Publication: **Investor's Business Daily**; Date:2006 Jul 26; Section: Issues & Insights; Page Number: A1

VIEWPOINT

Targeting Prices, Fed May Hit Economy

MIKE COSGROVE

Federal Reserve housecleaning is moving the FOMC toward inflation targeting, with Chairman Ben Bernanke, Philadelphia Fed President Charles Plosser, Gov. Randall Kroszner and Gov.-nominee Frederic Mishkin leading the charge. There are substantial pluses to inflation targeting. But one nagging concern of such targeting is the creation and bursting of bubbles and central bank response.

Household net worth climbed to nearly $54 trillion in the recent reporting period from about $25 trillion in 1994 — a remarkable achievement by the U.S. economy.
The conventional savings rate may be approximately zero, but households, on average, saw their assets leap ahead of their liabilities and accumulated wealth. A fundamentally solid economy consisting of a growth-favorable tax code, an able monetary system and sound property rights within a mostly open global economy provides the opportunity for wealth creation. And the U.S. economy delivered.

But paper gains and losses in household balance sheet items such as the market value of homeowners' equity and of corporate equities do create a queasy feeling. Combined, those two items increased by nearly $12 trillion from 1994 through 1999, which accounted for about 40% of the net worth increase. During the following bear market, the wealth loss in household corporate equities was $7 trillion.

Fortunately for the economy, the Federal Reserve lowered short-term interest rates to near zero, pumping up the real estate sector. The market value of homeowners' equity increased by $5.5 trillion post-1999, creating a positive wealth effect to offset the negative wealth effect of the loss in corporate equities. Implementation of a pro-growth tax code early this decade in combination with low interest rates let the U.S. economy recover and grow in the face of adverse shocks.

The market value of corporate equities on the household balance sheet — directly owned and indirectly owned such as in mutual funds and private pension funds — is within nearly $2 trillion of its 1999 peak. Meanwhile, other line items on the balance sheet have more than taken up the slack, so net worth is $10 trillion above its 1999 peak.

In hindsight, the Federal Reserve took the right action to offset that $7 trillion loss in corporate equities by lowering short-term interest rates to 1% in June 2003 from 6.5% in early January 2001. So the post-2000 central bank actions aren't of concern — their pre-1999 decisions are. The huge bubble in paper gains — $12 trillion in the 1994-99 period — is the issue. Fed officials, in their public comments, say they can't target bubbles with monetary policy since they aren't omniscient and won't know until later whether any particular bubble is a cyclical event or may turn out to be a secular trend.

Fed officials may be correct, but inflation targeting, by definition, places price level stability as the primary objective. The core PCE deflator, the Fed's preferred measure of inflation, averaged 2.1% from January 1994 to December 1999. The two monthly end points were 2.1% at the beginning and 1.5% at the end. This was during the time of the $12 trillion bubble enlargement. It goes without saying that monetary policy that is focused on inflation targeting would not be concerned about the magnitude of the bubble.

But the rub with inflation targeting seems to be on the downside. The corporate equity crash was over by late 2002, but that probably wasn't widely accepted until mid-2003 or later. The core PCE deflator averaged 1.8% from the beginning of 2000 to mid-2003 — not a concern from an inflation-targeting viewpoint while more than $7 trillion in market value was erased from the household balance sheet.

Under inflation targeting, the central bank would have likely stood on the sidelines watching the market bust since its inflation target was met. Had the Fed not lowered interest rates, could the U.S. have turned into another Japan? Perhaps the pro-growth tax policy implemented early this decade may have prevented that. But without major reduction in interest rates, the U.S. economy could have been close to following in Japan's footsteps.

The world's largest economy can't be locked in on some inflexible inflation target range that 12 people have a monopoly on. At minimum, an explicit inflation target range has to incorporate wide latitude for central bankers to respond proactively to adverse shocks to the economy and capital markets. The idea that central banks, which have adopted inflation targeting guidelines, have withstood adverse shocks only means that those banks have not experienced the shock that sends central bankers back to the drawing board.

Cosgrove

is principal at Econoclast, a Dallas-based capital markets firm, and a professor at the University of Dallas.