

SHADOW OPEN MARKET COMMITTEE*
Policy Statement
November 10, 2003

Economic Overview

The economy is well into a healthy recovery. Economic growth has averaged 3.2 percent during the last four quarters and over 5.0 percent in the last two quarters. Employment has grown for three consecutive months and the unemployment rate has begun to decline. We said in our last Policy Statement in May 2003 that the “economy is fundamentally sound and as external factors that have inhibited growth gradually dissipate, growth will accelerate.” In the last two quarters, consumption and business investment have rebounded sharply. We project healthy economic and employment growth in coming quarters.

It’s Time for a New Approach to Monetary Policy

The Shadow Open Market Committee (SOMC) has become increasingly concerned that the Federal Reserve’s lack of a clear, publicly announced objective is causing increasing volatility and uncertainty in the real economy. This uncertainty is reflected in the various newspaper stories and the debate inside the Fed about how the FOMC should communicate to the public. The FOMC’s own recent policy statements that have alluded to a commitment to a low funds rate for a “considerable period” have led to confusion regarding what the new language means or doesn’t mean. We believe that part of the problem is the lack of a clear, publicly understood objective function. With inflation low, the Fed now seems to lack a focus. While Federal Reserve officials may have a clear idea of what they intend, the unwillingness to be precise and committed to a clear objective causes volatility and confusion in the marketplace.

* 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.

We believe the Federal Reserve could improve and simplify its communication and improve 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.
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.

Consistent with these recommendations, the SOMC continues its practice of reporting on a collection of monetary policy indicators which are available on our website. These indicators include two policy rules – one proposed by John Taylor that shows how to set the federal funds rate, and another proposed by Bennett McCallum that shows the appropriate growth rate for the monetary base. These rules incorporate an explicit inflation target but also permit the authorities to respond to fluctuations in real economic activity.

We believe that the McCallum Rule provides a flexible framework and reasonable operational guidelines for achieving this long-term objective of 1 percent inflation. Our analysis finds that under current conditions the monetary base should grow approximately 5 percent per

year. We note that through the end of September, the year-over-year growth is 5.7 percent, but this reflects substantial slowing in recent months. The Fed should monitor this trend to ensure that monetary growth remains consistent with its objective.

Fears of Deflation

We continue to hear repeated references to the undesirable risks of deflation. Deflation is often characterized as “destabilizing,” “debilitating,” or “dangerous.” Despite these assertions, neither economic theory nor the historical record provides much reason to believe such fears are justified. Most of the concerns stem from the experience of the U.S. and a few other countries during the Great Depression (more precisely 1929-1933). Yet there are other episodes of sustained deflation in the U.S. and other countries associated with healthy real growth. Examples vary greatly, including the U.S. in the late 19th century, the U.S. and other countries in the 1920s, China since 1998 and Hong Kong since 1999. In fact, such episodes of sustained real growth far outnumber the periods of deflation combined with a declining economy. The current experience of Japan does not refute this argument, as its growth, while low, has remained positive. The experience of 1929-1933 is the exception rather than the rule, being virtually the only period in which deflation was accompanied by declining output. In addition, economic theory suggests that optimal monetary policy should target modest deflation and near zero nominal interest rates.

Some of the fear of deflation stems from the concern that substantial deflation may cause nominal interest rates to fall to zero, thus inhibiting the Federal Reserve from responding to a negative shock to the economy. While a reasonable concern, we concur with the Federal Reserve that even with nominal interest rates at zero, it has sufficient ability to reflate.

Current concerns about deflation are overblown. Nominal GDP has grown 5 percent in the last year, and the dollar has declined. Neither of these measures nor traditional inflation measures suggests deflation.

Employment

Employment has begun to rise but remains well below the recession trough. The weak labor market in 2002-2003 is largely attributable to the soft and uneven rebound in real GDP growth. Historically, employment variation can be explained primarily by cyclical movements. Recently, business uncertainty about the sustainability of product demand has contributed to inventory liquidation and limited hiring. Employment is expected continue to rise with further growth in consumer spending and product demand.

Current Account Deficits and Trade Barriers

The U.S. trade deficit —the amount by which our imports of goods exceed our exports — has been growing. It is now about 4 percent of GDP. The current account deficit largely reflects the trade deficit. Foreigners have used the proceeds of their exports to the U.S. to acquire investments here. Our claims on other countries have been declining and since the late 1980s, our net investment position abroad has been negative.

Should foreigners lose confidence in dollar assets and curtail their exports to the U.S. the trade deficit and the current account deficit would shrink. Until this year, they have been willing to sell their goods to the U.S. and take dollars as payment. They have not been willing to use their dollars to buy U.S. goods.

The U.S. has a large bilateral trade deficit with China, but China has only a small trade surplus, reflecting its trade deficit with numerous other nations. The U.S. Congress is now debating various protectionist bills. All such proposals are wrong-headed and must be rejected.

International trade and capital flows enhance economic growth and standards of living in the U.S. and around the world. Barriers to these flows must be avoided. The Bush Administration must support free trade through specific actions including the repeal of the steel import tariffs.

Privatization in Iraq

For the Bush administration to establish a basis for a prosperous and democratic Iraq it must demolish Soviet style government ministries and state-owned enterprises and reestablish a strong private property rights system. No matter how well the Iraqi constitution is written or how many troops are in place to secure the country, prosperity will elude the Iraqi people if they do not have clear title to their property, including oil. To wait for a future Iraqi government or the UN to do the job is to invite conflict between entrenched interests, between regions and between ethnic groups, over then main prize, oil. Assigning oil rights to every Iraqi citizen now will avoid an enormous source of future destabilization.

Freddie Mac and Fannie Mae – What to Do

There are two basic problems with the institutional set-up of Fannie Mae and Freddie Mac. First, the market perceives that the liabilities issued by Fannie Mae and Freddie Mac are privileged securities that have an implicit government backing. The second problem is that they no longer just facilitate the mortgage market, but rather have added onto their balance sheet increasing levels of interest rate and credit risk. This is a volatile mix. A number of remedies have been proposed. The most likely proposal to take hold is to shift responsibility for supervision of the two firms to the Treasury Department. Merely shifting their supervision to the Treasury, however, does not resolve the issues, particularly if the Treasury is unable to raise these GSEs' capital requirements. Moreover, Fannie Mae and Freddie Mac and their officers are very generous contributors to political campaigns and non-political, though influential, non-

profit organizations. This is a conflict of interest – one that our recent experiences with corporate governance would suggest that we avoid. Rather, these two financial firms should be privatized and regulated similar to other competing financial institutions.