Surprise cut in US interest rates highlights alarm over sinking economy

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The US Federal Reserve Board's surprise .5 percent cut in interest rates January 3 sparked a heady one-day rally on Wall Street. The technology-laden Nasdaq composite index rose a record 14.2 percent, the Dow Jones industrial average gained 2.8 percent and the Standard & Poor's 500-stock index rose by 5 percent.

More significant, however, was what the Fed's action revealed about the alarm within top financial circles over the plunge of the American economy into recession. Coming in the midst of falling share values and a raft of dire economic reports, the move by Federal Reserve Board Chairman Alan Greenspan had the character of an attempt to stave off a meltdown on the stock exchange and a financial crisis of indeterminate proportions.

Greenspan's initiative was highly unusual on two counts. It came nearly a month before the next scheduled meeting of the Fed's rate-setting body, and barely two weeks after the last such meeting, when the nation's top bank officials decided against a reduction in interest rates. Moreover, the cut of 50 basis points in the key federal funds target rate—the interest charged for overnight loans between banks—was a departure from Greenspan's long-standing policy of limiting rate changes to 25 points (.25 percent) at any one time.

Greenspan preceded the early afternoon announcement of the emergency rate cut with a hurriedly organized conference call with members of the Fed's rate-setting body, the Federal Open Market Committee. The statement issued by the Federal Reserve was clearly intended to impact that day's trading on stock and bond markets, and avert a round of panic selling.

In its statement, the Fed also announced it had approved a .25 percent cut in the discount rate, the interest which the Fed charges for loans to member banks, and indicated it would cut an additional .25 percent in that rate, a move which it carried out on Thursday. Making clear its readiness to make further interest rate cuts, the Fed declared its actions "were taken in light of further weakening of sales and production, and in the context of lower consumer confidence, tight conditions in some segments of financial markets and high energy prices sapping household and business purchasing power."

Reacting to the Fed's actions, Alan Blinder, a Princeton University economist who served as Greenspan's vice chairman from mid-1994 through early 1996, said, "This says to me that Alan Greenspan is considerably—and not just a little, but considerably—more worried about the health of the economy than the consensus forecasts. And if things are deteriorating as rapidly as Greenspan must think, this will not be enough to stop the deterioration."

In a January 4 editorial, the *Financial Times* of London offered a somber assessment of the Fed's move: "The Federal Reserve's decision to cut interest rates by half a percentage point was almost certainly the right thing to do in Thursday's [sic] increasingly gloomy circumstances for the US economy. Yet it also shows how wrong even this august institution was about the state of the economy only a few weeks ago. It may fail to end the gathering panic about the health of the 'new economy.' It may even confirm it instead...

"While Wall Street reacted with wild enthusiasm on Wednesday, Main Street may fail to react with equal alacrity. The situation is quite unlike that of the autumn of 1998. This time, weakness starts in Main Street and must be eliminated there...

"It is even possible that the cut will make people more nervous, since it demonstrates the degree of concern now felt in the country's most respected institution."

In referring to the autumn of 1998, the *Financial Times* was citing the last occasion when Greenspan slashed interest rates between meetings of the Federal Open Market Committee. In October of that year the Fed cut rates by .25 percent, one of three rapid-fire reductions, to head off a panic over the Asian financial crisis, Russia's default on international loans, and the collapse of Long-Term Capital Management, a US-based hedge fund into which major banks and investors had poured large sums.

But as the British newspaper noted, that crisis was largely precipitated by developments outside the US, while the current crisis is centered in a dramatic contraction in US economic activity.

Some commentators speculated on the possibility that Greenspan's preemptive move was prompted by private knowledge of a looming collapse of a major financial institution, akin to the Long-Term Capital Management debacle. Recent days have seen the bankruptcy of the

Montgomery Ward retail chain and LTV, the nation's third-largest steel producer, and there are growing signs of a credit crunch. Evidence of distress within the banking sector emerged on Thursday, when major US banks, including J P Morgan Chase & Co. and Bank of America, announced they would post lower fourth-quarter profits as a result of falling share values, the drying up of new securities offerings and a rising toll from bad loans.

