Credible Commitment

BY DOUG CAMPBELL

"Making the Systematic Part of Monetary Policy Transparent." Robert L. Hetzel, Federal Reserve Bank of Richmond *Economic Quarterly*, Summer 2006, vol. 92, no. 3, pp. 255-290.

It was only 12 years ago when the Federal Open Market Committee first began announcing whether it had changed the federal funds rate target. More recently, the committee started inserting thoughts into its post-meeting statements about the likely near-term behavior of rates.

In "Making the Systematic Part of Monetary Policy Transparent," Robert Hetzel, a Richmond Fed economist and senior policy adviser, makes his case for the next logical step in the Fed's communication evolution — an explicit policy rule.

To Hetzel, the "go-stop" monetary policy of the pre-Paul Volcker era was a failure because the attempted discretionary manipulation of real variables destroyed the expectation of price stability. In contrast, the Volcker-Greenspan era correctly turned its attention to managing inflation expectations. "By allowing the price system to work rather than superseding it, the FOMC produced more, not less, economic stability," Hetzel writes.

But there remains room for improvement. The Fed's ability to signal the future behavior of the funds rate in its post-FOMC statements, Hetzel says, is limited "by the difficulty of forecasting economic activity." One way to overcome this limitation is by adopting a transparent policy rule, which would allow markets to understand how the FOMC responds to new information. The Fed would respond to strength and weakness in the economy in a way that stabilized expected inflation at the chosen target for inflation.

"At any individual meeting, the FOMC need not respond in a quantitatively strong way to the emergence of a gap between actual and targeted inflation," Hetzel writes. What's important "is that financial markets believe that the FOMC will raise the funds rate in a persistent way as long as a positive miss of the inflation gap exists, and conversely for a negative gap."

By clearly communicating its objectives and its means of achieving them, the Fed will, by extension, enhance price stability. When firms see the Fed focusing on making sure that future prices will be contained, they won't overreact in the short term with immediate hikes in their own prices. Hetzel says: "With a credible inflation-targeting rule, real shocks can introduce fluctuations in the price level but not in trend inflation."

"Urban Density and the Rate of Invention." Gerald Carlino, Satyajit Chatterjee, and Robert Hunt, Federal Reserve Bank of Philadelphia Working Paper No. 06-14, August 2006.

Urban living has its drawbacks — traffic congestion, high rents, and long waits for a restaurant table, to name a few. But cities have their advantages, too, for both their residents and the economy. For instance, they make knowledge spillover possible. That is, people working in close proximity to each other create knowledge that extends beyond their firms to the entire community.

In a recently updated paper, economists at the Philadelphia Fed examine the effects of employment density on the invention rate. They find a strong relationship between patent intensity — the average rate of patenting per capita in a given metro area — and employment density. "All else equal, patent intensity is about 20 percent higher in a metropolitan area with employment density that is twice that of another metropolitan area," the authors conclude. Next up, the authors are investigating the contribution that a city's characteristics make to a firm's productivity and research efforts.

"The Looming Challenge of the Alternative Minimum Tax." Alan D. Viard, Federal Reserve Bank of Dallas *Economic Letter*, August 2006, vol. 1, no. 8.

The Alternative Minimum Tax (AMT) was first adopted in 1969 with the intent of keeping wealthy people from avoiding the payment of income taxes. The AMT has lower tax rates than the regular income tax, but it doesn't allow as many deductions and credits, so taxable incomes are higher. It kicks in when it generates a higher tax bill than the regular income tax. Historically, it has affected mostly richer households. But come 2007, the AMT may have the unintended consequence of raising tax liability for 22 million Americans, most of them squarely in the middle class.

In a new article, Dallas Fed economist Alan Viard explains how inflation coupled with recent tax cuts have expanded the reach of the AMT. To prevent too many constituents from having to pay the (usually higher than the regular tax system) AMT, lawmakers have repeatedly extended relief for short periods, even as they have failed to adopt long-term reforms. Viard discusses several remedies, including indexing the AMT to inflation or doing away with it altogether.

But in the end, Viard acknowledges that these solutions may be too politically painful for adoption because they entail revenue losses. "Surely, though, the time has come to fix a tax system that everyone agrees is broken," he concludes. **RF**