SHADOW OPEN MARKET COMMITTEE[1]
Policy Statement
May 2, 2005

The fundamentals for sustained economic growth in the U.S. remain sound despite a preliminary estimate of a modest slowdown in the first quarter of 2005. The potential long-run real growth rate of the economy is 3.0 to 3.5 percent; a growth rate of 3.1 percent should not be perceived as a setback, especially after the large (and most likely temporary) rise in the price of oil. Measured rates of inflation have risen somewhat, in part due to the impact of rising oil prices, but the impact will be transitory. Nevertheless, the Federal budget deficit, the current account imbalance, the falling dollar and the risks of rising inflation have generated a great deal of angst. The fact that Alan Greenspan will step down as Chairman of the Federal Reserve Board in January of 2006 has heightened these concerns.

Credibility and Future of Monetary Policy

Whatever the stated objectives and goals of the Fed have been during his tenure, the hallmark of the Greenspan Fed has been the pursuit of low inflation.

Unfortunately, when Greenspan departs, he takes with him his personal inflation fighting credibility and commitment. The Fed he leaves behind will have no explicit institutional commitment to long-run price stability. The history of Federal Reserve chairmen and their commitment to price stability is highly inconsistent. This lack of institutional commitment poses the risk that the next chairman or some future chairman may choose a different and potentially damaging course of action for the Fed and the economy. Regardless of who may be appointed, absent an institutional commitment to price stability, the markets will likely exhibit increased

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uncertainty until the intentions and commitment of the chair to maintain low and stable inflation are demonstrated. This uncertainty can be damaging to the economy but is largely avoidable.

As we have stressed in the past, we believe that the credibility and commitment of monetary policy to price stability is an essential ingredient in promoting long-term economic growth. The risks and uncertainty posed by a transition to a new chairman can be limited by a more explicit institutional commitment to sound monetary policy. To achieve this commitment we repeat our recommendations that the Federal Reserve:

- Adopt a clear public statement that its primary objective is to control inflation.
- Announce a specific target for inflation. The goal should be price stability, which implies zero inflation. Given the inherent measurement error in various indexes, we suggest that the Federal Reserve announce a goal of one percent inflation in the headline CPI measured year-over-year.
- Announce a policy process and guidelines consistent with this objective.

These principles would achieve the objective of establishing an institutional commitment to low inflation, but they also permit sufficient flexibility for the Fed to be responsive to other economic developments in the short run if it deemed it necessary and prudent. An important by-product of such an "inflation-targeting" regime would be a dramatic improvement in the public's understanding of the Federal Reserve (i.e. transparency) and a substantial reduction in the endless parsing of official communications.

Current Monetary Policy and Inflation

While we prefer price stability, in recent policy statements we have applauded the Federal Reserve's success in maintaining stable, low inflation. We support its efforts to remove monetary accommodation and believe that the federal funds rate remains below what is

commonly referred to as the "neutral" rate. We do not know exactly what that rate might be, but it is likely to be between three and five percent if the target inflation rate is one to two percent. More importantly, we believe that a higher funds rate is necessary to restrain growth in the monetary aggregates and thereby maintain a credible policy of low and stable inflation.

Concern that higher oil prices will cause higher inflation in our view is overblown. The rise in oil prices has certainly led to increases in the price indexes; however, it is unlikely that oil prices will continue to rise at the same pace as they have for the last six to nine months. This means that the upward pressure on the price indexes may well subside.

Our view that the recent increase in the measured inflation rate is only temporary is reinforced by the fact that inflationary expectations have not pushed up the yields on long-term bonds. In fact, many observes have called it a "conundrum" that long-terms rates remain at about the same level as they were when the Fed began its "measured" increases in the funds rate. This is no conundrum at all. The Fed's willingness to remove the monetary accommodation has made it clear that it does not intend to let inflation rise. Thus inflationary expectations imbedded in the long-term rates have remained low. Indeed, this is a sign of the credibility that the Greenspan Fed has achieved. In addition, the increases in the funds rate since June 2004 are effectively moderating the expansion of the monetary aggregates and thus keeping inflation low.

