

SHADOW OPEN MARKET COMMITTEE
Policy Statement
November 13, 2000

Outlook and Recommendations

The economy remains healthy despite what appears to be the arrival of the long predicted slowdown in economic activity. In our last statement in the fall of 1999 we warned that inflation was rising due to rapid monetary growth and suggested that the Federal Reserve should move aggressively to return money growth to a pace that was consistent with low inflation. Inflation did rise in 2000 (even excluding the effects of the oil price increases), and the Federal Reserve moved to tighten policy by raising the Federal funds rate four times this year. Much of the excess liquidity created during 1998-99 has now been eliminated so that the year-over-year growth of the monetary base is below 5 percent. The effect of this reduction in money growth and associated decline in inflationary expectations can be seen in the nearly 90 basis point fall in the interest rate on long-term Treasury bonds since the first of the year and a strengthening of the dollar against other major currencies.

The robust labor productivity gains and 4.5 percent real GDP growth from 1996 until mid-2000 were generated in part by cyclical and structural factors that have reversed. We believe sustainable trend line growth of approximately 3 to 3½ percent is a sounder basis for conducting monetary policy than more optimistic estimates of potential growth.

Recent developments are good news but risks remain. The Fed must resist temptations to fine tune the real economy and focus on the long-term objective of low inflation. Fine tuning risks a return to the destabilizing “stop and go” policies that proved disastrous in the past.

There is also an opposite concern. The Fed should be aware that, with slowing growth and declining expected rates of return on investment, real interest rates might fall. Holding constant the Fed Funds rate may result in further unintended monetary tightening. In the current environment, it is particularly important that the Fed pay attention to monetary aggregates.

Based on current conditions, including trends in the velocity of money, we recommend that the Fed maintain money market conditions so as to generate a growth rate of 3 to 5 percent for the monetary base. Given realistic prospects for sustainable real growth, this would be consistent with inflation of about 1 to 2 percent. As the economic environment changes, short-term interest rates are not a reliable measure of monetary thrust. Thus, the Federal funds rate may need to be adjusted to maintain money growth along a stable, low-inflation path. More importantly, we urge the Federal Reserve and Congress to take steps to institutionalize the commitment to low and stable inflation over the long term.

The rapid increases in oil prices are unlikely to be a disruptive influence on the health of the economy. Volatility in the price of oil has been commonplace since the 1970s, but since then it has not had significant impact on the aggregate economy. This appears to stem from recognition that the changes are temporary rather than permanent and from market projections that the price of oil will decline over the next two years. Thus, while the surge in oil prices may temporarily raise measured inflation, its impact on economic growth is likely to be minor at most. In general there is no reason for the Fed to respond to such temporary fluctuations in the prices of specific commodities.

Looking to the future, the Federal Reserve and the new Administration face a number of policy challenges and choices, yet much of the political discourse sheds little

light on the actual underlying issues or choices. In what follows we highlight some of the most important policy issues.

Perpetuating Sound Monetary Policy

The overall performance of the Federal Reserve during the last 10-15 years has been very good. The rate of inflation has been reduced from double digits in 1980 through the 3-5 percent range by the late 1980s to 1-3 percent in the latter half of the 1990s. We applaud Chairman Greenspan and the Federal Reserve for their successful commitment to price stability, but the Fed still lacks institutional mechanisms to ensure that it will continue on this wise course under future leadership. Consequently the U.S. remains at risk that inflation may resurface in a different political environment.

The United States should follow the lead of other industrialized nations and adopt an explicit monetary standard. Such a standard would establish for the Federal Reserve clear objectives regarding expected rates of inflation. The current guidelines (and, indeed, expectations of the general public) for the conduct of monetary policy are vague, holding the Federal Reserve accountable for nothing in particular and everything in general.

Thus, we repeat a recommendation we made at previous meetings. There should be institutional constraints or guidelines designed to assure the Fed's ongoing commitment to price stability. That commitment should not depend on the attitudes and beliefs of the transient members of the Federal Open Market Committee or of the Chairman of the Federal Reserve's Board of Governors. The Federal Reserve Act should be amended to include an explicit statement that the Fed is to conduct monetary policy so as to achieve on average an inflation rate of 1-2 percent per year in terms of a specified

price index. These guidelines must be unambiguous and not be complicated by multiple or potentially inconsistent objectives.

