The Federal Reserve: Can it prevent a recession?

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The Federal Reserve's latest interest rate cut on April 18, 2001 makes it the fourth in the calendar year. Each time, the Fed has cut interest rates aggressively by 50 basis points. The key Federal funds rate, the interest rate banks charge each other for overnight loans is now down from 6.5% at the beginning of 2001 to 4.5 percent, the lowest level since August, 1994. (See table for details of interest rate movements in the past 4 years).

Table

Year	*Months*	*Federal Funds Rate*
1998	January – August	5.5%
	September	5.25%
	October	5.0%
	November-December	4.75%
1999	January- May	4.75%
	June-July	5.0%
	August-October	5.25%
	November-December	5.5%
2000	January	5.5%
	February	5.75%
	March-April	6.0%
	May-December	6.5%
2001	January	6.0%
	February	5.5%
	March	5.0%
	April	4.5%

The Federal Open Market Committee (FOMC), the policy making body of the Fed has explained its latest interest rate cut: "Capital investment has continued to soften and the persistent erosion in current and expected profitability, in combination with rising uncertainty about the business outlook, seems poised to dampen capital spending, going forward. This potential restraint, together with the possible effects of

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earlier reductions in equity wealth on consumption and the risk of slower growth abroad, threatens to keep the pace of economic activity unacceptably weak. As a consequence, the committee agreed that an adjustment in the stance of policy is warranted during this extended intermeeting period."

The Fed's latest interest rate cut is a clear indication of its aggressive approach to monetary policy management. As the Financial Times recently reported, the Fed is trying to convey that it is ahead of the curve rather that responding in alarmist fashion to bad news. Compared to the stodgy ECB, the Fed certainly is certainly looking more decisive. According to Neil Mac Kinnon[1], a senior currency strategist at Merrill Lynch, "The Fed is taking decisive action in an attempt to ensure that any US downturn is brief. This is in stark contrast to the inaction of the ECB." According to another analyst, Sung Won Sohn of Wells Fargo[2], "The Fed evidently has decided that the risk of an economic downturn had increased, therefore, they decided to take out an extra insurance policy to make sure that the economy does not slide into a recession. They sprung an element of surprise. What the market needed was a positive shock." Not only that the Fed has not lost what we believe is a good quality of a central bank – the ability to surprise. Twice in the past four months, it has cut the Federal Funds rate between meetings. And the latest rebound in the US stock markets clearly indicates that Greenspan still has many admirers.

Yet, many including the venerable Economist Magazine feel that Greenspan may be losing his touch. The magazine feels that the Fed did not do enough to curb the irrational exuberance arising out of soaring stock prices. It has argued that the Fed did not pay adequate attention to asset prices and went by conventional measures of inflation. The main charge against Greenspan is that even while sharing his concerns about the irrational exuberance, he has mused loud about America's productivity gains. This has been interpreted as an indirect justification of the rise in stock prices.

We feel Greenspan can hardly be blamed for the volatility in stock prices. It is now becoming increasingly clear that the Nasdaq is resembling the Bombay Stock Exchange. And the reasons are not far to seek. Many of the tech stocks by their very nature have uncertain prospects. Today, the future looks bright. Just a few months later, doomsday prophets predict bankruptcy. Unlike the past, where tried and trusted

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[1] Christopher Swann and Alex Skorecki "Dollar falls on Greenspan rate move" Financial *Times* April 18, 2001.

[2] "Fed cuts interest rate by half a point in a bid to jump start sluggish economy" *Wall Street Journal (Web Edition)* April 18 2001.

companies were listed, today, many corporations with little track record to talk of are being listed. So, ups and downs in share prices can be expected. As a greater understanding of how to value new economy stocks emerges, we can expect the volatility in the stock markets to subside. Moreover, there is no guarantee that a rise in interest rates will necessarily depress the sentiments in the stock market. If the mood is good, the bull run will continue even if the rates go up. Indeed, many of the new economy companies use little debt. So, probably Greenspan could have done little to curb the exuberance of the stock markets even if he had tried.

Contrary to what many analysts feel, the Fed has been quite dynamic in its approach. It has taken note of the fact that more sophisticated supply chain management, facilitated by information technology, has resulted in faster and sharper adjustments to the economic slowdown. So, unintended inventory building has been reduced. Also, as informtion goes online, firms seem to be acting in much closer alignment with each other than in the past. So the adjustment is not only faster but also compressed into a very short span of time. Greenspan has admitted that this increased pace of change may lead to a paralysis of decision making, leading to depressed sentiments and lower investments. In his testimony before the House Financial Services Committee on February 28, 2001, Greenspan remarked "Because the advanced supply chain management and flexible manufacturing technologies may have quickened the pace of adjustment in production and incomes and correspondingly increased the stress on confidence, the Federal Reserve has seen the need to respond more aggressively than has been our wont in earlier decades. Economic policy making could not, and should not, remain unaltered in the speed of economic progress. Fortunately, the very advances in technology that have quickened economic adjustments have also enhanced our capacity for real time surveillance." Greenspan concluded his testimony by arguing that the sharp cut backs being seen now are a response to the excess capacity built up in the US high tech sector in 1999 and early 2000. He argued that the long term strengths of the US economy had not disappeared overnight and the Fed through more aggressive monetary policies could hasten the process of recovery.

Fundamentally, the US economy does seem to be moving in the right direction. Companies are restructuring and cutting costs. Innovations are taking place in Silicon Valley and other places. Among the Internet companies, a shake out is taking place and many weaker players have closed shop. Sentiments can be expected to improve in the coming months. The strong micro economic factors seem to suggest that recession if any in the US will be short lived. And the Fed by its aggressive and pro active measures is doing its bit.

References:

1. Report of "Hearing of the House Financial Services Committee," February 28, 2001.
2. "Fed cuts interest rates by half a point in attempt to spur second half revival," www. wsj.com, March 20, 2001.
3. "Beware of heroes," *The Economist,* April 14, 2001, pp 15-16
4. Federal Open Market Committee Statement on interest rates, April 18, 2001
5. Christopher Swann and Alex Skorecki, "Dollar falls on Greenspan rate move," *Financial Times*, April 18, 2001.
6. "Fed cuts interest rates by half a point in bid to jump – start sluggish economy," wsj.com, April 18, 2001.
7. Federal Reserve Monitor, www. wsj.com