Fed interest rate cut will not halt US downturn

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28 June 2001

The US Federal Reserve Board has cut interest rates for the sixth time this year. But there are concerns that the latest cut of 0.25 percentage points announced on Wednesday may be too little, under conditions in which each of the five previous cuts of 0.5 percentage points failed to stimulate the US economy.

Announcing its decision, the Fed indicated that it did not expect a turnaround in the US economy.

"The patterns evident in recent months—declining profitability and business capital spending, weak expansion of consumption, and slowing growth abroad—continue to weigh on the economy," it said. And it warned, "[T]he risks are weighted mainly towards conditions that may generate economic weakness in the foreseeable future."

Following the decision there was criticism that, given the tone of the Fed's statement as well as reports of further slowing in the US economy, the cut should have been larger.

Last week, the National Bureau of Economic Research, the official monitor of US business cycles, reported that the US economy may have already moved into a recession. The bureau said "data normally considered by the committee to indicate the possibility of a recession began recently."

The bureau, which defines a recession as "a significant decline in activity across the economy, lasting more than a few months," has so far denied that the US has entered a recession. But according to the most recent figures, industrial production has decreased in each of the last eight months and is now down by 3.9 percent since its peak last September.

In the lead-up to Fed's Wednesday meeting, sections of the international press expressed concern at the failure of the interest rate cuts to bring any turnaround so far. An editorial in the *Financial Times* urged consideration of a cut of 0.5 percentage points, pointing to what it called "deepening gloom."

While the Fed's actions so far had helped maintain consumer confidence, the editorial said, this was not the situation in the rest of the US economy. "Manufacturing is contracting sharply, capital spending is down and US exports are suffering from the strong dollar."

The editorial concluded that while inflation could be a long-run concern, the more immediate worry was that attempts by the Fed to stimulate the economy may lose their efficacy. "US monetary policy is not yet dramatically loose. But the more the Fed does, the more the impact of its moves on consumer and business psychology is likely to diminish. Faith in the Fed's miraculous powers is a dwindling asset. The world must hope that Mr. Greenspan's remedy will soon take effect."

An editorial in the *Washington Post* on Tuesday, which also called for a 0.5 percentage point cut, noted that the Fed was meeting in a situation where the world's three largest economies—the United States, Germany and Japan—were falling into recession or teetering on the edge of one.

"Not since the oil-price-induced recession of 1974-75 have the three largest economic blocs simultaneously experienced deep downturns, which had the unavoidable effects of reinforcing and exacerbating each other."

The editorial cited a report from the British magazine the *Economist* pointing out that in the three-month period to the end of May, industrial production in the US, the European Union and Japan had fallen by 0.5 percent, compared to an increase of 6 percent in March-May 2000.

Warning that "things could get quite dicey throughout the world's economic landscape," the *Post* noted that Japan had experienced negative growth in the first quarter while German business confidence and manufacturing orders had plunged recently.

"Meanwhile, in the United States, average annual economic growth for the six months ending in March fell to about 1 percent, compared to an annual growth rate of more than 6.5 percent that prevailed during a comparable period a year earlier. For the quarter ending Saturday, US economic growth will likely be at or near zero. Indeed, as the Fed itself reported earlier this month, US industrial output has declined for eight consecutive months. Business investment has collapsed. Moreover, in an economy where consumer spending represents two-thirds of gross domestic product, the rate of increase in retail sales has slowed to a crawl. Unemployment has increased by a half-percentage point since October."

Writing on the eve of the Fed's decision, *Financial Times* global economics commentator, Martin Wolf, noted that while most analysts were forecasting nothing worse than a "modest slowdown" in the US and world economy, they were "likely to be disappointed."

Wolf said the current US downturn was not like other turns in the post-war business cycle because it was the result of an investment mania triggered by technological innovation, rather than the product of tighter monetary policy.

"Powerful downward forces are at work. What was widely perceived as a transformation in economic opportunities drove an extraordinary rise in the stock market and subsequent expansion in investment and consumption. Expectations overshot reality. One measure of value—the 'valuation ratio' which relates the stock market to the replacement cost of the capital stock—reached historically unprecedented levels last year. The financial deficit of the private sector also was an unprecedented 6.5 per cent of gross domestic product in 2000—a shift of 12 percentage points since 1992."

Wolf pointed out that with the emergence of excess capacity as a result of the investment boom, the Fed's interest rate cuts were unlikely to stimulate new capital spending. And given the strength of the dollar, the US economy will not receive a stimulus from increased exports.

This means, he concluded, that the Fed's policies can work if, and only if, households continue to spend and go further into debt under conditions where the ratio of household debt to income has been steadily rising from about 70 percent in the mid-1980s to a little under 110 percent last year. In other words, the price of "success" in staving off recession by increasing indebtedness would be to create the conditions for even greater instability in the future.

Moreover, historical experience points to a sharp downturn even if the Fed keeps cutting interest rates. According to a recent report by the Bank for International Settlements, falls in private sector saving such as that experienced by the US have almost invariably been followed by sharp reductions in economic growth two years later.