SHADOW OPEN MARKET COMMITTEE*
Policy Statement
May 19, 2003

Economic Overview

The economy has remained sluggish through April 2003. This is not surprising given the widespread belief that a significant improvement was unlikely to materialize until after the geopolitical risks of the war were substantially mitigated. Any assessment of future economic performance based on the volatile data releases from March and April is unreliable. We believe that the economy is fundamentally sound and as external factors that have inhibited growth gradually dissipate, growth will accelerate.

Monetary policy remains stimulative and further easing is not a solution to the current situation. The federal funds rate remains at its lowest level in nearly four decades, and growth of the monetary base is above 9 percent so far this year. The risk of a sustained deflation, despite expressions of official concern, is remote. Nominal spending growth exceeds productive capacity, which is consistent with rising prices. Moreover, the Federal Reserve has ample tools at its disposal to combat deflation. We continue to believe that U.S. monetary policy would be well served by a more institutionalized and public commitment to low inflation.

We are broadly supportive of the Administration's efforts to reduce marginal tax rates and reform the tax code to reduce the penalties on savings and investment. Unfortunately, the current political debate over the tax package has been confused and distorted by placing undue emphasis on deficits while taking little note of the potential long-term gains for the economy.

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* Charles I. Plosser and Anna Schwartz, Co-Chairs, Gregory Hess, Lee Hoskins, Mickey Levy, Bennett McCallum, and Alan Stockman, Members. The SOMC maintains a website at www.somc.rochester.edu.

The fiscal policy debate should focus on government spending and tax reforms that increase efficiency, not error-prone static deficit projections.

Monetary Policy

The lack of systematic guidelines for the conduct of monetary policy continues to contribute uncertainty to the economic environment. Will the Federal Reserve raise or lower rates at its next meeting? What criteria will it use in making such a decision? Does the Fed have a commitment to low inflation? If so, what is the target value? Such issues introduce unnecessary uncertainty and volatility into the markets. More explicit guidelines for monetary policy would have the benefit of (i) increasing public understanding of monetary policy by increasing transparency, (ii) establishing a clear focus for the Federal Reserve regarding its goals and objectives and (iii) creating increased confidence that sound monetary policy will be followed in the future. The value of discretion in the hands of the monetary authority is vastly over-rated and can actually be detrimental to economic stability. Approximately 15 countries (including England, Canada, Sweden, Australia and New Zealand) have adopted some form of inflation targeting with generally positive results.

At present inflation remains subdued. However, the volatility remains significant in month-to-month economic statistics and caution should be exercised in interpreting short-run fluctuations. The Federal Reserve deserves much credit for this low inflation environment, but that commitment should be made more explicit.

We continue our practice of reporting on a collection of monetary policy indicators which are available on our website. Our objective is to improve the public discussion of monetary policy. These indicators include two policy rules – one proposed by John Taylor that shows how to set the federal funds rate and another rule proposed by Bennett McCallum that shows the

appropriate growth rate for the monetary base. These rules incorporate an explicit inflation target but also permit the authorities to respond to fluctuation in real economic activity.

In the current circumstance, the Taylor Rule suggests that for a 2 percent inflation target, monetary policy is too stimulative and the federal funds rate should be 100 and 200 basis points higher than the current rate of 1.25 percent. Largely because of time variability of real interest rates, we are more inclined to follow the indications of a monetary base rule. The McCallum Rule suggests that base growth should be in the range of 8 - 9 percent, fairly close to recent experience. We encourage the Fed to maintain base growth in this range. These rules take into account both the rate of inflation and the state of the economy. We recognize that there may be other specifications of these sorts of guidelines that could yield marginally different instructions, but one value of a systematic guideline is that it requires the FOMC to be explicit about its actions and why it believes deviating from the rules is warranted.

Fears of Deflation

The fears of deflation that have taken root are misguided. They give the impression that just because the prices of some goods are falling that deflation is unfolding, that deflation is necessarily destabilizing for the economy, and that once it occurs, the Fed is helpless to combat it. All of these concerns, we believe, are unfounded. Most measures indicate inflation is between 1.5 and 2.5 percent. Nominal GDP is growing at 3.7 percent, which is above productive capacity and thus consistent with rising prices. The alarmists point to the U.S. during the Great Depression when deflation was running at nearly double digit rates for nearly four years. They also point to Japan's recent sustained deflation. In the case of the Great Depression, the deflation was stopped, despite very low interest rates of less than 1 percent, by a vigorous monetary expansion. Moreover, deflation was a symptom of economic problems, not a cause. Japan's

main problem is a nearly bankrupt and grossly inefficient financial system that has not been reformed or restructured and declining nominal spending. Insufficient nominal demand generates deflation. The deflation has made that task increasingly difficult, but it is not a cause of the nearly decade-long stagnation.

Currently, the U.S. has mild inflation. Its banking and financial structure is sound. The Fed has sufficient flexibility to generate stronger demand and avoid problems with sustained deflation.

