

SHADOW OPEN MARKET COMMITTEE
Policy Statement
September 14, 1998

A remarkable shift of opinion about monetary policy occurred in the past two months. Demands to lower short-term interest rates have increased. Many of these demands are based on faulty analysis or misstatements of fact.

It would be a mistake for the Federal Reserve to lower interest rates and expand money growth at this time. There is no evidence of domestic deflation. The risk of higher inflation remains. The Federal Reserve has delayed responding to rising pressures for inflation. Principal monetary aggregates continue to rise rapidly. Domestic demand has slowed modestly but continues to be strong, particularly in interest rate sensitive sectors such as housing.

In March we warned that, with the current account deficit rising, growth of U.S. real output would decline much more than growth of domestic demand. The reason is that more of the growth of domestic demand is satisfied by growth of imports from abroad.

We again urge the Federal Reserve to slow the growth of the monetary base to 4 percent per year, a rate consistent with steady long-term growth and a stable price level. We urge this policy though we are aware of the risks in the world economy. We believe that, in the event of a flight to liquidity, the Federal Reserve's overriding responsibility is to satisfy the demand for money by expanding the monetary base as much as is required. At present, there is no evidence of a flight to money in the U.S. Stability of the U.S. economy should continue to be the Federal Reserve's primary goal.

FALLACIES ABOUT EASING

Deflation

The U.S. is not experiencing deflation, and deflation in the United States is highly unlikely. Prices, on average, continue to rise. The Federal Reserve, the Congressional

Budget Office and most competent forecasters predict that inflation will rise, not fall, in 1999.

In its July statement of objectives the Federal Reserve gave its annual tendency forecast for CPI inflation as 1 ¼ to 2 percent in 1998 and 2 to 2 ½ percent next year. It noted that “special factors” kept the 1998 inflation rate below the expected rate.

Why did the Federal Reserve expect measured inflation to rise when others now claim we have deflation? One reason is that forecasts and claims of deflation are based on the change in a select group of prices—mainly oil and commodity prices. These prices dominate the producer price index, so that index has been falling.

Those who argue that there is deflation make an elementary error. They confuse inflation with the movement of a specific, select group of prices. Inflation is the sustained rate of change of a broad-based price index. All broad-based measures of inflation continue to rise.

This is not the first time we have seen this misinterpretation. Chart 1 shows that in 1986-87 and in 1991-92 the producer price index fell, just as in 1998. The effect on the consumer price index was modest and temporary on both previous occasions. Inflation continued once these one-time changes ended.

We believe that inflationary pressures are rising. Money growth remains above the path required for price stability. Rapid money growth and high employment rates lead to rising prices and higher inflation. Labor markets remain tight. Growth of compensation per main-hour increased to 4.4% for the year ending in second quarter 1998.

Foreign Assistance

The Federal Reserve’s responsibility is to achieve and maintain price stability in the United States. It is not—and it cannot be—manager of the world economy. It should not change stabilizing domestic policy to solve problems abroad.

U.S. monetary policy, first and foremost, affects the U.S. economy. Because of the size and importance of the U.S. economy in the world, U.S. monetary policy affects the rest of the world by changing demands for imports and exports and changing their

prices. These effects are damped by exchange rate changes in the short run and vanish in the long run.

The Federal Reserve makes its greatest contribution to the world economy by maintaining a stable domestic price level for its own sake and as a contribution toward stable growth. Recent years, including this year, demonstrate the importance of this contribution. Federal Reserve policy, and the resulting expectations of low or falling inflation, contributed to stable growth and falling inflation despite the long period of slow European growth earlier in the decade, the even longer period of sluggish Japanese growth and deflation, problems in Mexico in 1994-95, and in the Asian economies in 1998. Through all of these unsettled conditions, the Federal Reserve continued to provide stabilizing policies. It did not listen to the anxious voices that demanded faster money growth and temporary reductions in interest rates. It should not heed such calls now.

The Federal Reserve made a major mistake in the 1970s by expanding money growth to offset a rise in oil prices. It would be a mistake now to expand money to offset a decline in oil prices. Oil price changes have real effects that are impervious to monetary policy.

Some markets for individual goods or services have experienced slowing demand. Agricultural producers, exporters to Asia, to Canada or Mexico are affected by the global changes that are now occurring.

The Federal Reserve cannot offset these real changes in world demand without increasing pressure for domestic inflation. Nor can it offset the effects on the world economy, or on Mexico, Canada or others, of a decline in the relative prices of oil and commodities.

Capital Market Effects

Many countries issue debt denominated in dollars. Lower interest rates here would reduce the burden of these debts for developing countries. Since some of these foreign debts are owned by U.S. banks and financial institutions, lower U.S. interest rates would reduce the losses some banks have experienced.

The Federal Reserve has responsibility to serve as lender of last resort to domestic financial markets. This responsibility is a market responsibility. The Federal Reserve should offset a rush for liquidity, but should not prevent groups of banks, financial institutions and their stockholders from bearing the losses on so-called emerging market debt.

Brazil is one of the countries of special concern at present. It has a large international debt outstanding. Much of the debt is denominated in dollars. For years, Brazil has financed large budget deficits by borrowing abroad, just as the United States did in the 1980s. To strengthen its position, the Brazilian government has held relatively large dollar balances. Unlike the United States, however, Brazil has chosen to prevent its exchange rate from adjusting to its budget and borrowing.

