US Fed decision not a vote of confidence

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After eleven successive cuts, the US Federal Reserve has held interest rates steady following the meeting of its Federal Open Market Committee (FOMC) this week. But this is not an expression of confidence that the US economy is about to move out of recession.

Announcing the decision, the FOMC said that with "forces restraining the economy starting to diminish ... the outlook for economic recovery has become more promising." But it then added that "the degree of any strength in business capital and household spending ... is still uncertain" and consequently "the risks are weighted mainly toward conditions that may generate economic weakness in the foreseeable future."

The FOMC decision came after a series of twists and turns by Fed chairman Alan Greenspan in response to criticism that he had been too gloomy in his outlook for the US economy.

The market disturbances started in the wake of a speech he gave on January 11 in which he cautioned that, while recent signals from the economy had become "mixed," rather than uniformly negative, there were still dangers ahead. "I would emphasise," he said, "that we continue to face significant risks in the near term. Profit and investment remain weak and ... household spending is subject to restraint from the backup in interest rates, possible increases in employment, and from the effects of widespread equity asset price deflation over the past two years."

But these relatively mild warnings were regarded as too strong. The Dow Jones index fell 3.8 percent in the week following Greenspan's remarks and critical comments were published.

This led to a series of adjustments. An article in the *Washington Post* by John Berry, regarded as an outlet for Fed leaks, indicated that Greenspan considered too much pessimism had been read into his remarks, a position reflected in an article published the following day in the *Wall Street Journal*.

While much of the earlier analysis was retained when Greenspan delivered his testimony to the Budget Committee of the Senate on January 24, the reference to "significant risks" to the economy was removed. Asked about his change of tone, Greenspan said he had overdone the pessimism with some "unfortunate phraseology."

By any objective standard the last two weeks represent an extraordinary chapter in the history of public financial policy. The world's most powerful central banker has been seen to change his assessment of the economic outlook in accordance with the comments in the financial media and in response to the movement of the stock market.

This is a sure indication that despite the reassurances that the US economy is about to make a fast turn out of recession, the officials of the Fed, and Greenspan himself are rather nervous about its future prospects.

In his testimony to the Senate, Greenspan noted that "some of the forces that have been restraining the economy over the past year are starting to diminish and that activity is beginning to firm." But the major factor in this "turnaround" is the run down in inventories. Stocks in many industries, he noted, had already been run down to levels at which firms would soon need to begin re-ordering if they had not already done so. This would lead in turn to an increased demand for manufactured output.

Such a process takes place in every recession. It only continues on to a recovery if demand increases. As Greenspan noted: "[The] impetus to activity will be short-lived unless sustained growth of final demand kicks in before the positive effects of the swing from inventory liquidation to accumulation dissipate. Most recoveries in the post-World War II period received a boost from a rebound in consumer durables and housing from recession-depression levels in addition to some abatement of the liquidation in inventories."

Herein lies the source of some of Greenspan's fears. The present US recession is unlike any other in the post-war period in that it has not been initiated by a cutback in demand for consumer durables, followed by cuts in production, leading finally to a reduction of capital spending. On the contrary, the recession has been induced by the sharp fall in capital spending following the collapse of the stock market bubble two years ago and the development of vast over-capacity in hi-tech industries.

Indeed the recession would have proceeded far more rapidly had it not been for the maintenance of spending on consumer durables and housing over the past year. But the question is how long can this continue?

The Fed's interest rate cuts have not led to increased investment spending. This is because even if interest rates were reduced to zero, firms would have no inducement to increase capital spending while overcapacity remains. But the rate cuts have helped fuel increased consumer spending, much of it financed by increased borrowing.

According to the latest figures, borrowing for November last year rose by $19.8 billion, the largest monthly increase since records were started in 1943. Herein lies the problem: the US economy is at present being propped up by debt-funded consumer spending. If that borrowing collapses, and spending falls, then the recession will rapidly deepen. This explains the speed with which Greenspan responded to the criticism of his remarks. He feared that a slide on the stock markets would rapidly find its reflection in falling consumption spending.

But the massaging of the markets in order to sustain consumer spending has very definite limits. Objective processes come to predominate in the end, often acting more forcefully through having been delayed.

One of the most important factors weighing down on the US economy is the growth of debt. This was the subject of two major articles in the January 24 edition of the *Economist*. Arguing against claims the recession may soon be over, it noted that the "excesses of the 1990s, most notably the surge in household and corporate debts, still loom dangerously large."

Optimists had lost sight of the fact that the recession was caused "neither by the events of September 11 nor, like every previous post-war recession, by tightening by the Federal Reserve in response to rising inflation. The root cause of this recession was the bursting of one of the biggest financial bubbles in history. It is wishful thinking to believe that such a binge can be followed by one of the mildest recession in history—and a resumption of rapid growth."

The growth of consumer debt means that the debt-service burden on US households is 14 percent of income, higher than the eve of the 1990-91 recession. The situation facing corporations is even more serious.

Basing itself on a study by Dresdner Kleinwort Wassterstein, the *Economist* claimed that corporate balance sheets in the US were in a "perilous state." "The ratio of short-term debt to liquid assets, and the ratio of debt to profits, are both higher than in 1990. Companies' interest payments are absorbing a record share of their profits, yet they continued to borrow more throughout last year. Their financing gap (capital spending minus cash flow) remains unusually wide compared with previous recessions, which suggests that investment has further to fall."

Moreover, much of the surge in borrowing in the late 1990s was based on over-optimistic estimates of future profits. "Last year saw the biggest fall in profits since the 1930s. Even when the economy recovers, profits are unlikely to grow at the double-digit annual rate that has come to be expected by many investors and borrowers."

Pointing to the wider problems of the global economy, the *Economist* noted that excessive borrowing by governments, companies or households lay at the root of every economic crisis of the past 20 years and that the post two months alone had witnessed "the largest-ever foreign-debt default, in Argentine, and the biggest-ever corporate bankruptcy, of Enron." And for the first time since the 1930s, the world was experiencing not too much inflation but too little as a result of "massive excess capacity."