

The Fed's Surprise: The April 18th Cut in Perspective

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The last time the Federal Reserve's Open Market Committee cut interest rates by 200 basis points was in 1991 and it took them 10 months to do it. The speed of the monetary easing this winter and spring – four cuts in just over three months – has really taken everyone's breath away! There is a clear sense of urgency that is without precedent. Do Alan Greenspan, Fed chairman, and his colleagues know what they are doing? Do they know something that none of the rest of us do? Why not wait until the next meeting in mid-May? The answers are: yes, no and once you decide, why not do it? Let me elaborate.

While it is true that the Fed systematically collects anecdotal evidence on the state of the US economy from a network of contacts maintained for times just like these, its information is basically little different from anyone else's. It is no secret that the US economy has slowed dramatically over the past six months or so, and that the collapse of business investment is very worrying. Concern initially focused on the build-up of inventories in old economy sectors such as automobiles and manufacturing; now the abysmal performance of the information and technology equipment producers is the source of anxiety.

The sharp fall in high-technology investment is a deep concern not only for current growth, but for the future as well. Investment in IT equipment and software was growing at a rate of 20 percent a year or more during the latter half of the 1990s – a significant driver of the economy in its own right. But there is increasing evidence that a significant portion of the new-economy miracle is a consequence of the efficiency generated from using this equipment; it helped generate the higher productivity of the US “new economy miracle.”

Over the last calendar year, however, there are reasons to believe that IT investment has actually been shrinking. The producers are certainly in bad shape, as the very poor first-quarter earnings reports that have come in over the past few weeks confirm. Anecdotal evidence is there too. The other day I saw a newspaper advertisement in which the Dell Computer Corporation offered a price cut on a high-speed server. I don't recall ever seeing such an ad before, and like most consumers I have no personal use for such an item.

Much of the concern arising from the recent sharp falls on Wall Street relates to the sell-off's possible impact on consumer spending – the “wealth effect.” In fact, household spending remains strong, and continues to grow at 2-3 per cent annually. The more pressing concern is that a major channel for financing corporate investment has been shut down. During the Nasdaq boom of the late-1990s, public stock sale was a major source of funding, especially for new-economy companies.

It is here that the Fed's thoughts must have been focused, as this is where the central bank interest rates have the most leverage anyway. While business equipment purchase decisions are

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surely sensitive to future overall prospects, in the short term they are influenced heavily by the cost and availability of funding. With the ability to raise money directly in capital markets so heavily curtailed, companies will turn back to traditional funding channels such as bank loans. Everyone's hope, the Feds and mine included, must be that significantly lower interest rates will give a significant push to high-tech investment.

That does not mean, however – as some complain – that the Fed is targeting the market.

So why did it act at the moment when everyone least expected it? And why didn't the Fed's policymakers on the open market committee cut interest rates by a full 100 basis points at its last scheduled meeting on March 20?

Taking the second question first, it is important to note that such a large cut would be absolutely unprecedented since federal funds rate targeting began in earnest almost 20 years ago. Central banks in general, and the Fed in particular, tend to move cautiously. Given the importance of their actions, they reason, it is best to wait for uncertainties to resolve themselves, to be absolutely sure, before making a move. This means a large number of small interest rate changes rather than a small number of large ones.

Why now? The answer to this question is, I believe, mundane. It is obvious that during turning points in the business cycle evidence on the state of the economy can accumulate more quickly than during periods of stability. This is true both of information that shows things are better than people thought they might be and, crucially, evidence that they are not getting better. Wednesday's decision can be explained by the lack of any unexpectedly good news. For Mr. Greenspan, no news was bad news.

And once evidence has accumulated for a move, why wait? It seems somewhat silly to be bound too closely to the rather artificial schedule of eight meetings per year that the FOMC has set. Wednesday's announcement came at almost exactly the mid-point between the March and May scheduled meetings, suggesting the possibility that the Committee members agreed in mid-March that they would need to take stock before they met again.

The speed of the four successive federal funds rate target cuts has been astonishing. The significant slowdown in real growth and the need to insure that the U.S. economy does not sink into a recession provide ample justification. But while focusing on maintaining high real growth and employment is appropriate at times like these, there is a trade-off. Monetary policy easing intent on stabilizing growth risks setting off future inflation.

Looking back over the past year or so, we see that inflation has risen from a trend of two percent or less to one that is now closer to three percent. Lower interest rates today could easily lead to even higher inflation next year.

Good policy now is rarely good policy later, as the risks the economy faces are constantly changing. Once this phase is behind us, policymakers will have to return their attention to maintaining price stability. If they wait too long, U.S. inflation will rise to unacceptable levels.