US Fed cuts rates, citing decline in investment

By Nick Beams
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The Federal Reserve Board has again cut interest rates by 0.5 percent amid signs that the only thing preventing the US economy from sliding into recession is the maintenance of consumer spending.

Announcing the cut on Wednesday, the fifth in as many months, the Fed brought its rate down to 4 percent, its lowest level in seven years.

In its statement the Fed said a reduction in excess inventories, to which it had pointed in earlier statements this year, seemed well advanced and consumption and housing expenditures had held up "reasonably well, though activity in these areas has flattened recently."

But it was a different story in the crucial areas of investment and profits—the driving forces of the economy.

The Fed pointed out that investment in capital equipment had "continued to decline" and that the slump would not end soon.

"The erosion in current and prospective profitability, in combination with considerable uncertainty about the business outlook, seems likely to hold down capital spending going forward. This potential restraint, together with the possible effects of earlier reduction in equity wealth on consumption and the risk of slower growth abroad, continues to weigh on the economy."

Holding out the prospect of a further rate cut before the next scheduled meeting of the Federal Open Market Committee at the end of June, the Fed statement said inflation was expected to be contained and that "the risks are weighted mainly towards conditions that may generate economic weakness in the foreseeable future."

A comment on the Fed decision by Standard & Poor's economist David Wyss highlighted the growing instability of the US economy, which is only being held up by high levels of consumption spending, much of it fuelled by increases in debt.

"What is keeping us out of recession is the consumer," he told Reuters. "There is a risk of a sudden attack of prudence. If people stop living beyond their means, this could turn into a recession."

Earlier this week statistics produced by the Fed on industrial production showed the continuing decline in the US economy. Output from mines, factories and utilities dropped by a seasonally adjusted 0.3 percent in April, the seventh consecutive monthly decline, and 1 percent below that of a year ago. The industrial capacity utilisation rate fell by 0.4 percent, compared to the previous month, to 78.5 percent, the lowest in more than a decade, and 4 percent down on the corresponding month last year.

The fall in industrial output has found its expression in employment figures. The manufacturing industry has lost more than 500,000 jobs in the past 10 months and the latest figures from the Fed point to more job losses in the future. Last month the unemployment rate rose to 4.5 percent as employers cut 233,000 jobs, the highest level in a decade.

Profit figures point to a fall in investment, output and consequently jobs. According to data compiled by *BusinessWeek* in a Corporate Scorecard, profits for some 900 companies fell by 25 percent in the first quarter. This was the biggest quarterly decline since the 1990-91 recession and the second consecutive quarter in which profits fell at a double-digit rate.

The sharp fall in investment, particularly in hi-tech areas, has prompted some gloomy assessments of the future course of the US economy. One of these was set out by *Washington Post* columnist Robert Samuelson in an article last month entitled "Greenspan vs. The Glut."

"We are now witnessing a startling collapse of US investment spending in the telecommunications sector—fiber-optic networks, switching equipment, the Internet," he wrote. "This is bad enough, but if it spreads to other industries it will quickly darken the economic outlook. The danger, in a word, is gluts. Excess capacity might overwhelm the Federal Reserve's campaign to revive economic growth through lower interest rates. Companies will not borrow and invest if they already have ample ability to meet demand.”

The crisis in the telecommunications industry has emerged in the wake of the massive overinvestment following the break-up of AT&T in the 1980s and the further deregulation of the industry in the past decade. Whereas there were three long-distance companies at the end of the 1980s, there are now at least 15 providing national fiber-optic networks for voice and data.

It was the expansion of these companies which fueled the growth of high-tech firms such as Cisco, Nortel, Lucent and others which supplied the equipment. But this growth was financed by an explosion of debt. From 1995 to September last year the debt of communications carriers quadrupled from $75 billion to $300 billion. In relation to sales, debts rose from 37 percent in 1995 to almost 100 percent at the end of 2000.

It is significant that the growing recessionary tendencies in the US economy are centred in the high-tech, telecommunications industry, for it was this industry, above all, which was held up as an example of the “magic of the market” and the power of the so-called “new economy.”

But it seems some old economic laws concerning the inherent wastefulness, anarchy and instability of the market and the profit system could now be asserting themselves, giving rise to serious concerns about the future.

According to Samuelson: “The larger worry now is the possibility that the retrenchment in telecommunications is just a harbinger of others. Companies curb new investment, because profits are down and they decide they were too optimistic about future demand. This would be a stunning blow. It would, almost certainly, raise unemployment and lower consumer confidence. It threatens a self-fulfilling prophecy: Declining investment spending leads to less consumer spending, which in turn worsens investment gluts and dampens profits, stock prices and confidence.”

While supporting a further interest rate cut, Samuelson did not seem to believe that it represented a viable overall strategy.

“The Fed is playing for time,” he wrote, “hoping that consumer spending and confidence—already somewhat shaken—remain resilient until the worst of the investment cutbacks have passed. As a monetary maneuver, this has a high degree of difficulty: somewhere between daunting and impossible.”

Another warning about the implications of the current downturn for the longer-term direction of the US economy was published in the *Financial Times* this week. According to Morgan Stanley chief economist Stephen Roach the US economy could be moving into a period of much slower growth.

Over the next three years growth could fall to between 1.5 to 2 per cent, less than half the 4.5 percent average recorded between mid-1995 and mid-2000. According to Roach, who has previously warned that the present situation is much more like pre-World War Two recessions resulting from over-capacity far worse than anything experienced in the past 50 years, a number of “structural flaws” have developed in the US economy over the past several years. These include record capital spending, rising corporate and consumer indebtedness, and a record balance of payments gap.

“Insofar as these structural and cyclical excesses took years to build,” he wrote, “it seems highly unlikely they will be purged quickly. That will not stop the authorities from trying to jump-start the economy, as a panic-stricken Federal Reserve is now attempting to do. But given the unique strain of systemic imbalances and excesses that have built up in private sector balance sheets, the quick fix of monetary and fiscal stimulus is not likely to work this time.”