias" in favor of the balance of risks statement and by releasing the voting record with the decision. The Fed should also experiment with the immediate release of the minutes of FOMC meetings and releasing transcripts in a shorter period of time.

The Fed and the Treasury have had a "warehousing" arrangement for foreign currency intervention. This arrangement allows the Treasury to continue to acquire foreign currency when funds in the Exchange Stabilization Fund are exhausted. Treasury "warehouses" previously acquired foreign currency with the Fed and receives funds to continue to acquire additional foreign currency. This practice was discontinued in the 1990s but the arrangement still exists. The arrangement should be terminated because it circumvents the intent of Congress with respect to the Exchange Stabilization Fund.

Government and Corporate Governance

The proper role for government in corporate governance is to enforce voluntary contracts; to define property rights efficiently and clearly; to provide well-designed standard contracts; to operate a legal system that efficiently enforces property rights and contracts and offers civil remedies for violations of contracts and intrusions on property rights.

Government should avoid extending its involvement beyond these proper roles. However, the government's role in defining property rights, designing standards, and operating an efficient legal system necessarily calls for decisions that involve details of corporate

governance. However, setting legal standards differs from regulation: courts should enforce voluntary contracts that override those standards.

Government should protect property rights in information, as in other resources. Firms that own information should have the legal right to restrict its flow. The legal definition of property rights in information should balance expected costs and benefits in the tradeoff between promoting use of existing information and creating incentives to develop new information.

Economic forces tend to punish many forms of misbehavior even without regulations and legal requirements. Reputation plays a powerful role in discipline. Actions that reduce an auditor's reputation, for example, tend to lead to lower future income for that auditor. Firms, like Arthur Andersen or Enron, that engage in misbehavior see their business decline and their equity price decline. These economic penalties occur automatically, if the flow of information is unimpeded, without the need for litigation or courts. Firms that hire auditors with better reputations can raise their own equity prices.

Limited information, of course, can limit the role of reputation. Agency problems (separation of ownership and control) in firms may favor auditors who enable actions by managers that exploit those agency costs (that separation imposes). However, there is little that regulators or the law can do about these problems except to provide legal institutions for remedies against fraud, theft, and other misbehavior. The legal system should also promote confidence in the enforcement of private contracts.

Whatever the changes in standards and definitions of property rights, the government should avoid intruding into private matters of corporate governance through regulatory expansions.