SHADOW OPEN MARKET COMMITTEE[1]
Policy Statement
May 8, 2006

As Ben Bernanke's first 100 days as Chairman of the Federal Reserve Board of Govenors draw to a close, the Fed faces a number of challenges. With core inflation hovering at 2 percent, and headline inflation exceeding 3 percent, the Fed must take additional steps to ensure that long-run inflation remains low and that inflationary expectations remain anchored. Chairman Bernanke has long advocated an inflation target and emphasized transparency. Yet the Fed continues to find communication a difficult task. We continue to recommend the adoption of an explicit inflation target. Transparency could be substantially improved if the Fed issued a periodic report on inflation that would include the Fed's outlook on inflation and its views on the inflation process. We also believe that it is an appropriate time for the Fed to review the scope of the Federal Reserve's non-monetary policy responsibilities and roles, and determine whether they constitute a critical activity or merely a distraction from the Fed primary role in setting monetary policy.

Monetary Policy and Inflation

Persistent increases in energy prices have maintained headline inflation, as measured by the Personal Consumption Expenditures index or the Consumer Price Index, in excess of 3 percent on a year-over-year basis. Core inflation rates have risen somewhat less but have reached 2 percent year-over-year. The GDP chain-weight price index is also rising at about 3 percent year-over-year.

While the Fed does not yet have an explicit inflation target, it has indicated that it desires to keep core inflation at 2 percent or below. The risks are increasing that inflation will continue

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to creep above the Fed's "comfort zone." Nominal spending growth in the economy remains rapid and the real economy continues to show substantial momentum. The monetary aggregates have been rising modestly, consistent with low to moderate long run inflation. Including the week's widely anticipated rate hike, the Fed will have increased the federal funds rate to 5 percent from 1 percent in mid-2004. However, the Fed's inflation fighting credibility is being challenged by these price movements; therefore, the Fed must focus on aggressively controlling long- run inflation and ensuring that inflationary expectations remain anchored.

We have been tracking the Taylor rule for the federal funds rate and the McCallum rule for setting the growth rate of the monetary base for assessing monetary policy. The McCallum rule, which has provided a relatively reliable tracking of Fed policy in recent years, presently suggests that maintaining a 2 percent inflation rate requires 3 percent growth in the monetary base, modestly slower than its current year-over-year pace. The federal funds rate target suggested by the Taylor rule depends critically on whether the inflation target is core or headline inflation. Presently, in light of the persistent rapid growth of nominal GDP—it has averaged 6.7 percent in the last two years—and the fact that core inflation is at the upper bound of its acceptable range—some further increase in the federal funds rate may be required.

Communicating Monetary Policy

The recent episode in which Chairman Bernanke was misinterpreted highlights the Fed's continued communications problem. We believe that this communication problem is to some extent a product of the Fed's own actions. Currently, financial markets and the media try to infer from Fed announcements and statements by individual Fed members a commitment to a future path of the funds rate. The Fed has not committed to a rule or specific inflation target and instead provides "guidance" about future rate decisions. Even in a perfect world Fed actions will be dependent on new information, but in the absence of a clearly stated objective and a policy rule the markets have to guess as to how the Fed might respond to new information.

As we have stressed before, the Fed can simplify and clarify its communications through the adoption of an explicit inflation target and a more transparent discussion of its views on the outlook for inflation and its views on the inflation process. We recommend that the Fed adopt the practice of issuing a periodic Inflation Report that develops these views and discusses the role of monetary policy in the inflation process. Such reports are common among the major central banks that have adopted inflation targeting and have proved to be valuable communication devices. The adoption of an explicit inflation target and periodic inflation reports would significantly reduce miscommunication. It would make clearer the Fed's objectives, build its credibility and reduce unnecessary speculation and volatility in financial markets.

Scope of the Federal Reserve's Responsibilities

Currently, the Fed's responsibilities extend well beyond the conduct of monetary policy. Some of these responsibilities have been assigned to the Fed by Congress and some the Fed has actively sought. We are concerned that the scope of these activities diverts the Fed from its primary responsibility of conducting monetary policy, and some may involve conflicting objectives. The start of Chairman Bernanke's term is an opportune time for the Fed to reexamine the scope of its activities and determine which of the Fed's many roles remain appropriate. Among the activities that might be reviewed include control over margin requirements on loans for the purchase of stocks; supervision and regulation of bank and bank holding companies; the role of the Fed as the primary regulator of the payments system; the Fed's responsibility to regulate consumer finances; and the Fed's agreement with the Treasury to intervene in foreign exchange markets as a partner of the Treasury.