Minutes point to mounting problems for the US Fed

Nick Beams
28 August 2001

The minutes of the Federal Open Markets Committee (FOMC)—the body that determines US interest rates—do not normally make for particularly interesting reading. Generally the decisions are reached through consensus, managed by chairman Federal Reserve Board Alan Greenspan.

However at the meeting of June 26-27, the minutes of which were released last week, there was dissension in the committee, with the president of the St Louis Federal Reserve Bank, William Poole, disagreeing with the decision of the other nine members to cut rates by 0.25 percentage points and to issue a statement indicating the Fed was willing to make further cuts if conditions weakened.

It is not known whether there was further dissent during the FOMC discussion earlier this month because the minutes of that meeting, which also decided on an interest rate cut of 0.25 percentage points, will not be released until early October.

At the June meeting, Poole disagreed with further cuts because, with money supply already expanding at a rapid rate, "adding further monetary policy stimulus raised an undue risk of fostering higher inflation in the future." Poole opposed the issuing of a statement that the FOMC continued to view risks as weighted on the downside as this would probably cause "expectations of further easing to become embedded in market interest rates."

His fellow members did not agree and expressed surprise that "economic activity continued to grow little, if at all, in the second quarter."

The minutes point to a discussion of data which "indicated that growth of spending and output was quite sluggish and below the pace many members had anticipated at the time of the previous meeting. Weakness in business spending for equipment and software, efforts to reduce excess inventories, and the ongoing adaptation to lower equity prices in the United States and around the world were likely to hold back economic activity in the short term."

The general bewilderment of the committee in the face of the continued downturn, despite one of the most aggressive round of interest rate cuts in the post-war period, was summed up towards the end of the discussion. According to the minutes: "In the view of a number of members, the Committee might well be near the end of its easing cycle. At the same time, several emphasised that they did not want to rule out further easing later if warranted by the tenor of incoming economic information."

In other words, they had no clear idea as to where the US economy is headed.

The perplexity of the bankers stems from what the minutes referred to as "the unique characteristics of the current cyclical experience."

This is a reference to the fact that previous downturns have been triggered by a tightening of interest rates by the Fed in response to inflation. The lifting of interest rates has in turn led to cuts in consumer demand, a build-up of inventories, cuts in production and finally to reductions in investment spending by businesses. Conversely, the upturn has been initiated by reductions in interest rates, leading to increased consumer demand, flowing through to investment spending.

In this case, however, the downturn has been triggered by falling investment spending, initiated by the rapid downturn in the high-tech sector but now extending across the board.

The problem for the Fed is that cuts in interest rates have little or no impact on investment decisions, which depend not so much on the cost of capital, but on the anticipated rate of return in the form of profits.

© World Socialist Web Site

However, with overcapacity developing in all sections of industry and deflationary pressures tending to push down prices throughout the economy, the profit rate is turning down and has been for some time. Recent figures show that much of the profits boom of the recent period was illusory, with real profit levels in decline since about 1997.

The bankers on the FOMC are of course aware that interest rate cuts will do little to boost investment spending. Their strategy appears to be aimed at trying to avert an outright recession by maintaining consumer spending until overcapacity is reduced and business spending moves upward again.

However, this policy is running into problems on a number of fronts. Business investment spending is showing no signs of improving and in high-tech areas may still have some way to fall.

According to a report published in the *Washington Post* last Saturday, corporate spending on new technology could fall this year for the first time since 1974. In the first six months of the year, businesses spent 2.4 percent less on computers, communications, telecommunications equipment and software than they did in the same period last year. The size of the turnaround is revealed in the fact that corporate technology spending last year was up 19 percent, or $65 billion, over 1999 levels.

While they have failed to lift investment spending, the Fed's interest rate cuts are having an impact. Lower interest levels have boosted the housing market with prices rising at their fastest rate in a decade. But this is very much a two-edged sword. While the booming housing market has tended to sustain consumer spending, as existing homeowners refinance their mortgages, there are fears that a bubble market is being created in real estate that could soon collapse and tip the economy into full-blown recession.

Overshadowing all the efforts of US policymakers to induce increased growth is the rapidly worsening situation in the global economy. According to Morgan Stanley chief economist Stephen Roach, the major economies of the world "came to a virtual standstill in the second quarter of 2001"—a phenomenon not seen since the "oil shock" in 1974-75.

"With the global economy now effectively at 'ground zero', the world growth dynamic is truly engineless—making the case for spontaneous recovery a real stretch. Does this stalling suggest the worst is over, or that it has merely just begun?"

Similar sentiments were voiced in the latest edition of the *Economist* magazine.

"One by one, economies around the world are stumbling," it noted. "By cutting interest rates again this week—for the seventh time this year—the Federal Reserve hopes it can keep America out of recession. But in an increasing number of economies, from Japan and Taiwan to Mexico and Brazil, GDP is already shrinking. Global industrial production fell at an annual rate of 6 percent in the first half of 2001.

"The picture may soon look even worse. Early estimates suggest that gross world product, as a whole, may have contracted in the second quarter, for possibly the first time in two decades. Welcome to the first global recession of the 21st century."

It is a measure of the mounting problems facing governments and central banks that the *Economist* could offer no policy prescriptions to avert the deepening global downturn, merely issuing some warnings about what should not be done. While noting that a modest slide in the value of the US dollar might help the shaky American economy, a plunge in the US currency would be "dangerous" because it could undermine confidence, knock share prices and weaken consumer spending.

The only advice it gave was for central banks to keep easing monetary policy, governments to be more flexible over their fiscal policies and that "all should keep their fingers firmly crossed."

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site