Policy Note 1998/5

The Fed Should Lower Interest Rates *More*

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Before the recent troubles in the U.S. stock market, some analysts argued against monetary ease, fearing that it might fuel a speculative stock market boom. Alas, given the recent substantial "market correction," this objection may safely be put away.

The recent quarter-point reduction in the federal funds rate is both insufficient and late. The stock market's "readjustment" continues to occur despite the fact that it is ever more clear that there is no significant inflationary threat. Indeed, the evidence is substantial that the United States and the world economies stand on the precipice of deflation. In his testimony before the House Committee on Banking and Financial Services on September 16, Federal Reserve chairman Alan Greenspan recognized these worldwide "deflationary forces" and even hinted that the Fed might lower interest rates at some point in the future; he refused, however, to endorse a concerted effort by the major central banks to lower interest rates around the world. The appropriate action for the Fed is to further loosen monetary policy and reduce interest rates more. While we do not believe that this will automatically prevent the coming deflation, a further reduction in U.S. interest rates will relieve some deflationary pressure, and the Fed will be able to look back upon the fall of 1998 in the knowledge that it got policy right.

Deflation around the World

As is well recognized, there are significant deflationary pressures in various areas of the globe. To some extent, these come from the collapsing Asian and Russian economies and also from the stagnant economies south of the U.S. border. UNCTAD forecasts that Hong Kong's output will contract by 2 to 3 percent next year; Thailand's economy will contract by 8 percent; Indonesia will have negative growth of more than 12 percent; and Malaysia and the Philippines will probably slip into recession. Japan continues to suffer severe recession with no serious observers expecting recovery in the foreseeable future. UNCTAD predicts that China's growth will slow from double-digit rates to a projected 6 percent (and it is likely that future projections will cut that in half); Latin American growth will slow to 3 percent; Europe's growth rate will come down to the order of 2.1 percent as a result of integration and the spread of the Asian flu. World output for 1998 and 1999 (as projected by J.P. Morgan) will grow by approximately 1.5 percent and 1.7 percent, respectively, falling short of the 4 percent average posted in 1996 and 1997.

Perhaps more important, commodity prices, wholesale prices, labor costs, and even retail prices have been stagnant or even falling for quite some time. In other words, the deflationary pressures are chronic and are not simply the result of what might be only temporary financial problems in Asia, Russia, and some Latin American economies. For example, by July, the Bank of Nova Scotia's commodity price index, measuring price trends in Canada's major exports, had fallen 12 percent below the previous July's index. Hourly wages fell 0.6 percent in Japan during 1998. Unit labor costs fell 0.6 percent in 1997 for advanced economies, and 1.3 percent for major industrial economies; throughout 1997, unit labor costs fell in the United States, Japan, Germany, and France. Since 1990, unit labor costs have fallen an average of 0.7 percent per year in Germany and 0.3 percent in France; they have generally been falling in the major industrial economies since 1994. In addition, the GDP deflator has been consistently below 2 percent for the major industrialized countries since 1994. With only a few isolated cases experiencing inflation above 4 percent (Greece, Israel, and Korea), inflation disappeared as a significant economic problem for advanced economies by the mid 1990s.

Prices also are falling in the United States:

- The producer price index for August declined by 0.4 percent.
- Prices of intermediate goods fell by 2.1 percent during the 12 months that ended in August.
- The crude goods index fell by 2.7 percent in August, following a 1.8 percent drop in July; prices for crude foodstuffs and feedstuffs fell by 1.1 percent in August and 2.8 percent in July; corn prices fell by 5.1 percent in August and will almost certainly fall further due to bumper crops.
- A recent report on National Public Radio noted that the price of steel had fallen by more than 40 percent over the past year (prices for iron and steel scrap fell by 7.4 percent in August alone), largely as a result of the Asian crisis and the strong dollar. (In fact, so much steel had been unloaded at the port in New Orleans that port managers were looking into using the employee parking lot to store it temporarily.)
- The September 5 issue of *The Economist* reported that its all-items commodity price index had declined 30 percent since mid 1997 to the lowest level for the index in real terms in over 25 years. It also noted that the U.S. Department of Commerce calculates that the prices of industrial commodities are at their lowest real level since the 1930s.
- The September 21 issue of *Forbes* reported that since January 1 of this year, prices have fallen by 25 percent for coffee, 27 percent for corn, 58 percent for Pentium II processors, 27 percent for milk, and 18 percent for gasoline.
- The CPI for all urban consumers rose by only 0.1 percent in August, or at a 1.2 percent annual rate. Since the Boskin Report estimates that the CPI overstates inflation by 1.1 percent, this means that CPI inflation is essentially zero.

