US economic outlook: fears of renewed recession—and worse

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The unexpectedly large interest rate cut announced by the Federal Reserve Board last week demonstrates that the US central bank shares the fears of renewed recession that are widespread in corporate America.

The Fed lowered its key federal funds rate, the rate at which banks loan money to each other overnight, from 1.75 percent to 1.25 percent, the lowest level in more than 40 years. A quarter-point cut had been expected, but the Fed's Open Market Committee said the US economy was encountering a "soft spot" that made a half-point cut appropriate. The Fed also lowered its discount rate, the rate at which the Fed lends to member banks, to 0.75 percent, the lowest in its 89-year history.

In its brief statement explaining the rate cut, the Fed said "greater uncertainty, in part attributable to heightened geopolitical risks, is currently inhibiting spending, production, and employment." This is a reference to the imminent prospect of a unilateral American invasion of Iraq, following the vote by Congress giving President Bush the authority to take military action at his discretion.

The rate cut was the twelfth such action since Bush entered the White House in January 2001. In course of 22 months, the Fed has lowered interest rates by 5.25 percent. With the funds rate down to 1.25 percent, the central bank has virtually exhausted its ability to stimulate the economy through rate cuts.

So far the Fed rate cuts have had no discernible impact on the plunging rate of business investment, the most important factor in the economic slowdown. Instead, the rate cuts have provided a temporary boost by touching off a frenzy of home mortgage refinancing. US homeowners have converted some of the equity in their homes into cash and spent it, partly offsetting the stagnation in their real incomes. Mortgage refinancing has doubled since July 1, and is 600 percent above the level of two years ago.

This short-term boost is largely past, however, and the most recent reports on employment, industrial production, retail sales and consumer confidence have revealed a distinct downward trend.

Fed Chairman Alan Greenspan touched on these concerns in testimony before Congress November 13, one week after the half-point rate cut. He blamed the difficulties in the US economy largely on the September 11, 2001 terrorist attacks, and hailed the actions of the big automobile manufacturers in offering zero-percent loans and huge rebates to stimulate sales of new cars and trucks. He added, however, "[I]t will bear watching to see whether this most recent softening is a payback for borrowed earlier strength in sales."

Greenspan indicated that the mortgage refinancing boom had played a critical role in sustaining consumer spending, but he warned that this could not in the long-run offset the overall decline in household wealth, due to the plunge in the stock market that has hit both pension funds and individual holdings. In other words, American consumers have fewer and fewer resources, but are spending more and more, a process that has definite limits.

As for corporate America, Greenspan offered one of his gloomiest assessments, declaring, "In the business sector, there have been few signs of any appreciable vigor. Uncertainty about the economic outlook and heightened geopolitical risks have made companies reluctant to expand their operations, hire workers, or buy new equipment."

He said that most improvements in corporate profit margins were coming, not from growth, but from squeezing costs and driving up worker productivity. This process, too, has its limits, Greenspan warned. "Businesses may also have managed to eke out increases in output per hour by employing their existing workforce more intensively," he said. "Unlike cutting fat, which permanently elevates the levels of productivity, these gains in output per hour are often temporary, as more demanding workloads eventually begin to tax workers and impede efficiency.”

Put in more straightforward language, the US central bank chief is warning big business that the drive to extract ever greater levels of production from the existing workforce—through speedup, forced overtime, job overloading, and refusing to replace workers when they leave their jobs—risks provoking a response from below.

Even greater pessimism was voiced by the Business Roundtable, a corporate lobbying group representing the 200 largest US companies. It reported November 12 that a survey of its members found that 60 percent expect to cut jobs in 2003, as against only 11 percent who expect to hire more workers. The average projected cut in payroll was 2 percent. More than 80 percent of the companies surveyed planned no increase in investments in new plant or equipment.

Business Roundtable chairman John T. Dillon, CEO of International Paper, issued a statement in releasing the survey’s results. “Our nation’s economic recovery has not been strong or sustained, and the survey shows that CEOs do not expect the situation will improve significantly in 2003,” he said. “Frankly, we are concerned.”

Dillon rejected criticism from Bush administration officials, including former International Paper CEO Paul O’Neill, now treasury secretary, who told a group of CEOs this week that unwarranted pessimism among corporate executives was holding back economic recovery.

“It has nothing to do with mood, or lack of confidence,” Dillon told a press conference. “It’s about the fundamentals of orders, operating rates, profitability and cash flow.”

Despite the efforts to boost business confidence through rate cuts and rhetorical boosterism, the stock market brushed off the Federal Reserve move, rising the day of the cut, then falling the next two days.

Commentators in the business press cited the danger that the US could slip into a protracted Japanese-style deflation as the Fed’s principal concern. The Gross Domestic Product price index, one of the broadest measures of inflation, grew only 0.8 percent in the 12 months ending September 30, the lowest rate since 1950.

According to Morgan Stanley chief economist Stephen Roach, actual price reductions in some sectors of the economy are combined with a slowdown in the rate of price increases in others. “An extraordinary deflationary shock in tradable goods has coincided with outsize disinflation in services, resulting in the most deflation-prone business cycle of the modern post-World War II era,” he wrote in a research note.

BusinessWeek magazine, in a commentary published last week, noted, “Policymakers dismiss the risk of deflation—just as in 1990 it would have seemed far-fetched to predict that Japan would enter a deflationary slump that would last for more than a decade. Yet as Marx reminds us: history repeats itself first as tragedy, then as farce.”

Even more ominous is the growing disequilibrium in the world economy, at a time when all three of the major centers of capitalism—Europe, North America and east Asia—may be sliding into recession simultaneously. Rather than coordinating their monetary policies, the central banks of the US, the European Union and Japan are working at cross purposes.

In response to the Federal Reserve’s rate cut, the European Central Bank (ECB) met November 7 and left interest rates changed at 3.25 percent. This leaves a huge 2 percent spread between base interest rates in the US and the European Union, encouraging a shift in capital to Europe and intensifying the pressure for a downward movement of the dollar against the euro. Britain’s Bank of England and the Swiss National Bank also left their rates unchanged.

ECB President Wim Duisenberg said business confidence in Europe had been undermined by “geopolitical tensions,” essentially blaming the downturn on the aggressive war policies of the Bush administration, which have brought it into direct political conflict with Germany, the largest economy in the European Union.