Federal Reserve cuts rates but markets fall

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After seven cuts since the start of the year it is becoming clear, even to those with the most optimistic outlook, that action by the Federal Reserve Board on interest rates is not going to boost the US economy.

The Fed reduced interest rates by a further 0.25 percentage points on Tuesday bringing the benchmark federal funds rate down to 3.5 percent—the lowest level in more than seven years—and a reduction of 3 percentage points since the interest rate cuts began in January.

Financial markets, however, responded negatively to the decision. After climbing by as much as 58 points before the decision was announced the Dow Jones index fell by 146 points for the day—a drop of 1.4 percent—while the Nasdaq composite index dropped by 2.7 percent.

The drop in the market indexes reflected the growing view in financial circles that interest rate cuts are not going to provide a significant boost to the near stagnant US economy and that profit levels for major companies will continue to fall.

Announcing its decision the Fed made it clear that it did not expect a quick turnaround in the US economy. “Household demand,” it declared, “has been sustained, but business profits and capital spending continue to weaken and growth abroad is slowing, weighing on the US economy.”

And it left open the door for further cuts, either at the next scheduled meeting of the Federal Open Market Committee at the beginning of October, or possibly earlier. While the long-term prospects for the economy remained favourable, it said, “the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future.”

The lack of response in financial markets and the economy as a whole to the interest rate cuts is adding to concerns about the extent and depth of the slowdown in the US and its implications for the world economy as a whole.

As far as the markets are concerned, all three major indexes—the Dow, the Nasdaq and the S&P 500—are below where they were last January when the rate cuts began. As some commentators are beginning to point out, the only other time the market failed to respond to seven interest rate cuts was at the start of the Great Depression.

In an editorial on Tuesday entitled “An Unresponsive Economy”, the *New York Times* noted that “the light at the end of the tunnel doesn’t seem to be getting any closer. For much of this year, analysts expected the Federal Reserve Board’s half-dozen cuts in interest rates to shift the economy out of neutral by the fourth quarter. Now, as autumn nears, medium- and long-term interest rates remain prohibitively high, and each day brings new of more layoffs. Pundits seize upon any sign of a turnaround, such as last month’s growth in new home construction. Clearly, however, companies are finding few reasons to increase their investments.”

A comment in the *San Francisco Chronicle*, published before the rate cut was announced, held out little prospect that it would provide a cure for the “ailing economy”.

“Silicon Valley,” it continued, “is suffering a catastrophic collapse of demand that doesn’t seem to be responding to lower interest rates. ... The tech sector is going through what many industry veterans say is the worst downturn in its history. But that slump wasn’t caused by high interest rates. It started when corporations bought too many computer and telecommunications products during the Internet boom years of the late 1990s and then lost their appetite as they struggled to digest the glut of equipment.”

The rapid slowdown in the US economy and the continuing downward trend in share markets are starting to exert pressure on the US dollar—a process which could bring some major financial problems.

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Since its high against the euro in July, the dollar has fallen by almost 9 percent while against the Japanese yen it is down by 5 percent from its 2001 high in April. A fall in the value of the dollar has contradictory consequences for the economy as a whole.

On the one hand manufacturers have been complaining for some time that a “strong dollar” policy hurts exports and profits. Recently the chief financial officer of General Motors, John Devine, said the company had asked the Bush administration to rethink its currency policy. “The strong dollar is frankly destroying the manufacturing capability and the manufacturing competitiveness of this country,” he said.

But on the other hand, a fall in the value of the dollar, particularly a rapid decline, could have serious implications for financial markets. With a balance of payments deficit of more than $400 billion per year—equivalent to about 4.5 percent of gross domestic product—the US economy is dependent on an inflow of capital of more than $1 billion per day.

If this money starts to move in the other direction, due to fears of losses incurred because of a fall in the value of the dollar, then interest rates in the US will be pushed up, adding to recessionary pressures. This would bring further falls in share markets and increased financial outflows.

The dangers of the emergence of such a vicious financial circle have been increasing in recent months. Figures published by Morgan Stanley show that there has been a shift in the foreign financing of the US deficit from the more stable and long-term foreign direct investment (FDI) to more volatile short-term portfolio investment either in the sharemarket or corporate bonds.

According to the Morgan Stanley analysis for the year 2000, FDI inflows to the US slowed to $135 billion while portfolio inflows increased to a record $313 billion, or 70 percent of total foreign fund inflows. And the change accelerated in the first quarter of this year with portfolio inflows rising to $118 billion while FDI inflows dropped to just $8 billion.

Another significant feature is the extent to which the US is dependent on Europe to finance its deficit. During 1999-2000 Europe provided nearly 80 percent of total US FDI inflows and some 61 percent of portfolio inflows.

Concerns over the extent of the current account deficit were voiced in the International Monetary Fund’s latest report on the US economy published earlier this month. The IMF noted that “whether domestic and external financial imbalances in the US economy would be resolved in an orderly manner depended importantly on prospects for underlying productivity growth.”

This is because the increase in productivity growth in the second half of the 1990s had boosted the relative return on capital in the US and attracted the capital inflows needed to finance the payments deficit. While the IMF said evidence suggested a “reasonably favorable outlook” for underlying productivity growth, less optimistic prospects could pose “a significant challenge for US policy.”

According to the report, the “size of the US external account did not appear sustainable in the longer term” raising concerns that the dollar might be at risk of a “sharp depreciation” with possible “adverse effects on the United States and the rest of the world economy.”

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