US interest rate rise to fuel economic policy conflicts

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The latest interest rate rise of 0.25 percentage points announced by the Federal Reserve Board on Tuesday is certain to fuel growing disagreements in US financial circles about the direction of economic policy. On one side are those who are concerned that the economy is heading for a financial crisis if present trends continue, while on the other side are those who fear the Fed's policies could trigger such an outcome.

Announcing the decision to lift the federal funds rate to 6 percent—the fifth quarter percentage point rise since June 1999—the Fed said it remained "concerned that increases in demand will continue to exceed the growth in potential supply, which could foster inflationary imbalances that would undermine the economy's record economic expansion."

The claim that interest rates must continue to rise in order to combat inflation has been disputed in a number of circles. Critics have pointed to last month's testimony to the US Senate by Fed chairman Alan Greenspan in which he noted that "inflation has remained largely contained" and that "unit labour costs actually declined" in the second half of 1999.

Opponents of the interest rate increases charge that Greenspan is not so much targeting inflation as the stockmarket. They claim that the Fed's policies are at least in part responsible for the wild gyrations seen in recent weeks and the divergence between interest rate sensitive "old economy" stocks and the technology-based stocks of the so-called "new economy."

Greenspan's warnings of inflationary pressures were set out in his Senate testimony. He claimed that productivity increases were fueling an escalation in share prices, producing a "wealth effect" as consumption spending rose faster than income, leading to increased demand.

While noting that the increase in productivity was "unprecedented in my half-century of observing the American economy", Greenspan claimed that the "beneficial forces" driving the American economy were also "engendering a set of imbalances that, unless contained, threaten our continuing prosperity."

"The problem is that the pickup in productivity," he continued, "tends to create even greater increases in aggregate demand than in potential aggregate supply. This occurs principally because a rise in structural productivity growth has its counterpart in higher expectations for long-term corporate earnings. This, in turn, not only spurs business investment but also increases stock prices and the market value of assets held by households, creating additional purchasing power for which no additional goods or services have yet been produced."

According to calculations by the Fed, three to four cents of every additional dollar of stock market wealth is reflected in increased consumer demand and that outlays prompted by this "wealth effect" have added about 1 percentage point to domestic spending over the past five years.

But Greenspan's theory that productivity increases are responsible for inflationary pressures has come under fire from several quarters. The *New York Times* recently published an editorial critical of his remarks to the Senate and an article on Tuesday was even more scathing.

"In Congressional testimony and speeches," it declared, "Mr Greenspan has left economists and investors scratching their heads by seeming to assert that the increase in the growth rate of productivity—almost universally considered to be the most unambiguously positive development in the nation's recent economic history—is now to be blamed for causing inflation."

Citing Greenspan's remarks to the Senate that the changes in the economy "may be unprecedented in our history" and that "a number of the old tools we have relied upon" do not have relevance to "how the new economy is working", it concluded: "Translation: Even Mr Greenspan is not sure that traditional monetary policy can be counted on to work as it has in the past, disconcerting, perhaps, to those who assume the Fed chairman has it all under control."

Other critics fear that rising interest rates will bring about an economic crash. An article published on March 22 in the *Australian Financial Review* by New York-based MSNBC columnist Deroy Murdock warned that Greenspan's actions could explode the US economy. Criticising his theory that increased productivity could be responsible for demand inflation, Murdock claimed Greenspan's statements "depart more dramatically from reality as he succumbs to irrational despair." He called for "distinguished free market economists" to "conduct an intervention with Greenspan to remind him of the way the world works... The alternative is to watch Greenspan make the US—and global—economy go ka-boom."

The economics editor of *Business Week,* Michael Mandel, has also weighed in against Greenspan. Citing remarks made in 1936 by the famous British economist John Maynard Keynes that lifting interest rates to curb problems arising from heavy investment “belongs to the species of remedy which cures the disease by killing the patient”, Mandel concluded that this was “exactly the situation facing the US today” and that Greenspan's main tool—higher interest rates—was “pointed in the wrong direction.”

Mandel went on to recall the collapse of the Japanese bubble in the early 1990s when the lifting of interest rates by the central bank to curb rising asset prices “pushed rates high enough to wipe out the banking system and squash the real economy as well.”

While Greenspan's critics maintain that the stockmarket should be allowed to roar ahead, lest a sudden fall crashes the whole economy, the present situation is becoming increasingly untenable.

As Greenspan noted in his Senate testimony, the increase in demand generated by the rising stockmarket had been met by increased imports. However, he continued, “growing net imports and a widening current account deficit require ever larger portfolio and direct foreign investments in the United States, an outcome that cannot continue without limit”.

The latest figures on the trade and debt position of the US make clear that Greenspan's public comments are in fact an understatement of the financial crisis now in the making.

Figures released last week show that the US current account deficit reached an all-time record of $339 billion last year, a more than 50 percent increase over 1998. The deficit measures the US trade balance in goods and services as well as net income transfers.

The rise in the payments gap was due in the main to a surge in the merchandise (goods) deficit, which increased to $347 billion, an increase of more than $100 billion during 1998. At the same time, the surplus on services fell from $82.7 billion in 1998 to $79.6 billion last year.

Other statistics point in the same direction. The deficit on net income from abroad more than doubled from $12.2 billion in 1998 to $24.8 billion last year. According to an analysis by economist Robert Blecker of the Economic Policy Institute: “The worsening performance on income is mainly a result of rising interest payments on the growing US foreign debt. These interest payments increased from a net outflow of $66.4 billion in 1998 to $77.6 billion in 1999.”

While official data are not yet available, the EPI estimate is that the US net foreign debt position “worsened dramatically in 1999”, rising from $1.2 trillion to $1.6 trillion.

“According to EPI estimates,” Blecker noted, “the US net international debt will reach $1.9 trillion by the end of 2000 and $3.8 trillion by the end of 2005, resulting in annual net interest rate outflows of about $86 billion this year and $166 billion by 2005, if present trends continue. These rising debts and interest outflows portend possible problems for the US economy in the form of a future dollar crisis or economic recession if foreign investors decide that it is too risky to keep lending the United States the amounts needed to finance its present levels of current account deficits.”

In a recent paper on the US trade and balance of payments situation, entitled *Seven Unsustainable Processes,* the economist Wynne Godley of the Jerome Levy Economics Institute noted that foreign debt was now nearly 20 percent of GDP.

“If the balance of trade does not improve, there is a danger that over a period of time the United States will find itself in a ‘debt trap', with an accelerating deterioration in both its net foreign asset position and in its overall current balance of payments (as net income paid abroad starts to explode). Such a trap would call imperatively for corrective action if it is not at some stage to unravel chaotically.”

The relationship between the balance of payments gap and economic growth was the subject of a recent analysis by the London-based organisation Lombard Street Research. It found that in order to cut the current account deficit from the present level of 4 percent of GDP to 2 percent, domestic demand growth would have to fall to 0.5 percent per year, compared to its present rate of 5.5 percent, and “that would mean hitting a brick wall”.

A measure of the present situation can be obtained if one views the US economy in the context of recent economic history. In the aftermath of the Asian financial crisis, the emerging “conventional wisdom” was that the profile for a financial crisis was excessive stockmarket speculation, a balance of payments deficit and an increasing dependence on foreign capital inflow. It is a profile which increasingly matches that of the US.