As concerns about emerging market debt increased, lenders have withdrawn from the Brazilian market, demanding dollars. The Brazilian government paid out dollars to maintain its exchange rate. If it wishes to maintain the current exchange rate, it should reduce government spending to lower its budget deficit and its demand for dollar loans. This is a responsibility of the Brazilian government.

The Federal Reserve and international financial agencies can urge Brazil to change its policies. The Federal Reserve should not lower interest rates to offset Brazil's mistakes.

Japan

Japan is experiencing deflation, a deflation of its own making. Broad-based price indexes are falling. Japan has not adopted policies to restore growth and end deflation.

Lower interest rates in the United States would delay Japanese recovery. The reason is that lower interest rates here weaken the dollar exchange rate and appreciate the yen. As talk of a reduction in the Federal funds rate has increased, the dollar has fallen against the yen and other principal currencies.

A stronger yen requires more deflation by Japan to restore equilibrium. The risk of bankruptcy for Japan's banks and corporations would increase. This risk is already high, and bankruptcies have increased recently.

Recovery by Japan is critical for full recovery in Asia. Japan's GDP is 60 percent of Asian GDP. Thirty percent of Asia's exports are sold to Japan.

Again, the main contribution the Federal Reserve can make to the world economy is to maintain low inflation and stable growth. Changing policy to help some countries service their debt harms others. Higher inflation in the United States has no lasting benefit for us or others.

Securities Markets

Many stock traders took a dim or scornful view of Alan Greenspan's comments about "irrational exuberance." They argued that the Federal Reserve should not adjust monetary policy to influence the stock market.

Now, after the fall in stock prices in August, many traders—perhaps including some who have changed their mind—want easier monetary policy to stop the decline in stock prices. A reduction in interest rates, they claim, would help the economy and stock market.

The traders were right the first time. Considerable research has shown that the effect of the stock market on the economy is relatively small. More important is the effect of the economy on the stock market. Sustained growth with low inflation contributes to growth of profits, investment and productivity.

As in 1987, the Federal Reserve should respond to the threat of default by lending freely, at a penalty rate, on marketable securities to all financial institutions that offer marketable assets.

CAPITAL CONTROLS

A well-known economist recently proposed capital controls as a solution to problems currently faced by developing countries. Malaysia recently imposed such controls. A current concern is that Brazil, Russia and others may follow.

Capital controls prevent banks and other lenders from withdrawing their loans. Lenders are forced to keep their money in the country despite concerns about local inflation or other destabilizing local policies.

Lenders and investors avoid countries with capital controls. The same controls that try to keep money in also keep new loans and investments out. This reduces growth and lowers living standards. Capital controls permit governments to choose inflation and other confiscatory policies that also reduce growth and living standards. For a time exchange controls permit governments to avoid the full consequences of their actions.

Any short-term benefit is ephemeral. Capital controls can be, and almost certainly will be, circumvented by well-known techniques. The lasting effect is negative.

Chile taxed short-term capital inflows without any clear effect. Recently, it has reduced the tax.

THE IMF

If the IMF were a successful manager of world financial problems, it would have a role as crisis manager. This cannot be done. As evidence, we note that its recent record shows errors, misjudgments, and few successes.

Mexican, Thai, Indonesian and Korean citizens have suffered while lenders to these countries have been repaid with interest. IMF policies spared lenders while imposing large costs on equity investors and the domestic public.

IMF policies failed most notably in Russia. The Russian government promised much and did little. Billions of dollars are missing, unreported and probably stolen.

Congress should not approve additional financing for the IMF. More money would support increased moral hazard. Further, the IMF was designed to solve problems that no longer exist. Its original function disappeared in 1973 when the fixed exchange system ended. It is time to redesign international financial institutions to eliminate moral hazard.

OUR 25th ANNIVERSARY

With this meeting the Committee completes twenty-five years of semi-annual meetings. Those of us who started in 1973 never contemplated a 25th anniversary. We hoped that our role would end much sooner.

Our initial purpose was to improve monetary policy and policy discussion. At the time we advocated a policy of gradual disinflation. We spoke about the costs of inflation

and the costs of disinflation, but we also emphasized the benefits to the economy from ending inflation.

We recognized that these views differed from the mainstream view of that time. That is no longer so. We are pleased to look back and see the change in mainstream thinking that has occurred. We thank those in the media who have reported our ideas and made them available to the public.

Monetary policy, and the discussion of monetary policy, is much improved. We have often been able to praise the Federal Reserve during the past five years. The Federal Reserve has improved its actions, its discussion, and its accountability.

What remains to be done? The Federal Reserve has not made a formal commitment to long-term price stability, to be achieved at lowest cost. Decisions remain ad hoc. Once memories of the costs of inflation fade, or there is a change in membership and leadership, the Federal Reserve might return to past policies. Indeed, our statement today reflects the fact that recent discussions, pressures from the financial community, and from abroad encourage return to the policies that failed in the past.

To avoid a return to these mistaken policies, we will continue to urge the Federal Reserve to develop and adopt systematic rules for monetary policy. These rules should aim at a long-term goal of zero inflation. Several other countries have moved decisively in that direction with good results. It is past time for the Federal Reserve to do the same.