Peter Hartcher
Greenspan is running out of buttons to push
Financial Times
10 August 2004

The US Federal Reserve has offered such an extraordinary stimulus to the US economy for the past three years that America's official real interest rates are still in the remarkable state of being deeply negative. In June, Alan Greenspan, the Fed chairman, and his colleagues started the long process of bringing rates back to a more normal level. But Friday's jobs data must have given them a serious jolt.

It was just over five weeks ago that the Fed gingerly edged up the main policy rate, the Fed funds rate, from its 46-year low of 1 per cent to 1.25 per cent. A neutral level - at which the economy is being neither stimulated nor restrained - should be about 4 per cent for the US, according to economists at the Organisation for Economic Co-operation and Development. Markets had been expecting that the Fed would take the rate up to 2 per cent by the end of the year. But the jobs data were so feeble that they stirred a storm of doubt. While Wall Street had expected that about 215,000 new jobs would have been created in July, the Department of Labor reported that the number was a scant 32,000. It was the second month of worryingly weak numbers. The crucial question is whether America's economic recovery can bear the strain of anything even approaching a normal interest rate.

The Federal Open Market Committee, when it meets today, is expected to press ahead and raise the Fed funds rate once again by the same cautious increment of 0.25 percentage points, taking the rate to 1.5 per cent. But futures markets have shifted to reflect a new view on the chances that the Fed will continue its campaign into September; the odds have shifted from a 70 per cent likelihood to only half that.

The FOMC members will have much to ponder. The market movements on Friday spotlight the twin dangers through which Mr Greenspan must navigate the economy. The Dow Jones index of share prices fell by 1.5 percentage points to its lowest level for the year. Stock investors are anxious that the recovery is slowing unexpectedly. That is the first danger Mr Greenspan must avoid.

But consider two other prices: the price of gold leapt by $7 an ounce to $402 after the report, and the price of oil remained at about $44 a barrel. These numbers suggest no slackening in inflationary pressures. If anything, they imply that inflation is returning. This is the second danger. Of course, the Fed's cure for inflation is to raise interest rates. Yet, with the recovery in an apparently delicate state, that could precipitate a sharp slowing.

In all likelihood, the jobs figures will prove not to be a harbinger of a slump but an aberration, or handmaiden to a modest slowing in growth. There are too many signs of persistent recovery to believe that a crunch is upon us. From other July reports we know that motor vehicle sales were up strongly and retail sales in reasonable shape. Still, the troubling news is an important reminder of the restraints on US monetary policy. If anything were to go seriously wrong with the economy, the Fed would be more constrained in its options than it has been for many years. With official interest rates so low, there is very little scope for any meaningful cuts.

How did America get to this point? In 1996 Mr Greenspan hovered on the brink of trying to manage the Wall Street bubble - remember his famous warning of “irrational exuberance”? But he decided that this was too politically risky. He instead accommodated the bubble, cheered on the so-called New Economy and waited for the bubble to burst.

In the following three years the bubble bloated to become, in proportion to the US economy, more than twice the size of the one that had preceded the Great Crash of 1929. When it burst, Mr Greenspan had to take extraordinary measures. His recovery plan took rates so low for so long that America's conventional monetary policy options now approach the point of exhaustion. The problem Mr Greenspan is trying to solve is one of his own making.

The other arms of US economic policy are constrained too. Fiscal policy is not in a robust condition to offer help. The Federal Budget is on course to be in deficit this year by $478bn - or 4.2 per cent of gross domestic product - according to the Congressional Budget Office, and both George W. Bush and John Kerry, his Democratic challenger for the presidency, have pledged to halve the deficit over the next four years.

There is some scope for using a cheaper dollar as a source of stimulus. It has fallen by 15 per cent against main currencies in the past two years and it could fall further without serious consequences, although any precipitate plunge could begin a rout. In sum, however, America already has pushed all three of its levers of macroeconomic stimulus fairly hard over to the “go” position. Mr Greenspan must be praying that nothing goes awry in the year ahead.

The writer is international editor at The Sydney Morning Herald and a visiting fellow at the Lowy Institute for International Policy. He is author of a forthcoming book on Alan Greenspan and Wall Street, entitled Bubble Man.