



The Market Gets its Wish as the Fed Cuts 50 Once Again

Critics of monetary policy measures to counteract an economic downturn got 50 basis points more to chew on today. The Fed cut the federal funds target rate to 2.50% while reducing the discount rate to 2% for eight Federal Reserve Districts. Shades of the early 1960's, but suspicion is widespread that monetary policy has been ineffective in halting the economy's slide. On Sunday, for example, Paul Krugman used his New York Times podium to worry an already frightened American public. He strongly suggested that the U.S. could fall victim to the Japanese disease by arguing that Japanese monetary policy has been totally ineffective in righting the once-proud Japanese economy.¹ Most economists familiar with Japan's Dismal Decade were no doubt appalled by Krugman's sophistry as he glossed over the huge differences in how markets in the two economies operate. But, Krugman has moved from economics to rhetoric with great agility. He is playing to a crowd already worried that monetary policy is not effective against a capital spending collapse.

That worry was not lost on the FOMC today. Despite an unparalleled amount of liquidity released by the Fed since September 11th, the Fed did not wish to disappoint the equity and bond markets. Further, the Fed left open the possibility that more can be done yet this year. The Greenspan 'put,' damaged though it may be, is still there. Financial markets count heavily in monetary policy determination. The Fed's latest move means that the short end of the yield curve has been moved downward by 125 basis points in the less than six weeks. How much will it take?

The Fed statements for August 21st and the two statements in September, however, portray quite different FOMC concerns. In August, the Fed was comforted by consumer demand, but worried by declining business profits, weakening capital spending and overseas growth.²

In its September 17th emergency meeting, the Fed responded to the terrorist attack in several different dimensions.³ The discount window was opened freely and the Fed supplied massive amounts of liquidity through open market operations to buttress the settlements mechanism. Further, it cut both the target and the discount rate. In its statement, the FOMC shifted its concerns. It ignored consumer spending and focused on the weakness in employment, production and business spending and the potential for further declines.⁴

¹ "The Fear Economy," Paul Krugman, **New York Times**, September 28, 2001

² "Household demand has been sustained, but business profits and capital spending continue to weaken and growth abroad is slowing, weighing the U.S. economy." (FOMC statement 8/21/01).

³ The Fed also made public what the money market already knew. "The Federal Reserve will continue to supply unusually large volumes of liquidity to the financial markets, as needed, until more normal market functioning is restored. As a consequence, the FOMC recognizes that the actual federal funds rate may be below its target on occasion in these unusual circumstances."

⁴ "Even before the tragic events of last week, employment, production, and business spending remained weak, and last week's events have the potential to damp spending further. (FOMC statement 09/17/01)



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Today, the Fed's concern was the effect of uncertainty in an already weak economy.⁵ The economy's agents are uncertain--and the Fed is uncertain as well! This is a marked change from August when the Fed clearly saw signs of improvement in the economy and was willing to be modest with only 25 points of ease. Then, it thought it saw light at the end of the tunnel. Today, that light does not shine.

What were the signs in August? Household spending was being maintained at some 2.5% per year, a reduction from the zesty levels of 2000, but still growing. Home construction and sales were continuing at near record levels. Even the industrial sector was beginning to show some signs of improvement with "new orders" data from the NAPM while industrial inventories seemed to be getting worked down. Capital spending remained the Achilles heel of the economy, but the Fed discerned some improvement. The financial markets did not agree and August showed continued equity declines. Still, a case could be made for bottoming out at the end of QIII or early QIV. September 11th changed all that.

The Fed's focus now is to do whatever it can to overcome the uncertainty that could delay both consumer and business spending decisions. Greenspan has spoken often on the importance of confidence. The recent, sharp declines in consumer confidence and other indirect measures of business sector confidence mark out his battlefield. The Fed will stay on that field until it determines that true economic ignition has taken place again. Not all the heavy lifting required to get the economy moving again will be borne by the Fed. While it is clear that a significant fiscal policy package will soon be in place, the Fed will not quite...yet!

Still, the debate over the efficacy of monetary policy has begun once again. Despite considerable econometric evidence that the lag in effect of monetary policy changes on the economy is both long and variable, (somewhere between 6 and 18 months), the Bear Market has lasted 17 months. It has tried the patience of even the most patient investor. "Show me the money," is a drumbeat in Wall Street. Investors will applaud economists who have a taste for Government spending for other reasons. Both will rant against the Fed. Krugman will not be the last in that parade. Were it not for the terrorism, it is likely that the Fed would have modestly slowed its course of ease. September 11th made impatience a virtue.

Ironically, economists who have great faith in monetary policy are concerned for just the opposite reasons. They worry that too much has already been done. Some even worry that too much fiscal policy will now be undertaken. They firmly believe that the effects of an enormous monetary stimulus will yet bear fruit--just when the fiscal stimulus shows up.⁶ That would force a reaction by the Fed that would cause interest rates to rise and choke-off investment spending.

Terrorism has changed the policy equation. Neither the monetary nor the fiscal authority will err on the side of modesty. The Bush administration will not have a two front war. Despite the terrorists or because of them, no effort will now be spared to get the economy moving again. Financial markets will get their way.

⁵ "The terrorist attacks have significantly heightened uncertainty in an economy that was already weak. Business and household spending as a consequence are being further damped." (FOMC 10/02/01)

⁶ "Don't Cut Taxes Yet," Martin Feldstein, September 28, 2001, [Wall Street Journal](#).



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