Although declining asset prices do not pose the same sorts of problems generated by falling commodity prices or retail prices of final output, they do indicate that financial markets recognize that the outlook for private sector profits around the globe is not rosy. As of Friday, September 11, U.S. stock prices had fallen by more than 18 percent since the market peak; Mexican stock prices had fallen by 58 percent this year; Brazilian stock prices had fallen by more than 60 percent since their peak; British stock prices had fallen by nearly 17 percent since their peak; German stock prices had fallen by 23 percent since their peak; and Japan's moribund stock market had fallen by 15 percent since its latest peak. Not only do these falling stock markets reflect pessimism, but they are also likely to have a negative impact on consumer investment and business demand around the world. Higher stock prices make equity finance for investment cheaper and engender consumers' confidence by making them feel richer so that they spend more. Stagnant, or lower, stock prices will discourage investment and consumer spending.

The Real Costs of Deflation

While the Federal Reserve has focused almost exclusively on the dangers of inflation for most of the past two decades, most studies find these dangers are very low. For example, Michael Bruno and William Easterly (chief economist and principal economist, respectively, at the World Bank) show that inflation below 40 percent per year has no discernible effect on economic growth and even inflation above 40 percent causes only temporary damage to growth. Although the United States has no recent experience with deflation, there is reason to believe that the real costs would be quite high.

Deflation increases real interest rates and debt burdens. While it may be true that deflation would generate falling nominal interest rates (lowering real rates), even the shortest-term interest rates are constrained to positive nominal rates. And many debtors will be stuck with longer-term, fixed rates that will rise in real terms. Although the negative impact on debtors is partially offset by higher real returns to their creditors, this is true only so long as debtors are able to meet their contractual liabilities. As Wynne Godley of the Levy Institute has demonstrated, the U.S. private sector has been running record deficits and accumulating record debts. As the prices that U.S. firms can obtain in an era of deflation begin to fall, they will find it increasingly difficult to meet their obligations. Bankruptcies can easily wipe out all the real gains that creditors expect to reap from higher real yields on the IOUs they hold.

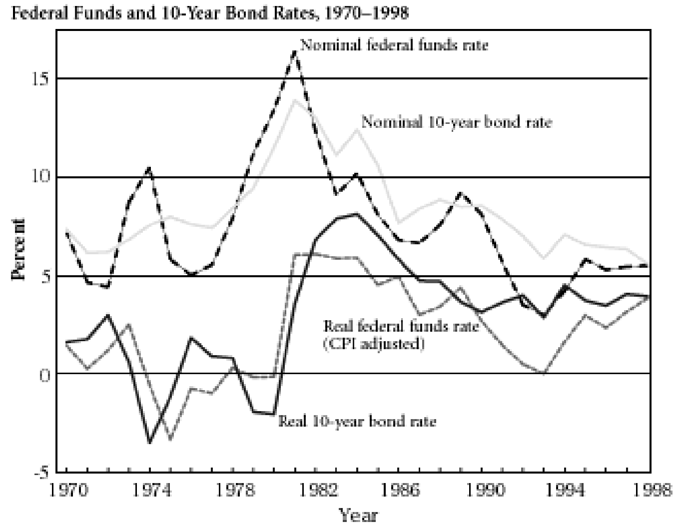
Deflation also discourages investment, research and development, and technological advance because firms cannot be reasonably sure that their expenditures can ever be recovered in an environment in which prices are falling. Many pundits try to extrapolate from rapid technological change and falling computer industry prices to conclude that deflation is beneficial. This confuses cause and effect. Many products--especially high-tech consumer goods--follow a normal product cycle in which rapid advance and highly competitive conditions lead to falling prices until the industry matures with fewer suppliers and stabilized prices. This is quite different, however, from a situation in which prices are falling because of depressed demand conditions, which, rather than encouraging innovation, simply discourage investment. Falling prices following rapid technological advance should not be turned into an argument that falling prices *cause* technological advance.

