Concerns that US may be going down the Japan road

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The US Federal Reserve has again cut interest rates by half a percentage point, taking the federal funds rate to just 2 percent—its lowest level since 1961. The rate cut, the 10th so far this year, was almost a foregone conclusion following the release of data last week showing the extent of the slowdown of the US economy.

While the announcement of a 0.4 percent fall in gross domestic product for the third quarter was generally smaller than expected, the release of employment data on Friday revealed that the US is well into a recession. The jobless rate for October rose from 4.9 percent to 5.4 percent, representing the loss of 415,000 jobs in the biggest single monthly increase in more than 20 years.

Announcing the rate cut, the Fed said that "heightened uncertainty and concerns about a deterioration in business conditions both here and abroad are damping economic activity." It indicated there could be further interest rate cuts before the end of the year—markets are already pricing in a rate of 1.5 percent—saying that "the risks are weighted mainly towards conditions that may generate economic weakness."

While there is general support for the interest rate cuts in business and financial circles, concerns are being voiced that the ineffectiveness of the cuts so far could leave the Fed with few weapons with which to stave off a deepening recession. Some commentators have even pointed to the Japanese situation where the Central Bank, having already cut rates to almost zero, is unable to give the economy an effective stimulus.

Ethan Harris, an economist at Lehman Brothers, told the *New York Times* that in his view the financial authorities were "using up their monetary medicine too fast" and there was a danger that if rates approached zero "there's a perception of a powerless central bank."

"That is the bind that is bedeviling Japan," the *Times* article noted, "where official interest rates are close to zero, leaving Japan's central bank severely constrained in its ability to fight a continuing recession."

Similar sentiments were expressed in an article published in the *International Herald Tribune*. It pointed out that analysts were becoming concerned that the US could be "running out of policy options" after the series of cuts this year. "With rates so low—and headed lower—the United States begins to risk unpleasant comparisons with Japan, which dropped interest rates virtually to zero to revive its own slumping economy in the past decade."

In a commentary issued before the latest rate cut, Morgan Stanley chief economist Stephen Roach warned that recession could lead to deflation. Such an outright contraction in the aggregate price level would have a "lethal result for the real economy and financial markets." While the US had not yet reached that position, this was where the risks lie. "There is a growing chance ... that both the world and the US economy could experience a whiff of deflation over the next couple of years."

According to Roach, the single most disruptive macro force in the US economy is the excesses associated with the high-tech bubble and the overcapacity resulting from earlier high levels of business investment.

"Lingering investment excesses are a classic manifestation of an overhang of aggregate supply that puts ongoing pressure on the overall price level. The same is true of the excesses of household debt, the shortfall of personal saving, and a massive current account deficit. They all speak of a US economy that lived beyond its means as the asset bubble expanded.

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Now that the bubble has popped, a purging of those excesses is in order—an outcome that has the potential to trigger a lingering series of deflationary aftershocks on the demand side of the equation. Just ask Japan."

The interest rate cut will do little or nothing to boost investment because of the existing excess capacity and predictions that profit rates will continue to decline. According to *BusinessWeek*, a survey of 124 "bellwether companies" showed a 54 percent fall in profits for the third quarter—the sharpest quarterly decline in more than a quarter-century, with a further 20 percent profit fall expected in the fourth quarter. This means that the decline in business investment, which has been the key component of the recession, is likely to continue well into next year.

Other survey data reveal that the recession is spreading out from manufacturing. The National Association of Purchase Managers (NAPM) index for the service sector fell from 50.2 to 40.6 in October. The NAPM index for manufacturing went down to 39.8, from a level of 47 in September. The manufacturing index has been below 50 since August 2000, an indication that this sector of the US economy has been in recession for more than a year.

With the US economy having accounted for around 40 percent of world growth in the latter years of the 1990s, the recession is having a major impact on the rest of the global economy.

This has led to a call by former secretary of Labor in the first Clinton administration, Robert Reich, for an initiative by the White House to join other countries to "stave off a global economic meltdown."

Writing in the *Los Angeles Times*, Reich noted that while the US was experiencing shrinking national output, falling consumer spending and confidence, the situation in the rest of the world "is as bad or worse."

"Germany, the largest economy in Europe, is in a slump, dragging the rest of Europe down with it. The Japanese economy is nearly comatose. Argentina, until recently South America's powerhouse, is in deep recession and about to default on its international loans. The former 'tigers' of Southeast Asia—Malaysia, Singapore, Hong Kong and Taiwan—are basket cases. The global economy is teetering."

Reich insisted that Fed cuts while necessary were not sufficient. Even if matched with cuts by other central banks this would still not be enough to get the global economy moving. There had to be a stimulus package from governments—deficit spending—for at least a year.

But even if agreement were obtained on such a coordinated response there are considerable doubts as to whether it would produce a turn around given the experience in Japan. Since the collapse of the Japanese asset bubble at the beginning of the 1990s, the largest deficit spending program in peacetime has failed to prevent the stagnation of the economy.

The World Bank has also highlighted the impact of the US recession on the global economy. Releasing its Global Economic Prospects report, the bank said that "the global economy is slipping precariously toward recession" with developing countries experiencing a plunge in their growth rates.

"Growth in trade," it noted, "has undergone one of the most severe decelerations in modern times—from over 13 percent in 2000 to 1 percent in 2001. Developing countries are confronting a 10 percentage point drop in the growth of demand for their exports." While holding out hope for an upturn by the middle of next year, it said the risks posed to a recovery were the "gravest in a decade" and that the terrorist attacks in the US had "unleashed new and unpredictable forces that have substantially raised the risk of a global downturn."

At a meeting held in Geneva at the weekend, the International Labor Organisation warned that millions of jobs around the world are threatened. "The loss of nearly half a million jobs in the United States in the past month shows that the tidal wave has started to move and will end up on everyone's shore," said ILO vice president Bill Brett.

According to the ILO, the sharp reversal of the world economy could result in the loss of 24 million jobs by the end of next year.

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