US Fed cuts again amid deflation fears

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The US Federal Reserve Board yesterday cut interest rates by 0.25 percentage points in the 11th reduction so far this year as it strives to bring about a recovery from the recession. The federal funds rate is now 1.75 percent, the lowest in more than 40 years, and below the inflation rate. But the central bank's efforts to turn the US economy around have so far met with little success.

This is acknowledged by the Fed itself. In a statement announcing the decision, the Federal Open Market Committee said that, while "weakness in demand shows signs of abating," those signs were "preliminary and tentative." Overall, it continued, "the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future"—leaving the door open for a further rate cut in the New Year.

The consensus in stock markets and financial circles appears to be that the US economy will start to rebound by the first quarter of 2002. But there are growing concerns in some quarters that this recession is not like others in the post-war period and consequently interest rate cuts will do little to promote strong economic growth.

Among the abnormal conditions is the threat of deflation in the US and world economy. Falling prices mean interest rate cuts have to be larger and more rapid to have any impact on growth. According to present estimates, the fed rate is effectively zero—the first time it has fallen this low since the recession of 1990-91. Under normal circumstances that should stimulate growth. However, conditions are far from normal.

A new factor has emerged—slowing price increases and even deflation. Their effect is to nullify the impact of interest rate cuts. This is because while nominal rates may be reduced, the real interest rate increases because prices fall, which in turn necessitates a further cut. If this process continues for any length of time a point is eventually reached where the nominal rate is at or close to zero, so no further cuts are possible and the Fed effectively runs out of financial ammunition. While the US has yet to reach this point, there are fears that it could soon get there.

In a front-page report entitled "Greenspan battles to head off the deflation bogy," the *Australian Financial Review* commented that Japanese authorities left it too late before they started to cut rates and "fell into a deflationary spiral".

The chief strategist at Fuji Futures in Chicago, John Vail, told the *AFR* that the Fed was "really afraid of deflation. And they should be. I put the chance of the US falling into a Japanese-style deflationary cycle at 40 to 50 percent."

An editorial published on the eve of the latest decision in the London-based *Financial Times* noted that the consensus on Wall Street seemed to be that, with real interest rates at zero, "free money" would end the recession as it had in the past. However, it continued, "nagging doubts remain."

These doubts centre on where the impetus for a recovery will come from. It will not come from corporate investment, because of the "recent huge decline in capacity utilisation to levels last seen in the early 1980s". Moreover, "with profits as a share of national income having fallen every year since 1997, companies have added reasons to be cautious."

In an article published on December 6, the *Economist* commented that corporate profitability in the US had fallen to its lowest level since the depression of the 1930s. "In the third quarter of this year, the pre-tax profits of non-financial firms fell by 26 percent from a year earlier, to a level equivalent to 7.5 percent of GDP in the non-financial business sector. As recently as 1997, that figure was 12.5 percent. Profits have further to fall. Economists at J P Morgan forecast that average profits will drop at an annual rate of over 20 percent this quarter, leaving profit margins at their lowest for

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more than 60 years."

Nor will the rest of the world provide a stimulus to the US economy. On the contrary, with the US having provided around 40 percent of the increase in global output over the past five years, the recession is dragging down the rest of the world economy. Japan, the world's second largest economy, is already in recession and Germany, the third largest, is about to join it.

According to the *Financial Times*, government action is "unlikely to provide sufficient stimulus" with the fiscal package now in Congress only adding about 1 percent to GDP. Even this estimate may be too high for, as critics of the package have pointed out, the "stimulus" measures are based on tax cuts and are directed at the wealthiest layers.

No stimulus can be expected from consumer spending either. Previous recessions have generally ended with a sharp upturn in consumer demand. But in this case, the downturn has been caused by a sharp decline in business investment, with consumer demand remaining relatively high. However, with the rapid increase in unemployment—more than 800,000 jobs have been wiped out in the past two months—and the rate of wage increases about half what it was in the latter years of the 1990s, consumer demand can be expected to remain stationary, if not fall.

The *Financial Times* global economics commentator Martin Wolf has also cast doubt on the optimistic view that the Fed's interest rate cuts will generate a resurgence in the US economy. "The view that there will be a more or less conventional recovery rests on the assumption that this was a conventional downturn for which conventional demand management policies are an effective remedy," he wrote.

According to Wolf that "cheerful view" has been undermined by a recent analysis by Stephen King of HSBC on financial bubbles and deflation, centring on the US in the 1930s and Japan in the 1990s. The major problem confronting a large "post-bubble" economy is that it cannot easily use the rest of the world as a source of demand—a description, which, "fits the US experience of the 1990s disturbingly well."

According to this analysis, "the story of the post-bubble correction is not over" and "may have hardly begun." Rather than experiencing a turnaround next year, the US may experience a "limping recovery", stronger than that of Japan, but nowhere near the growth rates of the late 1990s.

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