It may well turn out that the imminent failure of a major institution played a role in Greenspan's surprise move on Wednesday. But even in the absence of such a development, the signs of a recession, or even a depression, are mounting rapidly, providing ample grounds for the Fed's intervention.

Prior to Greenspan's action on Wednesday, the hemorrhaging on the stock market that occupied the final months of 2000 was continuing in the new year. The Nasdaq index, which had fallen by more than 50 percent since its high point last March, plunged another 7.2 percent on Tuesday, the first trading day of 2001. For the whole of 2000 some $3 trillion was wiped out on the hi-tech index, and for the stock market as a whole the loss was a massive $2.7 trillion. Greenspan would have good reason to fear an outbreak of panic selling, with potentially devastating consequences for banks and other financial institutions. His sharp cut in interest rates was aimed, in large measure, at reassuring big investors and speculators that the Fed would act to avert an outright collapse of the market.

But the downward trajectory of the stock market is by no means an isolated phenomenon. It has merged with a sharp slowdown in economic growth over the past several months, bringing in its wake a decline in consumer spending and consumer confidence, falling profits, a slowdown in capital investment, slumping production in the manufacturing sector and a wave of job cuts.

US economic growth in the fourth quarter of 2000 declined to 2.2 percent, a four-year low and less than half the rate of growth recorded last spring. On Tuesday, one day before the Fed's interest rate cut, the National Association of Purchasing Management reported a steep decline in manufacturing activity in December, suggesting that the overall economy was growing at a rate of less than 1 percent a year. It was the fifth consecutive monthly decline, the sharpest one-month drop in more than five years and the weakest monthly reading since the end of the last recession in 1991.

The auto industry began 2001 in a tailspin, with dozens of General Motors, Ford and Chrysler plants temporarily idled for periods of a week or more. GM had already permanently closed down its Oldsmobile division and announced 5,000 white-collar job cuts, and Chrysler was expected shortly to announce a major program of downsizing.

Vehicle sales fell sharply in December, recording an overall decline of 7.6 percent from year ago levels. GM, Ford and Chrysler reported declines of 17.9 percent, 14.9 percent and 14.8 percent, respectively. On Thursday the automotive intelligence firm Autopolis predicted that annual auto sales in the US would drop by 20 percent by the middle of 2003.

The collapse of Montgomery Ward involves the loss of 28,000 jobs, but that is only the most dramatic instance in a growing wave of layoffs. Sears Roebuck and Co, the country's second largest retailer, announced Thursday it would close 89 stores and eliminate 2,400 jobs. The phenomenon of the 1999 holiday season, eToys, announced it was laying off 700 of its 1,000 employees. The Internet retailer's market valuation had fallen to $25 million from $11 billion in 14 months.

The outplacement firm Challenger, Gray and Christmas reported on Thursday that US firms announced 133,713 job cuts in December, up 203 percent from November. It was the highest number of monthly job cut announcements recorded since the firm began making its survey in 1993. The US Labor Department underscored the growth of layoffs, reporting Thursday that new claims for unemployment benefits rose for the third straight week, hitting 375,000 in the week ending December 30.

A report on retail sales issued on Thursday gave further proof of a rapidly decelerating economy. It documented the poor performance of retail chains over the holiday period, estimating that December same-store sales rose by a mere .5 percent, the smallest increase since March of 1995.

Recessionary forces are taking their toll on corporate profits, which slowed sharply in the fourth quarter of 2000. A host of major companies reported lower-than-expected earnings, and AT&T cut its dividend for the first time in its history, slashing the payment by 83 percent. The *Wall Street Journal* carried an article Thursday with the headline “Decline in Corporate Profits is Expected,” quoting a series of economists who said the Fed's action the previous day would not prevent corporate profit trends from turning negative.

The threat of a major economic emergency is compounded by the political trauma of the 2000 election. Greenspan and the Fed are no doubt concerned over the prospect of the Bush administration taking office under conditions of a full-blown financial and industrial crisis.