SHADOW OPEN MARKET COMMITTEE[1]
Policy Statement
May 3, 2004

The last six months have reinforced our view in our November 2003 statement that the economy was "well into a healthy recovery." Economic growth has averaged 4.1 percent during the last two quarters and 4.8 percent in the last four quarters. Moreover, nominal spending has grown at 6 percent during the last two quarters and 6.5 percent year-over-year. The outlook for inflation has deteriorated as we have seen inflation rise to nearly 3 percent or more during the last three months according to most of the common measures. The current stance of monetary policy is inconsistent with maintaining price stability, and the Federal Reserve should end its policy of accommodation and begin raising its federal funds rate target.

In our last meeting we expressed concern that the Federal Reserve's lack of a clear, publicly announced objective causes unnecessary volatility and uncertainty in the real economy. We stated that the Federal Reserve could improve and simplify its communication and its long-run policy effectiveness by the adoption of three basic principles:

1. The Federal Reserve should adopt a clear public statement of its primary objective. We believe that the objective should clearly state that the primary goal of monetary policy is to control inflation.
2. The Federal Reserve should announce a specific target for inflation. We believe that the objective should be price stability, which implies zero inflation. Given the errors in measuring inflation, we recommend that the Federal Reserve announce a goal of 1 percent inflation in the CPI measured year-over-year. The CPI is the most widely recognized and used measure of inflation and thus a reasonable metric to choose.

[1] 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.

3. Announce a policy process and guidelines that it will follow consistent with this objective.

We believe that these principles provide sufficient flexibility to the Federal Reserve in its conduct of monetary policy and would clarify its communications with the public.

In the last three months, inflation has risen, pushing the real federal funds rate more negative, and the growth rate of monetary aggregates has accelerated. In the last year, nominal and real GDP growth rates have increased. As economic activity continues to gain momentum, maintaining a 1 percent federal funds rate will lead to continued increases in money growth that would generate accelerating nominal spending and increase inflationary pressures.

An assessment of two rules that provide guidelines for Fed policy—the McCallum monetary base rule and the Taylor rule for the funds rate—suggests the need for the Fed to move toward a less stimulative monetary policy. According to the McCallum rule, 5 percent monetary base growth would be consistent with our inflation target of 1 percent. The Taylor rule implies a federal funds rate in excess of 3 percent. Both guidelines call for Fed tightening. Federal Reserve officials clearly have recognized that monetary policy must be tightened at some point.

With strong economic growth and the expansion on sound footing, the Fed must now begin the process of raising interest rates. Nobody knows the level of the federal funds rate consistent with a “neutral” monetary policy (one that generates sufficient growth in money while maintaining price stability). Such a neutral funds rate is a moving target, depending on the rate of money growth and velocity, productivity and other factors. But that neutral real rate is clearly not negative.

The Fed has worked hard over the last 20 years to reduce inflation and enhance its commitment to low inflation. Last year it was pre-emptive in its actions to prevent what it described as an "undesirable fall in inflation." Now, it is imperative that the Fed act with the same energy to prevent inflation and inflationary expectations from taking root in the marketplace.

Communicating Monetary Policy

The Fed has attempted to be more transparent, but its efforts have been of limited usefulness because it has not clearly stated its long-run objective and the process for achieving it. Accordingly, communicating monetary policy to the markets remains a challenge for the Fed.

The fundamental problem is not that the Fed is a poor communicator but that it cannot agree on its primary objective. As a result it is unable to provide a predictable policy response to new information. The aim of Fed policy meetings is to make a decision about the funds rates. While the objectives of price stability and sustainable growth will be discussed, no agreement about specifics is required.

The best way for the Fed to insure sustainable growth over time is to maintain price stability. Attempts to respond to short-term fluctuations in GDP, employment or other real variables often lead to big problems for the economy. Even an economy with a perfect monetary policy would still have recessions.

Bad data, bad models and bad news are going to continue to provide Fed officials and market participants with plenty of surprises. Neither the Fed nor markets can prevent them. The goal of Fed communication should be to insure that markets understand how the Fed will respond to such surprises.

Chinese Exchange Rates and Monetary Policy

The U.S. government has recently been expressing concern over China's exchange rate policy, with Treasury Secretary Snow urging a float of the Renminbi (RMB). In part, that position reflects some catering to U.S. protectionist sentiment, based on a guess that the RMB would appreciate and reduce China's exports to the United States. In this respect the U.S. position is highly inappropriate and inconsistent with traditional free-trade principles. From a monetary perspective, however, China's policy of pegging its currency to the U.S. dollar is inducing rapid base money growth in an economy that is already facing the prospect of inflation. Correcting this situation will be difficult, given China's structural problems that include an insolvent banking system and an absence of market-based institutions. Ultimately, if China is to gain control of inflation, it must reevaluate its approach to monetary policy.

Inflation and the Depreciating Dollar

Over the last two years, the dollar has fallen against the Euro, British pound, Japanese yen and Canadian dollar. Some observers suggest that dollar depreciation may cause inflation, so that the large dollar depreciation seen in the past two years is a warning signal about inflation. However, the evidence does not support that view: once other factors that predict inflation are also included in the analysis, currency depreciation plays essentially no role at all in predicting future inflation. The explanation is simple. First, movements in the exchange rate change the relative price of imported goods versus domestic goods, and relative price movements are not the same thing as inflation, that is, a continued increase in the overall price level. Second, the anticipation of higher inflation is often the cause of a depreciating currency – a reversal of the causality mentioned above. Therefore, the recent depreciation of the dollar against all other major currencies may concern policymakers for other reasons, but it does not create inflation by itself.

Gaining Control of Fannie and Freddie

Fannie Mae and Freddie Mac are two enormous government sponsored enterprises (GSE's) that are intertwined in mortgage financing. They are perceived by the markets to have an implicit federal guarantee on the securities that they issue. In addition, they are on the receiving end of explicit legislated benefits such as exemption from the Securities and Exchange Act and a line of credit at the U.S. Treasury. Recent research from the Federal Reserve Board suggests that these GSE's receive a 40 basis points cost of funds benefit from these subsidies vis-à-vis their competitors, and yet pass on only 7 basis points of this in terms of lower mortgage rates. Fannie Mae and Freddie Mac also have recently engaged in accounting misdeeds and a ratcheting up of lobbying activity – key components of many of the scandals of our recent financial scandals. Given the interest rate risk exposure on their portfolios, the intermediate legislative solution to avert a potential crisis in the mortgage market is to move the supervision and regulation of these GSE's to the Treasury, to explicitly remove the implicit and explicit benefits that they receive and to significantly raise their capital requirements. Ultimately, however, these institutions should be privatized so that the mortgage market reaps the full rewards of a competitive market environment.