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This Is Not the Next Depression!

Stephen G. Cecchetti*
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Interest rates in the US are now at their lowest in 40 years. After 10 reductions in as many months, the Federal Reserve's target rate has fallen from 6 per cent to 2 per cent. With consumer price inflation running at more than 2 per cent, the overnight real interest rate has probably fallen below zero.

These unprecedented interest rate reductions have, however, failed to stem the steep decline in business investment suggesting, to some, that monetary policy has become relatively ineffective. Indeed, an increasing number of analysts draw parallels with both Japan in the 1980s and America in the Great Depression.

Karl Marx wrote that history repeats itself, first as tragedy and then as farce. The worldwide cataclysm of the 1930s was a clear tragedy, and the Japanese experience of the 1990s contains elements of farce. But does the US stand on the brink of deflation? I think not.

It should come as no surprise that the funds rate cuts have had very little direct impact on business borrowing. After all, investment decisions have never been very sensitive to movements in short-term interest rates. Monetary policy operates through banks, and remains effective so long as the financial system continues to function normally.

The US financial system is strong, and that the Federal Reserve knows its job is to keep it that way, is precisely why fears of deflation are misplaced. Low short-term interest rates act as a subsidy to banks, and so provide insurance against exactly the type of collapse that seen in Japan or during the Great Depression.

In the 1930s the Fed simply did not understand the importance of ensuring liquidity of the financial system, and followed a policy that ultimately led to severe price falls. Deflation caused default, leading to bank failures, which reduced the quantity of money in the economy, thereby exacerbating the deflation.

What about the more recent experience of Japan? Here, again, the story is about the financial system, with banks taking centre stage. Over the past 15 years or so, they have sustained huge loan losses, leaving many insolvent.

* Professor of Economics, Ohio State University, and Research Associate, National Bureau of Economic Research. ©2001 by Stephen G. Cecchetti. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without permission provided that full credit is given to the source.

As Takeo Hoshi and Anil Kashyap⁺ describe, deregulation of the bond market allowed the banks traditional corporate customers to find cheaper financing elsewhere. This forced the banks to find new lines of business, including more speculative property lending. All of this began at the worst possible time, at the height of the Japanese property price bubble. Add to this lending to borrowers in emerging Asian countries and the fact that banks purchased equity at the height of the Japanese stock market, and the stage was set for disaster.

After a series of calamitous setbacks in the 1990s the Asian crisis, the stock market and property market crashes many Japanese banks today have nothing left. There is serious question about the solvency of almost every Japanese lender.

Against this backdrop, the Bank of Japan has been making the best of a nearly hopeless situation. By 1995 it had reduced interest rates to one-half of 1 per cent on there way to zero in late 1998. That said, deflation has meant that the real short-term interest rate remains significantly positive in Japan. There is immense controversy over what to do about this, and all proposed solutions look politically difficult.

We do know one thing for sure, and that is until active financial intermediation returns, virtually nothing can help.

All of this suggests that the similarities between the past and present are more apparent than real. Unlike the cases of either the Great Depression or contemporary Japan, the American financial system is as strong as it has been in decades. While prices of some goods are surely falling, prompting their sellers to cry that there is deflation, this crucial ingredient to catastrophe is clearly lacking.

Three things have conspired to create a very healthy banking system: stronger supervision and regulation; a decade of economic growth; and innovations that have created secondary markets for most bank assets. As a result, US banks are protected by high levels of capital and relatively low levels of risk.

More important, central bankers are attuned to their role in preventing financial crises. Among other things, this means ensuring that banks and markets have sufficient liquidity to continue operating. A negative real federal funds rate makes it very cheap for banks to obtain funds, acting as a modest break on their manager's natural tendency to cut back as times get tough.

The US is surely in for a bumpy year or two. But so long as its financial system stays healthy, the danger that it will follow Japan into deflation and depression remains distant.

⁺ See Takeo Hoshi and Anil Kashyap *Corporate Financing and Governance in Japan: The Road to the Future*. Cambridge, Mass.: MIT Press, 2001.