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COMMENTARY

We've Cut Rates, Now Let's Cut Taxes

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The Federal Reserve has been cutting the discount rate in fits and starts since late 2000 and yet the economy and the stock market continue to languish. Now in one grand flare of dramatic excess the Fed has cut the discount rate and the federal funds target rate by an amazing 50 basis points. The discount rate is at an unbelievable low of 0.75%.

Unfortunately all of the hyperactivity surrounding these moves really doesn't amount to much. The Fed at present doesn't have the power to propel this economy. It's power rests in it's ability to create a favorable environment conducive to growth, not to provide the actual growth stimulus itself. For growth stimulus we need to turn to other macro-economic policies. But first, let's take a quick look at the Fed's recent actions.

The Fed is not a participant in the federal funds market -- neither a borrower nor a lender -- and therefore can only jawbone rates. I, for the life of me, can't figure out why anyone makes such a big to-do about the Fed's setting of the federal funds target rate. It's a nothing gesture.

In addition, the Fed's actions on the discount rate make little difference. As of Oct. 30 total borrowings from the Fed by member banks was $101 million as compared to total reserves of $71 billion and a total monetary base of more than $ 690 billion. If this isn't de minimis, I don't know what is. With all the other news items available to the press, it just doesn't make any sense why people would get all hot and bothered over the Fed's latest pronouncements.

And, as if this isn't enough, the 91-day T-bill rate has been falling since mid-March of this year while the discount rate hasn't changed at all. Given market trends and the need for the Fed to keep rates roughly in line, it's about time they cut rates. The Fed is a market follower not a market leader. If there is any boldness about the Fed's action it could perhaps be attributed to the 50 basis points. Whoop-de-do!

Risk free short rates are obviously very low because of all the uncertainty here and abroad. People are first and foremost wary of the stock market. Since it's high in early 2000 the stock market is way, way, way down. This has been one of the longest and deepest stock market declines in ages. People are rightfully panicked. Since the third quarter of 2000 real GDP growth has also been virtually non-existent -- another big negative. With all the accounting scandals, the threat of war with Iraq, and domestic terrorist threats is it any wonder that investors are clinging to safety and congregating around risk-free short rates?

Investors all wanting to hold short term government securities have pushed the prices of those securities up and their yields down. As of Friday, the 91-day T-bill yield stood at 1.20% -- the lowest rate in years and years. The last time it was this low was just before my 18th birthday on Aug. 6, 1958, when it stood at 1.15%. The Fed can't solve the accounting scandals nor can it disarm Iraq. But the Fed still has an enormously important role to play by maintaining price stability, which it has carried out flawlessly for many years.

The way the Fed controls inflation is by controlling growth in the monetary base (bank reserves plus currency-in-circulation). When combined with reserve requirements growth in the monetary base determines growth in bank liabilities. And finally, growth in bank liabilities in conjunction with growth in real income yields inflation, interest rates, exchange rates, etc. It's pretty simple but very important. That's the Fed's job and they need to stick to it.

Since Paul Volcker took over as chairman of the Fed in 1978 and throughout Alan Greenspan's tenure as chairman, the Fed has done a wonderful job controlling inflation and reducing inflationary expectations. Looking at the monetary base data the Fed seems to be right on target for doing all it can to provide the proper environment conducive to growth.

Perhaps the greatest stimulus to future economic growth is the pent up growth resulting from the long, long slowdown in the economy over the past two plus years. Since the third quarter of 2000, real GDP has grown at close to a 1% annual rate. Even under bad conditions, this type of slow growth will ultimately transform itself into faster growth unless new bad policies are heaped onto the economy. And new bad policies aren't very likely given the result of the midterm elections.

To eliminate the markets' reticence all that's needed to get a normal recovery going is a clean resolution to the Iraq crisis. And that appears to be close at hand.

But a lot more could be done to accelerate growth and propel this economy back to where it should be. To further stimulate growth on the fiscal policy front the recently emboldened Bush administration would be well advised to accelerate and make permanent its tax cuts. But if the administration decides to go for champagne instead of chianti, a once-and-for-all elimination of the capital gains tax would do for the whole economy what it has done for the housing market.

In 1997 President Clinton signed into law the largest capital gains tax cut in our nation's history. In addition to lowering tax rates on all realized capital gains, the legislation effectively eliminated any tax on capital gains for owner-occupied homes. The first $500,000 of capital gains on the sale of an owner occupied home was legislated to be exempt from taxation and this exemption could be repeated every two years. State tax codes followed suit and owner occupied home prices took off. If the federal government were to enact the same policy for all other assets their values too would follow the lead of owner occupied homes.

Other fiscal measures that would help stimulate the economy would include the deductibility of dividend payments for businesses. Not only would this stimulate growth, but it would also remove the tax incentives for excess corporate debt -- a twofer. The president's highly touted Social Security reform is also a clear winner.

On the trade front, President Bush could polish up his tarnished image resulting from the ill-conceived tariff on steel with a radical extension of Nafta -- hopefully to the whole world. The president wants to do it and now he has the power to do it. What better legacy could he leave the world than global free trade?

On the regulatory side of macro-economic policies, President Bush has been forced into adopting all sorts of anti-growth policies. He had to push for heightened domestic security measures everywhere, a far greater defense budget to secure our nation's safety, and corporate accounting reform. All of these measures, as necessary as they are, are a drag on the economy. As a partial offset, the president, with his new-found majority in Congress, could succeed in major tort reform and the appointment of pro-growth judges. He should go for it.

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