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The Fed and the Global Economy: 7th Inning Stretch

It's a "pick'em" call on the Fed, but we will say 50 bp cut. Here's why!

Much like the election last Fall, the consensus is badly split among the cognoscenti on what the Fed will do and what it ought to do. What it ought to do is perhaps more debated than what it will do. In spite of 250 basis points of ease, there is at best **only indirect evidence that the downward spiral that started last fall in the tech sector (and which continued the already established weakness in manufacturing during 2000) has stopped. It may yet continue.**

The Good, Bad and the Ugly

The Good News

The principal signs of optimism last week were the **"less negative" Philadelphia Fed number; the drop to 400,000 in initial unemployment claims; the continued strength of housing and autos and the absence of any negative wealth effect detectable in the data flow.** One could also add the index of leading economic indicators if one prefers a 'composite' number.

The Bad News

On the negative side, there are many contrary signals that suggest that the **binge on capital spending that characterized the Long Boom will be a long time correcting itself.** This can be seen from continuing, pre-announcement shortfalls in the Tech Sector and the revisions of forward expectations by companies and analysts an future sales growth. On the data side, the **recession-like factory utilization numbers can be read to indicate: (1) plenty of capacity was built during the Long Boom and (2) insufficient effective demand for capacity utilization to increase.** About the only bright sign in all of this was some relief on gasoline and natural gas prices that will mean less of a bite from consumer, non-energy spending and corporate profits. So far, those declines mean only marginal improvements. Even if there are less downside pressures out front on corporate profits due to minor relief on the energy side, it will be such a marginal contribution that in light of the excess capacity, business profits and therefore business investment are bound to suffer further. Average costs have to fall and typically that means output expansion.

While domestic business investment is still a relatively small portion of GDP, the serious correction in investment spending has imparted considerable downward force on the economy in the U.S. and globally as well. **Since a large part of the investment spending was part of the process of expanding global supply chains from the most developed countries to the less developed countries, it has a global impact.** The sharp fall of such spending has contributed a contractionary shock in the recipient countries (don't build more capacity, now!). **Lower investment spending here has contracted U.S. and other developed country imports, which has created contractionary pressures in its own right. The vortex of the decline is the U.S.** Bottom line, we are hanging by the threads of the consumer's purse, and the Fed has to ask whether it is desirable to loosen once again and by how much. The Whole World is Watching!

Delay is Ugly

The "contagion" of globalization, now seems to be getting recognition. Global supply chain management has had deleterious effects in the other two industrial 'Poles," Japan and Euroland. In the latter two areas, the relevant question is the immediate future course of monetary policy. For different reasons, strong fiscal expansion is not in the cards in either of those Poles. **In Japan, changes in monetary policy are**

suspended, it would appear, until after the Upper House election at the end of next month. Then, an evaluation by the Bank of Japan as to whether sufficient "reform" is truly underway will allow a major change in BoJ monetary policy.

In the EU, in spite of a token cut on May 10, many observers see the ECB "stuck" in a rut because the targeting of inflation as the primary goal of ECB monetary policy has removed much if not all incentives for monetary loosening as a cyclical defense. The inflation numbers have been "bad," clearly above the 2% level that the ECB takes as a target level for inflation. While there seems to be no threat on the wage side, the ECB takes every opportunity to admonish wage negotiators to bear the economy in mind when fixing new contracts. The political crowd is roaring at the ECB. Even if Duisenberg doesn't listen, he may yet hear. He could open his eyes sooner as one of his forecasts (inflation has peaked), seems to have acquired some positive data points.

Some Slight Price Relief in Euroland?

On Friday and again today, some information trickled out in Europe that can be construed to imply "inflation has peaked." If true, that will allow the ECB to take an earlier, easing step, **perhaps as soon as the July meetings**. Even if this optimistic assessment of early ECB easing prevails, the conventional 'lags' in effect of changes in monetary policy would suggest no substantial upward thrust will be created in 2001 by the ECB. Still, since the ECB are followers, not leaders, the European “pols” will be cheering the Fed to lead the way.

Without a push, both non-American Poles will at best be neutral and that is likely to be negative for world growth. **This expectation is to be added onto the downward thrust of new investment at home. This leaves the game squarely in the hands of the FOMC.**

Seventh Inning Stretch Time for the Fed

The Now and Future Economy

Will the Fed pay attention to the global economy or to the admonishments of some FOMC'ers and other policy wonks already worried about an inflationary overshoot in 2002. Those who argue for 25 bps are arguing that 'enough has been done,' and more ease now will make adjustment in 2002 difficult. Further, the cavalry is coming---in the form of the tax rebates. Will any wagons be left standing by the time the cavalry has arrived? **There is a more subtle argument on the tax cut. It might not have much effect on consumption if past history is prelude. The private sector could 'offset' the decline in public sector savings! In addition, some will argue that the Wealth Effect (negative this time) will soon begin to show, overwhelming the positive benefits of this tax cut. Is it ‘Now or Never time for the Fed?**

There is in fact a deeper issue that the Fed may need to argue over on Wednesday. If this recession is to bottom out soon (we will call it that now without worrying when or if the NBER gets around to telling us that one has started), the consumer will have to pull a stronger oar. And, somewhere down the line, the business sector is going to have to begin to stop slashing inventories and do some positive investment once again. If a positive impulse is to be sent to many developing countries, business investment will have to start rising at home before global companies seek to build substantially again abroad. Foreign economies too are stuck. Export-led growth was wonderful mantra----until domestic expansion is needed. Overseas, there are fewer internal demand management policies other than monetary easing available. Their policy makers will also root for more ease by the Fed.

This puts the Fed in the global limelight. Its normal charter is to think local. We should remember, however, that back in September of 1998, when the Russian crisis and the LTCM crisis hit---along with a strong statement from then Finance Minister Miyazawa that Japan was not about to do anything in Japan for the global economy--Greenspan made his famous Berkeley speech. Remember those lines about the U.S. not being able to stand as an island of prosperity in a global storm? What will he do if he recognizes, as he surely does, that the storm began here? He could remember that old maxim, 'Think Global and Act Local!

The U.S. is actually running behind in this game. It may only be the seventh inning, but Greenspan has to worry about the current runners on the bases and drive them home. If he needs a relief pitcher after knocking in the tying runs, he can look around next year! Right now, the home team is behind.