

SHADOW OPEN MARKET COMMITTEE¹

Policy Statement December 5, 2005

We applaud Alan Greenspan for his 18 years as chairman of the Federal Reserve Board, leading its successful disinflationary monetary and its more orderly conduct of policy and transparency. Ben Bernanke is an outstanding monetary scholar who has long advocated the pursuit of low inflation and will be an excellent replacement. His experience as a member of the Board of Governors showed him to be a thoughtful and clear communicator with the correct objective of zero inflation, and he garnered tremendous respect within the Federal Reserve and the global financial community. We congratulate him and wish him well.

The fundamentals for sustained economic growth in the U.S. remain sound despite the effects of hurricane Katrina and a spike in oil prices. The resiliency of the economy continues to confound the skeptics. The Fed's inflation-fighting credibility has been a key reason why the economy continued to expand rapidly in the face of the sharp rise in energy prices. Consumption and business investment continue to grow solidly.

A New Era for Monetary Policy and Some Advice for the New Chairman

Bernanke has publicly stated his preference for an inflation-targeting type regime. We share that view and hope that he will take the appropriate steps to move the Federal Reserve in that direction. In doing so, he will face a number of tasks.

There is no legal barrier keeping the Fed from adopting an explicit inflation target. Yet Bernanke cannot impose it on the FOMC. He must develop a consensus within the Fed. Some observers assert that inflation-targeting is inconsistent with the Fed's "dual mandate," required by the Full Employment Act of 1979, stipulating that monetary policy generate both low

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.

inflation and high employment. But Greenspan and Bernanke have expressed the view that keeping inflation low and stable is the best way to promote economic growth and employment thus satisfying both objectives. Inflation targeting would not create an inconsistency.

Bernanke has also been a big proponent of transparency. We encourage him to continue the progress towards a more open and transparent Fed. Transparency is important for achieving and sustaining a credible monetary policy, and it enhances economic performance. It makes policy more predictable, which reduces the inflation risk premium and the real cost of capital. A more open and transparent Fed reduces mistakes by financial markets, households and businesses. An inflation target would facilitate transparency.

There are other important issues that the new chairman should address. On regulatory policy, the Fed must avoid creating moral hazard through “too big to fail” policies for financial institutions. The Fed should continue to pursue reform of the government sponsored enterprises such as Fannie Mae and Freddie Mac. The Fed recently decided to stop publishing the M3 measure of money supply; this was a mistake. While Fed policy continues to focus on the federal funds rate as its instrument of monetary policy, we warn that ignoring the behavior of the monetary aggregates has led to damaging policy errors in the past. Inflation remains a monetary phenomenon and the aggregates continue to be a useful input into policy.

Current Monetary Policy

The Fed must continue its focus on inflation and anchor inflationary expectations. The current year-over-year growth in the monetary base is consistent with future inflation of one percent. However, inflation has been 4.9 percent, and even excluding food and energy prices, it has been 2.0 percent. These conditions require a more aggressive stance to ensure that inflation

and inflationary expectations do not take root. Thus, we encourage the Fed to keep monetary base growth near 4 percent which is likely to require further increases in the federal funds rate.

Tax Reform

The U.S. tax code is desperately in need of reform. The President's Advisory Panel on Tax Reform tackled this very difficult task with the goal of emphasizing "simplicity, fairness and remov[ing] the impediments to growth." The output of the panel was both impressive and disappointing. It was not the bold plan that some hoped for. Yet the proposals provided meaningful steps toward eliminating preferences that are major sources of economic distortions, including lowering marginal rates on personal income and either maintaining or reducing tax rates on dividends and capital gains. The major way the Panel raised revenue was through a broadening of the tax base and the elimination of various tax preference items. The two most significant of these was a limitation on the home mortgage interest deduction and the elimination of the deductibility of state and local income taxes.

The proposals provided specific guidelines for legislation and were quite detailed. Unfortunately, the panel's proposals are likely to fall on deaf ears in the Congress. There is very little appetite for any kind of reform, whether in taxes, Social Security or Medicare.

Trade Negotiations

Next week trade ministers from 148 countries are scheduled to meet in Hong Kong in the hopes of negotiating a new global trade agreement. There are so many resolved issues that officials are playing down the prospects for any progress. The major stumbling block remains agriculture. The U.S. offered to cut tariffs and subsidies but the European Union has not reciprocated. France has been particularly obstructionist. The developing countries, have refused

to reduce their trade barriers on more advanced industrial goods unless the developed world opens their agricultural markets.

This stalemate at the Doha round of trade negotiations demonstrates that insistence on reciprocity for reducing trade restrictions has become a major barrier to free trade. To get past this barrier the U.S. should unilaterally implement its recent proposals to lower subsidies and tariffs. This would not only benefit developing countries but the American consumer as well.

Oil and Monetary Policy

The monetary policy response by the FOMC to a large, positive change in the price of oil has historically been varied. In the 1970's, these oil price "shocks" occurred in an environment where the U.S. economy was substantially less flexible, and the baseline level of inflation in the economy was much higher. The FOMC's anemic response to the temporary acceleration of inflation stemming from these oil price shocks further damaged the economy in that they further fed a ratcheting up of inflation expectations. The consequences were disastrous. Subsequently, the increased flexibility of the U.S. economy and the collective understanding by U.S. policymakers about the long term benefits of low inflation have brought forth two fundamental policy lessons: first, oil price shocks, even large ones, have only a limited, temporary impact on real economic activity. As such, the FOMC should avoid responding to any perceived output shortfalls associated with them. Second, positive oil price shocks can lead to upward pressure in the overall price level, and hence can temporarily lead to a rise in the rate of inflation. The only insurance against stopping this rise in inflation from becoming permanent is for a monetary policy tightening to extinguish the temporary rise in inflation and inflation expectations

Exchange Rates

Few economic events of recent years have attracted as much attention as the announcement last July that henceforth the exchange rate of the Chinese renminbi would no longer be kept fixed in relation to the U.S. dollar, but would be managed relative to a basket of currencies and adjusted more frequently via a “managed float” arrangement. Some commentators have suggested that the new system would be somewhat like that for the Singapore dollar, which is a managed float relative to a basket of currencies with a band target. Actually, however, the Singapore system features frequent adjustments in the target band designed to be appropriate in relation to an overriding target for inflation, basically as in an inflation targeting regime. The Singapore dollar appreciation rate is adjusted much as the Fed adjusts the federal funds rate, which is appropriate for Singapore because of that small economy’s extreme openness to foreign trade. This reasoning does not apply to China, however, and all indications are that it will not be mimicking the Singapore system in any significant sense.

With respect to China’s exchange rate, it is important to distinguish between two different positions taken by segments of the U.S. government. Some members of Congress have been concerned about its effects on the China-U.S. trade balance, whereas the U.S. Treasury has focused instead upon the need for China, for its own economic health, to have a monetary policy that is directed toward Chinese macroeconomic conditions (especially inflation). The latter suggests that an exchange-rate float would be appropriate for China, a position that is economically quite sensible. Suggestions to oppose the delinking of the Chinese currency from the U.S. dollar, by contrast, are economically indefensible. Bilateral trade balances are entirely inappropriate objects for policy concern and totally inconsistent with the doctrine of free trade, which the United States should strongly support.