Fiscal and Budget Policy

The projections of large Federal budget surpluses have created a frenzy of proposals to “spend” the windfall on new programs, the expansion or bailing out of old programs (such as Medicaid, Social Security and defense), and tax cuts. The presumption that these surpluses will actually materialize (at least in magnitudes being discussed) should be taken with a large grain of salt. That belief assumes that there will be no recession in the next ten years, that tax receipts will remain at its current high proportion of GDP, and that spending on discretionary programs will adhere to the legal spending caps. The first two assumptions are dubious, and discretionary spending has already violated the legal caps.

The policy makers in Washington have yet to face up to the problems of Social Security and Medicare. The Social Security and Medicare trust funds are nothing more than accounting entries. In reality, while the unfunded liabilities of these programs far exceed the trust fund “surpluses,” current payroll taxes in excess of paid benefits have been, and will be, spent by the government. The “trust funds” are merely the promise by the government to raise tax revenues in the future to cover future benefits. Political rhetoric is no substitute for fundamental reform.

The current surpluses are driven by a combination of increases in personal tax receipts and reductions in spending. Personal tax receipts have risen from about 7.7 percent of GDP in 1991 to over 10 percent of GDP in 2000—the highest level in recent history. At the same time the tax code has become increasingly complex, with a dizzying array of targeted tax credits, hidden tax increases through limitations on deductions, etc.

Meanwhile, total government expenditures have declined from about 22.0 percent of GDP in 1991 to about 18.5 percent in 2000, with almost 3 of the 3.5 percentage point decline attributable to reductions in defense spending. The sound concepts of broadening the tax base and reducing marginal rates to simplify the tax code clearly should be the objective of tax policy. Spending initiatives should be evaluated in terms of how to allocate resources, and should not be driven by political incentives to spend the bulge in tax receipts.

International Finance and Trade

The new Administration will also face challenges in the international arena. The fiascos of the Asian and Latin American financial crises have called into question the roles of the IMF and World Bank. The critics have called for fundamental reforms of both institutions. U.S. leadership will be required to implement these reforms. Some of the central elements of the reform proposals include:

- limiting the scope of IMF activities to emergency short-term lending and the cessation of long-term lending to poor countries—in effect deferring anti-poverty programs to the World Bank;
- requiring the IMF to charge penalty (above-market) interest rates for loans, rather than below-market rates, in order to discourage use of loans as aid;
- and, to be eligible for IMF loans, requiring countries to ensure adequate capitalization of domestic banks, to allow foreign banks entry into their financial systems, and to guarantee timely and accurate financial information;
- requiring the World Bank to cease lending to richer developing countries that have access to capital markets and thus to focus its efforts on very poor nations;

- instructing the World Bank to provide grants rather than loans for poverty relief—offering subsidized loans to support institutional reforms only.

The World Bank appears to have rejected the proposed reforms while the IMF seems to have accepted some elements of the reform proposals and rejected others. The new Administration should press hard for all of these basic reforms. In their absence the world is likely to experience crises that it could otherwise avoid.

The large current trade deficit may result in political pressure from some quarters to raise trade barriers or manipulate the exchange rate to reduce imports. Policy makers should resist this pressure. Both the trade and current account deficits reflect and contribute to the strong economic performance in the U.S. The trade deficit is associated with capital inflows that have helped fuel the U.S. expansion. Since 1990, imports of capital goods and industrial materials have constituted over 70 percent of total import growth. As U.S. economic growth moderates, the trade deficit should stabilize.

The U.S. should not be lured into debate or action over the value of the Euro. The decline of the Euro relative to the dollar is a symptom of U.S. economic strength and weakness of the European economies. The European governments have been unable to reduce the scope of the social welfare state, to lower taxes and social spending, and to reduce burdensome regulation in product and labor markets. The U.S. should not participate in intervention to defend the Euro or any other currency.