Taxes, Deficits and Fiscal Policy

Tax reform should remain high on the agenda for both the Administration and the Congress. The tax code is overly complex and rife with unnecessary distortions. We support the Administration's effort to continue to lower marginal tax rates and to reduce the excessive taxation of capital through the elimination of the double taxation of dividends. Eliminating the corporate tax altogether would be a simpler and more direct method than what has been proposed and would boost savings and investment, reduce fraud and generally enhance economic efficiency. The U.S. remains one of the only major industrialized countries that does not provide some integration of the personal and corporate tax. Efforts to simplify and restructure the tax code to more closely resemble a consumption tax should be pursued. The current proposal does more to add complexity than reduce it.

The current debate surrounding the many versions of the tax package pending in Congress is filled with hyperbole, misperception and poor analysis. Concerns about the budget deficit dominate the debate with frequent claims of "record" deficits that will damage economic performance. This has steered attention away from the reform that would generate stronger economic growth and job creation. Claims about the effects of deficits are misleading at best.

The often asserted impact of deficits on interest rates is minimal and should not be a major cause of concern. Chart 1 below shows the deficit projections constructed by the CBO under their baseline forecast and under the Administration's tax proposal. As a share of GDP the deficits under the Administration's proposal are significant but remain below 4 percent and rapidly begin to shrink. They are below those experienced during the 1980s. Moreover, the government's debt to GDP ratio of 34 percent, shown in Chart 2, is well below its earlier peak and low compared to that of other nations.

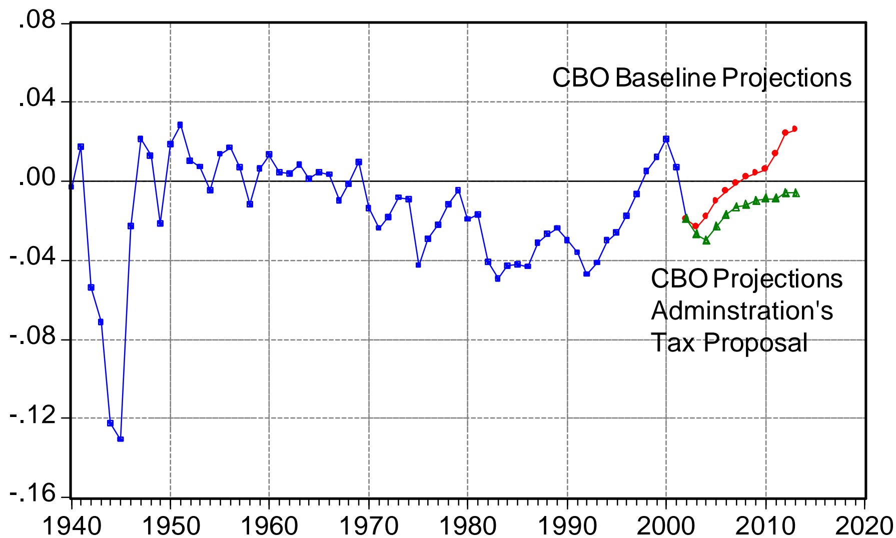
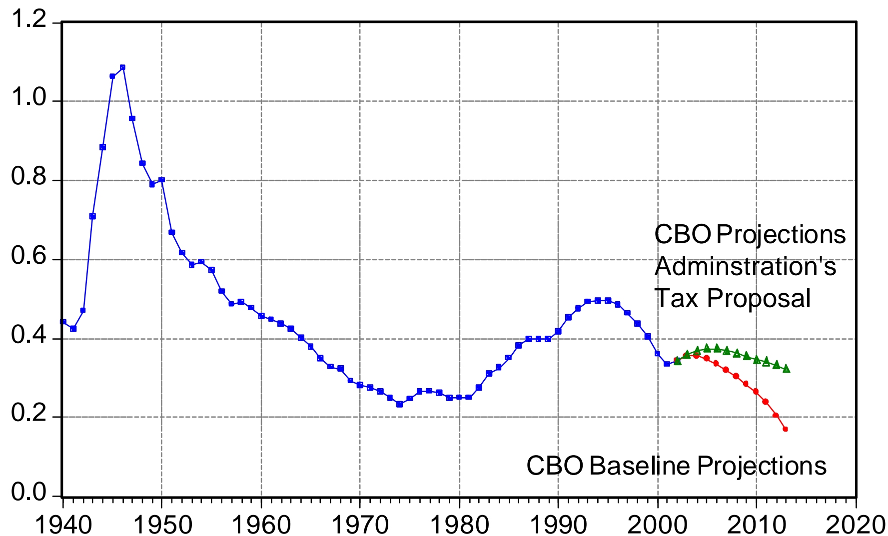


Chart 2
DEBT TO GDP RATIOS
Projections Based on CBO Estimates



Some Economic Effects of War

Like all wars, the Iraq war has been costly. Even if a war is fought abroad, its outcome is favorable and its benefits exceed its costs, valuable resources are consumed. This reduces private sector economic activity. Based on estimates from cross-country data in prior wars, the reduction of U.S. consumption is approximately 2 percent or about $150 billion. This may explain the recent slowdown in consumption growth over the past 7 months.