

# The Bear's Lair: Fed pushing on a string

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WASHINGTON, Nov. 4 (UPI) -- The Federal Funds futures market at midday Monday indicated a certainty of a 0.25-percent Federal Funds rate cut at the Federal Open Market Committee meeting Wednesday, with a 15 percent chance of a 0.50 percent rate cut. The stock market seems to have greeted this likelihood with whoops of joy; one is forced to ask: why?

During 2001, the Fed made a total of 11 cuts in the Federal Funds rate, dropping it from 6.5 percent to 1.75 percent. The result was not the expected economic recovery but an economy that, while showing strength in the first half of 2002, has dropped back since, and is now showing distinct signs of weakness. The Challenger Grey and Christmas tally of layoff announcements, released Monday, jumped from 70,057 to 176,010, the second highest level this year, indicating that layoffs were once again accelerating. This belief was confirmed by the weekly initial claims for unemployment, released Thursday, which moved back above the critical 400,000 level, by the monthly unemployment figures, released Friday, which showed a net 5,000 job losses (115,000 gains per month are needed to absorb new job market entrants) and by the Institute of Supply Management Index, released Friday, which showed a further drop below the break-even 50 percent level.

Monetary policy, extremely stimulative during 2001, became less so during 2002, no doubt through no fault of Greenspan's. M3 money supply, which had increased by 13.2 percent in the year to November 2001, increased at an annual rate of only 5.6 percent in the 10 months from then to September 2002.

This looks restrictive, but even the latter rate, with inflation running at no more than 1.5 percent per annum, is sufficient to accommodate an annual growth in gross domestic product of more than 4 percent, surely adequate for most purposes. A further drop in interest rates may have little effect on the real economy, since monetary policy appears to be losing its effectiveness. With economic growth sluggish, and stock prices declining, the Fed is to some extent "pushing on a string" -- there is simply not that much demand for money. Notoriously, monetary policy takes six to nine months to have any effect, so a rate cut now may simply provide further inflation for the housing bubble, while doing nothing to help the non-housing economy.

At some point, Fed Chairman Alan Greenspan is going to have to wake up to an unpleasant reality: he has been operating since 1996 on the wrong playbook. On Dec. 4, 1996, he made his famous comment that the stock markets were in danger of "irrational exuberance." Had he at that time raised interest rates sharply to counter the asset price inflation that was gathering speed, the United States would have suffered a short sharp recession, that would have been over by 1998. Instead, he discovered the joys of the productivity miracle, and spent the next half-decade justifying ever-higher stock prices by claiming that U.S. productivity had moved onto a new permanently higher growth track.

As exhaustively demonstrated here two weeks ago, this is not the case. U.S. labor productivity growth does not appear to have moved onto a significantly higher growth track in the middle 1990s, even without discounting the effect of the 1997-2000 tsunami of capital spending. In any case, productivity growth since 1995 has clearly been significantly lower than for the quarter century following World War II. Accordingly, stock valuations, too, should be no higher than they were during the latter part of that quarter century period, when fears of the Great Depression had worn off. However, the S&P 500 Index, following the recent recovery in stock prices is once

again trading at more than 50 times true trailing earnings, three times its 1960s average. The market thus remains substantially overvalued, by any historical measure.

If however the stock market is overvalued, then lowering interest rates, reflatting the economy, and producing stock price resilience simply defers further the necessary return to an appropriate valuation level. The example here is Japan, whose stock market was not allowed to find its equilibrium level in the early years after the 1990 peak, but instead was artificially sustained in an effort to prop up the capital base of the Japanese banking system. As a result, each trough in the Japanese stock market has been lower than the previous one; the Nikkei 225 Index, over 39,000 in January 1990, bottomed at 20,000 in 1992, 15,000 in 1994, 13,000 in 1998, 9,500 in 2001 and 8,400 (so far) in 2002.

This slow erosion has been far more damaging to investor confidence than a sudden drop, even a huge one such as that in the United States in 1929-32, in which the Dow Jones industrial index lost 88 percent of its value in 33 months, before beginning its long slow rebound. Investors in Japanese stocks have seen their money eroded for more than a decade, and each time a bottom appears to have been reached it is shown to have been a false one. Japanese investor confidence is consequently very low. Even a rebound in industrial activity (Japanese industrial production, announced last Tuesday, is no less than 4.9 percent higher than in September 2001, or 3.5 percent higher than last year in the third quarter as a whole) is producing no rebound in stock prices.

On this basis, if Greenspan continues to pump money into the economy in order to reflate it, the Dow Index will bottom out, not at 5,000 in 2003, as it might have done had he kept monetary policy steady in 2001-2, but at 2,500 in 2012. The result will be that a generation of investors will shun equities at all costs, preferring the relative security of bonds, money market funds and of course gold. Economic growth will thus be stunted, and productivity growth will revert to the anemic levels of the late 1970s, when the Arab oil crisis, poor economic policy and high taxes caused it to stagnate for a decade.

The central economic question of our time is this: are the U.S. and world economies better off having had the bubble of the '90s, followed by the recession since then? Alan Greenspan, in testimony to Congress in August 2001, emphasized his belief that the bubble experience was well worth it. Now he would presumably be less sure.

Whether or not Greenspan cuts interest rates next week, it is likely that by the time of the presidential elections in 2004 we will know for a fact, and not just an opinion: the bubble of the late '90s was a chimera, it has done incomparable economic damage that may last a decade or more, and we would be far better off by any reasonable measure if it had not occurred.

In that context, it probably doesn't matter what Greenspan does on Wednesday. Either way, by November 2004 his reputation will be in ruins.

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(The Bear's Lair is a weekly column that is intended to appear each Monday, an appropriately gloomy day of the week. Its rationale is that, in the long '90s boom, the proportion of "sell" recommendations put out by Wall Street houses declined from 9 percent of all research reports to 1 percent and has only modestly rebounded since. Accordingly, investors have an excess of positive information and very little negative information. The column thus takes the ursine view of life and the market, in the hope that it may be usefully different from what investors see elsewhere.)

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