Current Account Deficits and Exchange Rates

The U.S. current account deficit has risen dramatically over the last decade to almost sic percent of GDP, sparking fears of economic Armageddon as either foreigners dump dollar assets, igniting a major financial crisis, or as rising indebtedness pushes down U.S. living standards to the level of a third-world nation. These fears are completely unfounded. In fact, we have far

more to fear from the "solutions" frequently offered for these problems: protectionist legislation or other government interference with free world markets.

The large increase in the U.S. current account deficit over the last decade has not resulted from government budget deficits. Nor has it been caused by the fall in U.S. household saving. Instead, it has resulted from a massive increase in savings elsewhere in the world, combined with the ability of the United States to provide highly promising investment opportunities that attract foreign savings. Rather than a problem, the U.S. current account deficit has resulted from the natural operation of market forces. While that deficit may persist for many years, it will also decline as a reaction to market forces, as foreign savings decline back to more normal levels, raising long-term real interest rates back to the levels of a decade ago, and in turn raising the U.S. private savings rate. The rise in U.S. foreign debt over the past decade has been matched by increased investment and productivity in the U.S. economy and does not threaten American living standards.

The current account deficit has raised calls for protectionist policies, and the Bush administration and Congress have been far too accommodating in this regard. Protectionist policies would benefit special interests but would harm American consumers and reduce U.S. productivity and economic growth. The rising calls for protectionist policies pose one of the greatest threats to American living standards and a healthy world economy.

The fear of a financial collapse resulting from foreign central banks dumping dollar assets is similarly unfounded. First, such a flight from dollar assets is very unlikely. Second, if such a flight did occur, the resulting rise in U.S. real long-term interest rates and fall in real long-term rates elsewhere would quickly attract savings from elsewhere in the world. The large volume of liquid investments on world capital markets would severely limit the effects on U.S.

asset prices. The Federal Reserve, moreover, can easily stand ready to provide sufficient liquidity to U.S. financial markets to prevent a crisis.

The U.S. should stop worrying about the dollar and the renembi. As Herb Stein once said "if something can't go on forever it will stop." Let the market determine the value of the dollar. If it has declined "too much" the market will make the adjustment. Governments should avoid placing restrictions or barriers on market forces. Open and flexible markets are the best way to ensure that adjustments will be made in an efficient and predictable manner.

Monetary Policy and Fiscal Deficits

Forecasting future fiscal budget deficits (or surpluses) is difficult, but it seems quite likely that the deficits will be large for at least several years in the future. How should the Fed respond to this situation? More generally, should monetary policy be designed to coordinate with fiscal policy prospects? Our answer is that it should not; monetary policy should not be tailored to fiscal conditions. Instead, the Fed should be resolute in conducting monetary policy so as to achieve inflation rates that are low enough to constitute effective price stability. In this regard it should be recalled that there is virtually unanimous agreement that central-bank independence is of paramount importance. Then it should additionally be noted that tailoring monetary policy to fiscal "needs" is exactly what independence is designed to avoid. There is among some utopian economists a tendency to praise monetary-fiscal "coordination," but we believe that such recommendations are misguided. One example involves an esoteric body of theory known as the "fiscal theory of the price level," but analysis of its results indicates that even this debatable theory actually does not imply that monetary-fiscal coordination is desirable, given that each agency is pursuing a sensible, independent policy strategy.

Communicating Monetary Policy

Federal Reserve communications should focus on explaining current monetary policy decisions and making future decisions more predictable based on a current shared understanding of the economy and forecasts for its likely development. While the Federal Reserve System has greatly raised the level of transparency of its decision-making process, further improvements are still warranted. Such changes should focus on committing to an inflation target and articulating an understanding of how the economy works as well as distinguishing between expected and unexpected developments in the economy. One-hundred word statements after FOMC meetings are insufficient to meet these needs. Rather, the Bank of England’s Inflation Report can provide a useful guide for formulating a new avenue for communication.