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The Fed holds off

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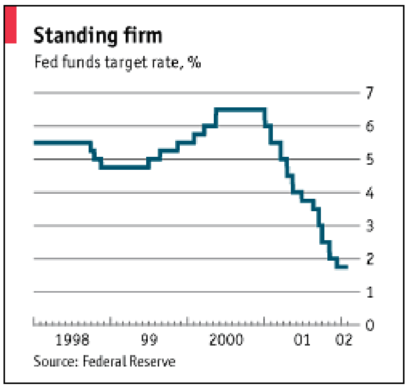
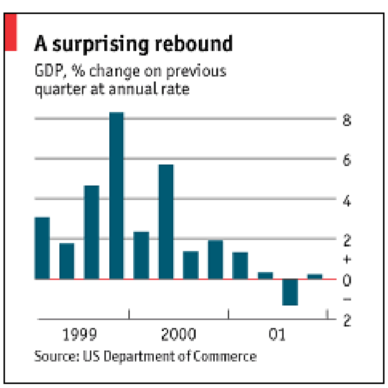
At its January meeting, America's Federal Reserve left interest rates unchanged for the first time in more than a year. This appears to support those who believe that the worst is now over for the American economy. But new labour market data suggest the Fed is right to remain cautious



IT HAD to happen sometime. After a long period of aggressive interest-rate cuts—eleven in less than a year—the point was bound to be reached when the Federal Reserve, America's central bank, decided to call a halt. Since the beginning of January last year, interest rates have fallen from 6.5% to 1.75%. So with signs that the worst may be over for the world’s largest economy, the Federal Open Market Committee (FOMC), the Fed’s main policymaking body, seized the opportunity on Wednesday January 30th to take a breather from the relentless rate-cutting, and left American interest rates unchanged. It is a decision fraught with risk, as the all-powerful Fed chairman, Alan Greenspan, surely knows.

For policymakers, as well as businesses, economic slowdowns are acutely difficult to read accurately. The key challenge is to spot the turning points—both on the way down and on the way up. The picture is usually confusing, as some data give cause for concern, while other figures suggest less need to worry. During the current downturn, for example, the persistent optimism of American consumers for much of last year puzzled many economists. The latest labour market data, released on February 1st, are equally confusing.



Yet at the beginning of 2001, when economists and many businessmen were still trying to measure the speed and extent of the economic decline, and to assess the likelihood of recession, Mr Greenspan and his colleagues were quick off the mark. Without waiting for the regularly-scheduled meeting of the FOMC at the end of January 2001, the Fed took everyone off-guard by cutting interest rates at the beginning of that month, in response to business data which had alarmed Mr Greenspan. From then on, the Fed sought to stay ahead of the game.

In the autumn of last year, the National Bureau of Economic Research confirmed that the economy had actually gone into recession in March. This showed Mr Greenspan had been right to act quickly. As the economy went into a nosedive, some started openly to criticise the Fed chairman's policies during the late 1990s: they argued that the Fed should have acted to curb market exuberance before it did. But whatever mistakes might have been made before the slowdown, few have questioned the wisdom of the Fed's actions after it began.

Now, though, Mr Greenspan is once again in trickier territory. There have recently been mixed signals from the chairman and some of his colleagues. In a speech in San Francisco on January 11th, Mr Greenspan said it was still premature "to conclude that the forces restraining economic activity have abated enough to allow a steady recovery to take hold." But when he testified before the Senate Budget Committee on January 24th, he seemed subtly to have shifted tack. "There have been signs," he noted, "that some of the forces restraining activity have started to diminish and that activity is beginning to firm." In its statement after the meeting on January 30th, the Fed concluded that the signs of strengthening economic activity have become more prevalent.

And they have. Figures published on February 1st showed that unemployment unexpectedly fell in January, to 5.6%, compared with 5.8% in December. (They had been expected to rise further.) Most significant, though, are the advance GDP figures for the final quarter of last year, published on January 30th and showing a small rise: 0.2% at an annual rate is admittedly tiny, but it contrasts with widespread expectations of a further fall. The figures should be treated with great caution—they will be revised twice more, and these revisions could be significant enough to change the plus sign to a minus. Moreover, much of the increase comes from a spectacular surge in durable-goods orders, which rose at an annual rate of more than 38%. This largely reflects a big rise in car sales in response to temporary special offers, including interest-free credit, used by the car industry to boost sales. At least some of the big jump in demand simply reflects orders brought forward from the future, rather than a genuine upturn in sales. Caution is needed when analysing the unemployment figures, too: payroll figures suggested that the number of people in work also fell, nearly four times as much as most economists had forecast.

Nevertheless, quite a bit of the latest data suggests economic confidence among consumers and businesses may, slowly, be picking up. This arguably strengthens the Fed's decision to pause before deciding whether further interest rate cuts might be needed. After all, the monetary easing which has already taken place is still working its way through the economy. There has already been some fiscal easing as well, with tax cuts and government spending increases; and President George Bush, in his state of the union address on January 29th, made it clear that much more government spending is on the way.

Some economists, and no doubt some members of the FOMC, have recently begun to express concern that as interest rates fell closer to zero the Fed would lose room for maneouvre. Some of the more extreme pessimists keep thinking about the Japanese predicament, where deflation has meant that even zero interest rates have done nothing to help kickstart the economy. Worries about Japanese-style deflation, though, seem misplaced in the American context. Prices aren't falling in America.

But inflation is, which is one argument for further interest-rate cuts: to ensure that the decline in interest rates is real, rather than simply nominal. And since it is hard to see inflation as a serious threat in the immediate future, it is reasonable to argue that the Fed could continue to cut rates consistent with its statutory obligation to promote maximum employment, stable prices and moderate long-term interest rates.

The inscrutable Greenspan

Second-guessing Mr Greenspan and his colleagues is a pastime from which many economists and commentators derive much pleasure, if not much enlightenment. It is nevertheless possible to infer from the latest Fed statement that the decision to leave interest rates unchanged does not necessarily mark the end of the prolonged rate-cutting spree. The risks, says the Fed, "remain weighted mainly towards conditions which may generate economic weakness in the future." By the time the FOMC meets again, in mid-March, the Fed chairman is no doubt hoping that those signs of recovery will have further strengthened. He does not seem ready to commit himself too firmly for now, though.