A revealing speech by a US Federal Reserve Board governor

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Two conclusions emerge from a speech delivered by US Federal Reserve Board member Laurence Meyer this week: that the deterioration in the American economy has gone much further than financial authorities expected, and that they are not at all confident that interest rate cuts will bring it to an end.

Addressing the National Association of Business Economics in St Louis on Tuesday, Meyer held out the prospect that the economy should "gradually strengthen" next year but pointed out that the Fed's interest rate cuts—10 so far this year—had failed to lift it as expected.

The economic outlook was a "complicated mixture" of forces at work before the terror attack of September 11 and the new forces set in motion by the events of that day. Even before the attack, the Fed had been "struggling to understand the severity of the slowdown and the prospects for recovery."

The economy had slowed "more steeply than the Fed expected or intended." While increased interest rates over the year 2000 had a role, along with increased oil prices, the most important factor in the slowdown was "the shock that hit the economy in late 2000 and early 2001—a reassessment of the profitability of producing and owning high-tech equipment."

"This shock was manifest in both the financial markets and in the real economy. It resulted in a sharp correction in equity prices in the technology sector—the bursting of the technology bubble—and, at the same time, it led to a sharp retrenchment in the demand for and production of high-tech equipment. The economy slowed to the point where real GDP was nearly flat in the second quarter of this year and likely would have been nearly flat in the third quarter, even without the events of September 11."

Meyer pointed out that those who expect the US economy to quickly rebound based their assessment on the belief that productivity growth in the latter part of the 1990s had risen well above the historical trend. However, recent revisions to the national accounts figures had forced a reassessment of productivity growth and a consequent "trimming" of economic growth estimates. Furthermore, he continued, "some of the earlier productivity growth, reflecting the frenzied pace of investment in high-tech equipment, now appears to have been unsustainable."

Turning to the actions of the Fed, Meyer noted that before September 11 it had already cut interest rates by 3 percentage points, the most aggressive easing in almost 20 years. "However, many see the effect of that easing as disappointingly small."

One of the most important considerations in this process had been the change in overall financial conditions. Monetary policy, he noted, does not operate through the direct effect of the federal funds rate on spending. Rather it works via a transmission mechanism which includes short-term private interest rates, long-term private interest rates, equity prices and the exchange rate of the dollar. In normal circumstances, a cut in the federal funds rate could have been expected to lower both short and long-term rates, boost equity markets and cut the value of the US dollar (thereby giving a boost to US exports).

In this instance, however, there has been "painfully little pass-through from the funds rate to the operative channels, other than declines in short-term interest rates." The reason appears to have been the "offsetting effect of other financial shocks that were occurring at the same time the Fed was easing." Meyer said indexes constructed by private sector firms to try and measure the impact of the Fed's actions indicated that financial conditions had not improved since the rate cuts began and may even have deteriorated.

"The response of overall financial conditions to monetary policy easing in this episode," he continued, "has been unusual, if not unique. In previous recession periods, financial conditions have generally improved as the Fed has eased, reflecting the pass-through to lower short- and long-term private rates, higher equity prices, and a lower exchange rate."

The main reason for the lack of response on this occasion was that the severe downgrading of profit expectations in the area of high-tech investment sent a shock to financial markets and to aggregate demand, leading to a fall in equity markets. In addition, "the dollar appreciated rather than depreciated, for reasons no one seems to fully understand", meaning that "two of the key channels in the transmission of monetary policy behaved differently than expected."

Admissions that the Fed had underestimated the extent of the downturn, was not clear on why its policies had not worked and essentially did not have a clue on the currency movement, would in themselves have been a clear enough indication of the atmosphere of fear and bewilderment surrounding financial authorities.

But the real state of affairs behind the official mask of confidence was revealed even more clearly towards the end of Meyer's speech. Here he addressed calls from some quarters for the Fed to "keep its power dry" and hold back on rate cuts, lest the downturn turn out to be more serious than expected or there were further shocks. Meyer insisted that such a policy was "misguided—indeed the reverse of what would be appropriate."

"Given the initial low level of the nominal federal funds rate," he said, "we face the risk that, in what is arguably a worst-case scenario, that rate could be driven to zero, the practical limit for a nominal interest rate. This of course is the situation that has lately confronted the Bank of Japan ... In my view, the appropriate policy response, when confronted with such a potential limit, is to respond especially aggressively to any adverse demand shock, in effect, substituting speed of the move for the cumulative size of the easing. The danger in waiting is that inflation might drift lower, limiting the ability to drive the real federal funds rate into negative territory, as might be necessary to support a timely recovery. In the worst case, as in Japan today, inflation might turn to deflation, limiting the ability to lower the real policy rate even to zero."

The implication of a low interest rate was not to go slowly but to respond more aggressively to an adverse shock. "I did not view this consideration as relevant before September 11 and not even immediately after," he said. "But it was a consideration in my favouring the last 50-basis point move."

How rapidly the economic outlook has darkened. Barely a few months ago, any suggestion that the US might be faced with the same problems as Japan would have been greeted with reassurances that the US financial system was far more "robust", there was not the level of debt and financial markets were more capable of adjustment. Now it seems that prominent members of the Fed are guided by the conception that they must do everything possible to avoid the Japanese experience.