Deflation also discourages home ownership. For most Americans, equity in the home is the main form of saving, outside retirement savings. Deflation will increase the burden of mortgage payments on either fixed- or variable-rate loans and will reduce the possibility that owners can accumulate equity in their homes (unless real estate prices should buck the trend--an unlikely event). This will have wide-reaching deleterious impacts. For example, it will be more difficult and expensive to obtain home equity loans for making home improvements or paying college tuition for children. While it is true that rapidly rising housing prices can generate speculation with subsequent problems, this does not mean that falling prices cannot have deleterious effects. No one can doubt that neighborhoods with falling real estate prices experience significant problems quite apart from problems that might have caused the falling prices.

Current Fed Policy and Real Interest Rates

Although nominal federal funds rates and 10-year bond rates are not currently high by historical standards, real interest rates are quite high. Adjusting nominal rates by the inflation rate (as measured by the CPI), we find that the current 3-month Treasury bill rate is 3.39 percent-- the highest since 1986, nearly double the average since 1970 (1.8 percent), and higher than the rate achieved in all but six years since 1970. As the graph shows, the fed funds rate, which is strictly determined by monetary policy, is 3.86 percent in real (CPI-adjusted) terms, far higher than the post-1970 average of 2.6 percent. As economists are now aware, the CPI almost certainly overstates the true rate of inflation. Thus, we have also analyzed "Boskin" real rates, which adjust the CPI downward by 110 basis points to account for the Boskin Report estimate of the most likely bias of the CPI. This means that real interest rates are higher; in Boskin-adjusted real terms, the corporate bond rate is 6.1 percent and the federal funds rate is nearly 5 percent--well above the long-term average.

Federal Funds and 10-Year Bond Rates, 1970–1998



Note: 1998 data are for the first six months of the year.
Source: Board of Governors of the Federal Reserve System: http://www.bog.frb.fed.us/

Such high real rates might be justified in a regime of high inflation, such as that which existed in the early 1980s, but not at present when there is a great deal of evidence that significant disinflationary, if not deflationary, pressures exist.

Before the recent troubles in the U.S. stock market, some analysts argued against monetary ease, fearing that it might fuel a speculative stock market boom. Alas, given the recent substantial "market correction," this objection may safely be put away. In any case, it is likely that financial markets, as they usually do following a market correction, have concluded that interest rates are likely to continue to come down, so that any further easing by the Fed will just confirm expectations that are already incorporated into market prices.

The Benefits of Lower Interest Rates

Current high U.S. interest rates are contributing to world crisis by keeping the dollar high, hurting our continuing abysmal (and unsustainable) trade imbalance (our current account deficit hit $56.5 billion in the second quarter of 1998, up 21 percent from the first quarter), and encouraging capital flows out of weak currencies into the U.S. dollar. Lower U.S. interest rates and depreciation of the dollar would be good for the world economy, especially for world financial markets. Depreciation of the dollar would benefit U.S. firms that have to compete with cheap imports, especially from Asian countries that have had huge currency devaluations. South Korea is already running a trade surplus, partly at the urging of the IMF, and will almost certainly increase the supply of cheap imports to the United States during the coming year. While the prospects for U.S. exports are not great, an overvalued dollar is making the situation increasingly worse.

Furthermore, lower interest rates would increase disposable family income for the millions of indebted American families that would be able to negotiate lower mortgage and consumer lending rates, thereby lowering debt burdens. Lower interest rates could also prevent the demand for housing from falling too much.

Lastly, lower interest rates might reduce some of the pressures on Wall Street. Indeed, recent hints that rates might go down have reversed some of the market sell-off. Many commentators have noted that the huge run-up of stock prices played an important role in fueling the economic expansion of the 1990s and in raising tax revenues to allow the federal government and some state governments to reduce fiscal deficits. Lower rates automatically reduce government finance costs on outstanding debt by reducing the portion of the budget devoted to servicing the outstanding debt.

If the United States goes into recession and reduces its level of imports, it is likely that world output also would fall. The challenge to policymakers in the United States and elsewhere is to cut interest rates and even to allow budget deficits to occur or widen. It is the only remedy to avert a deep global recession.

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