SHADOW OPEN MARKET COMMITTEE[1]
Policy Statement
November 15, 2004

U.S. economic performance remains healthy. Real GDP has grown nearly 4% during the last four quarters, and employment growth has picked up after a "soft patch" during the summer. Inflation remains low after a brief rise in the spring. The economic environment provides a strong base for the Bush Administration's second term to focus on important long-run issues that enhance long-term growth. Three broad areas of economic policy should be addressed:

- Monetary Policy
- Fiscal Policy and Entitlements
- International Economic Policy

In each of the areas the administration faces important challenges and opportunities to improve economic policy.

Monetary Policy

We applaud the Federal Reserve's success in maintaining stable, low inflation and in its initial steps in removing monetary accommodation. We encourage the Fed to continue to raise the federal funds rate. While the monetary aggregates are growing at a pace consistent with low inflation, we are concerned that the current level of the funds rate could lead to more rapid growth of money and inflation.

We compliment Chairman Greenspan's leadership in reducing inflation and making the Federal Reserve more transparent. We also appreciate the Fed's articulation of the benefits of low inflation. The SOMC encourages the Fed to institutionalize the process of maintaining low and stable inflation. To achieve this we recommend that the Federal Reserve:

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[1] 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.

- Adopt a clear public statement that its primary objective is to control inflation.
- Announce a specific target for inflation. The objective should be price stability, which implies zero inflation. Given the errors in various measures of inflation, we recommend that the Federal Reserve announce a goal of 1 percent inflation in the headline CPI measured year-over-year. The CPI is the most widely recognized and used measure of inflation and thus a reasonable metric to choose.
- Announce a policy process and guidelines consistent with this objective.

We believe that these principles, which we have previously recommended, provide sufficient flexibility to the Federal Reserve in its conduct of monetary policy and would clarify its communications with the public. Having an explicit inflation target in no way requires that the Fed be concerned only with inflation. In practice, the Bank of England, the Reserve Bank of New Zealand and other leading inflation- targeting central banks clearly show concern for output and employment in their decision-making process.

In this context, it is useful to note that this year's Nobel Prize in economics was awarded to Finn Kydland and Edward Prescott for policy-relevant work in dynamic macroeconomics. Their work has important implications for monetary policy. In particular, the basic implication is that monetary institutions should be designed to encourage a rule-like, process-oriented type of behavior—normally by having an independent central bank with a clear monetary rule. This result is now widely accepted among monetary economists inside and outside central banks.

Fiscal Policy and Entitlements

There is much discussion of the President spending political capital to achieve his second-terms goals. We encourage the President to use this opportunity to curb the growth in government spending and to reform mandatory entitlement programs. The focus on deficits or

"imbalances" misses the point of the large liabilities being created by government entitlement programs. Efforts to reduce the imbalance without addressing the magnitude of the benefit commitments will require rising taxes that will reduce standards of living. Policies designed to promote long-term growth are more desirable than tax increases that will inevitably reduce growth.

Built-in spending growth in Social Security and Medicare and other so-called "mandatory" programs are the largest source of growth in government spending. Growth in these programs generates an allocation of national resources that distorts economic decisions. Future benefits for the aging population under current law are unsustainable. Moreover, growth in these programs is leading to an ever-expanding demand for resources by government. This increased demand by government is worrisome regardless of how it is financed. Ultimately, working Americans will be required to pay for these commitments and the tax increases needed to close long-run unfunded liabilities would reduce economic growth and living standards. Programmatic changes must replace political rhetoric about fiscal responsibility.

Social Security should be partially converted into a system of tax-free individual retirement accounts while preserving the benefits of those near retirement under existing law. The age of retirement should be raised. Both changes, enacted immediately, should be implemented gradually over at least a generation. These changes would reduce the government's long-run budget imbalance, raise the nation's capital stock, and provide workers with retirement savings they fully control. The long-run benefits of these changes would far exceed any transitional costs of higher cash-flow budget deficits.

Medicare reform ultimately must be based on reducing the government's third-party payments, and beneficiaries must bear increased out-of-pocket costs at point of provision of

medical services in order to eliminate the over-use of medical care due to subsidies in the current system. Adjusting health care financing through expansion of tax-deferred Health Savings Accounts and emphasizing catastrophic health insurance are important foundations for reform.

Pro-growth tax reform should be designed to reduce the tax burdens on savings and investment. In addition, reform should eliminate existing inefficiencies and complexities in the tax code, including politically-motivated loopholes.

International Economic Policy

The second term of the Bush administration should take a stronger stand in support of free trade. The administration should refrain from adopting protectionist policies to appease special interest groups. The decision to impose steel tariffs, the temporary tariffs on Chinese textiles and the expanded farm subsidies were ill-advised. There is already pressure from textile manufacturers and unions for new quotas on China starting January 2005, when the 20-year Multifiber Agreement expires. Protectionist measures and government subsidies will not save industries that are unable to compete with lower-cost providers.

Over four years ago a Congressional advisory commission, headed by Allan Meltzer, presented to Congress a list of recommendations for major reform of both the IMF and the World Bank. Too little reform has occurred. IMF lending is redundant in a world where capital markets are broad and deep. It is poorly done and creates moral hazard. The IMF does not have the ability to be a lender of last resort since it cannot create money. Lending by the World Bank continues to be ineffective, costly and also increases moral hazard. Going forward the Congress and the President have several policy options. They can accept the status quo and the attendant cost to the U.S. taxpayer estimated to be $1.5 – 2.0 billion annually. They can renew their efforts for reform. Or they can withdraw U.S. support, effectively abolishing the institutions.

One option that has not been considered but deserves a serious look is privatization. There are advantages to privatization, not the least of which is that it may be politically achievable.

Oil Prices and the Economy

The statistical evidence in the U.S. of a temporary though persistent impact of a 60% rise in oil prices is as follows: a short-term 1 percent annualized decline in real economic activity and a temporary 0.5 percentage point annualized rise in inflation. Also the federal funds rate declines temporarily between 25 and 50 basis points.

While these estimated impacts are modest, it is likely that for the recent increase in oil prices, the actual effects on economic activity and prices will be smaller. The primary reason for the muted impact is that a large part of the current rise in oil prices likely stems from an increase in the world demand for oil, rather than from a sharp decline in availability. While a decline in availability would pose difficulties for the U.S. economy, the rise in world demand is likely to be associated with buoyant U.S. economic activity. Furthermore, a permanent increase in the demand for oil should encourage additional exploration as well as the adoption of energy alternatives and energy conservation, neither of which are negative developments for the U.S. economy.