



Saturday, November 09, 2002

# The Fed's Prescription for Disaster

## An Interview with Frank Shostak

[Posted November 7, 2002]

*Frank Shostak is an economist at Man Financial, Australia. He was interviewed following the announcement of the Fed's latest policy move.*

**Mises.org:** The Fed has lowered the interest rate, again, and it seems that the whole world is celebrating.

**Frank Shostak:** Actually, it is a disastrous move, so far as I'm concerned. Last year, the Fed cut interest rates 11 times. Why anyone should believe the 12<sup>th</sup> is the charm is beyond me. From the end of last year until now, the federal funds rate was 1.75 percent, and now we have a very aggressive lowering by half a percent to 1.25 percent.

This indicates desperation. It shows that the Fed believes the economy is doing poorly, more poorly than is usually reported, but that they have no idea why or what to do about it.

**Mises.org:** Why does the Fed say it is lowering rates?

**Shostak:** The Fed believes it has to fight deflation. This is in addition to its traditional claim to be fighting *inflation*. So now we find that the Fed is fighting both inflation *and* deflation. In truth, the Fed doesn't fight inflation; it creates it, and in doing so, it creates the foundation for deflation. They are fighting the problem with the same means that they used to create the problem in the first place.

**Mises.org:** What does the lowering of rates mean for the supply of money and credit?

**Shostak:** If you read the Fed's statement, you see that creating money is the goal. If you look at the money base, the latest figures for October, increases were running 6.7 percent year on year. In September, the increases were running 5 percent. So already, the Fed was pushing quite a bit of new money into the system. It won't surprise me to see them really step it up now.

While the Fed is going to do its best to inflate the money, it can happen that money supply won't increase - depending on the behavior of banks. If banks stop lending, due to tighter credit standards or fewer borrowers, the money supply will not respond. This is what happened in the 1930s

**Mises.org:** What is the current situation with regard to lending?

**Shostak:** Consumer and real estate loans by commercial banks are still strong. But business loans have been declining on a yearly basis for 15 months in a row. Credit standards are

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tightening and many businesses have difficulties to obtain credit. Also, the debt-to-asset ratio in business is at the highest level as far back as we have data.

In short, banks are happy to lend to consumers and on real estate and mortgages. But in the business sector, the credit crunch is real. The possibility that the US could end up like Japan is quite high. Given the record high consumer debt-to-assets ratio I envisage that banks will slow their lending to consumers in the months ahead.

**Mises.org:** You mean a persistent lag in productive capacity, a kind of long-run recessionary environment that doesn't go away.

**Shostak:** Right. If you look at industrial production, we see that the cyclical component—which is the underlying movement in relation to the long-term trend—has been below the trend for 18 months.

This raises a question. If you have had such aggressive lowering of interest rates for so long, from 6 percent to less than 2 percent, and nothing has happened to industrial production, that immediately raises the possibility that we are dealing with something more serious than people realize.

The analogy between the US and Japan is increasingly conspicuous. In both cases, the central bank has lowered rates to virtually nil, and not revived the economy. Most of the recent indicators in the US have been declining.

**Mises.org:** How does this square with forecasts?

**Shostak:** All the official forecasts said that by now we should have a strong recovery. Yet it is nowhere to be seen. All the Keynesian and mainstream forecasters have been completely wrong. Yet no one says anything about it. Meanwhile, the Austrians have been completely right in their forecasts.

In the symposium we had early last year at the Mises Institute, the Austrians all predicted that there would be a shallow recovery that would quickly peter out. This was in contrast to what most everyone else in the major investment houses said. They said that the recovery would be there by this time last year. Well, the Austrians have been correct.

And only the Austrians have an explanation. As with Japan, it appears that the pool of real funding--the real resources available in society for production and consumption of wealth--could really be in trouble. If the pool of funding had been there, the lower rates would have created a big rebound. But that has not happened.

**Mises.org:** If the Fed believes money is the answer, why doesn't it just reduce rates to zero?

**Shostak:** The worry is that this would produce panic. It would underscore the reality that the Fed is incapable of producing wealth from its printing press. It would show that the Fed is completely powerless, except to produce mis-signals that generate malinvestment. The only thing that might temporarily move is the stock market.

**Mises.org:** To what extent is the Fed looking at stocks as a proxy for the whole economy?

**Shostak:** It does seem that the Fed is watching stocks very closely. They believe that if the Fed can raise valuations, that will have a psychological impact and causes consumers to spend and producers to borrow, and the economy will pick up. But this is complete nonsense.

The stock market does respond to cuts, even to the prospect of cuts, at least temporarily. On October 9, the Dow fell to a low of 7,286. Today it closed at 8,771, an increase of 20 percent.

The S&P has increased 19 percent, and Nasdaq has risen by 27 percent. But the issue here is that valuations are becoming extremely high, once again.

**Mises.org:** And so you regard yet another downward correction as highly likely.

**Shostak:** Most certainly. To give you an indication, look at the dividend yield on the S&P, a good measure of valuation. We are currently seeing a yield of 1.6-1.7 percent. If you look at the historical average from 1900 until today, it is 4.3 percent. This means that if reality asserts itself, as I believe it will, stocks are going to follow suit and dividend yield should increase. Consequently, there is a high likelihood that the S&P500 could half from its current levels.

Eventually you have to look at what is happening to real corporate profits. So far, the indications are not that good. You can do lots of things with smoke and mirrors, but the bottom line is that genuine profits cannot be created right now. It is not possible, given the level of debt-to-assets on all levels. The bottom line is just not there. I cannot agree with those who say that we have seen the worst.

**Mises.org:** Any other indicators to watch?

**Shostak:** All the ratios of capital goods to consumer goods production are still at very high levels. This means that the adjustment we need has barely begun. If we look at the consumer sector, at durables versus non-durables, that's even worse, which means that we are a long way from meaningful economic recovery.

What we need if we want recovery is a big liquidation of capital goods, to normalize it with the consumer goods sector. And in the consumer sector, we need a reduction in the durable goods production relative to non-durable goods production. The Fed should not attempt to forestall that.

**Mises.org:** Sometimes it is said that Greenspan is the most powerful man in the world.

**Shostak:** Right, but this reminds us that this powerful man only has one tool at his disposal: printing money. And this tool only creates an illusion. One cannot create real wealth by printing money. If printing money could create wealth, there would not be poverty in the world today. Every third world country could print money and become rich. There would never be a recession. We would have perennial wealth creation with no effort.

You can pump all the money you want but it does not create anything; it only destroys. It creates a misallocation of resources, consumes capital, and makes everything much worse.

**Mises.org:** With all the new money, why don't prices respond more dramatically?

**Shostak:** Prices have not responded because businesses do not have pricing power. The reason is that people don't have as much real income as they used to have. If you don't have the means to spend, it is hard for business to raise prices.

There would be price inflation if people were spending at the same level as they used to. When production is falling, those who produce have less means of payment. We are looking at a snowball of downward pressure.

**Mises.org:** What would you tell Greenspan today?

**Shostak:** I would tell him that what he has done in lowering rates is delay recovery by many months and maybe many quarters.

**Mises.org:** This is why Greenspan doesn't call you.

**Shostak:** Well, true, but at least the Mises Institute does call.

Frank Shostak is an adjunct scholar of the Mises Institute and a frequent contributor to Mises.org. Send him [MAIL](#) and see his outstanding Mises.org [Daily Articles Archive](#).

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