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COMMENTARY

Just Say No to Rate Cuts

By **BRIAN S. WESBURY**

The Federal Reserve is poised to cut interest rates even further this week. But, instead of asking by how much, the markets should be asking, why?

There has been no ground swell of complaints about high interest rates or tight money. In fact, corporate bond issuance is booming, and mortgage-refinancing applications exceed the capacity available to handle them. Total commercial bank assets have climbed by 11% in the past year and bank profits have soared -- a clear sign that the financial system is not starved of liquidity. Private non-farm payrolls have grown for two consecutive months, purchasing managers' indices are rising, deal-flow is improving again on Wall Street, corporate bond spreads have narrowed sharply, and the stock market is up.

Cheap 'Insurance'

Nonetheless, Fed Chairman Alan Greenspan says that any rate cut would be cheap "insurance" against what he seems to believe is a 1930s or Japanese-style deflationary recession. After all, the economy has grown just 1.7% annually over the past three years, well under its potential growth rate. Fed economic models take this as a certain sign of inadequate liquidity, no matter what else is happening. But it is non-monetary factors that have held the economy back and easier money won't help.

In the past two years, one development after another has added uncertainty to the process of decision-making. Terrorism, war, strange weather patterns, higher oil prices, and debate over a tax cut have all boosted the risk of investing in the first half of 2003, reducing the velocity of money. Another rate cut might well have as many negative effects as positive.

In 1911, before the Federal Reserve existed, Irving Fisher developed the seminal formula describing the relationship between money and the economy. He published it in his book "The Purchasing Power of Money." The formula has been a staple of money and banking textbooks for decades. It's simple: It says that

"money x velocity = price x quantity." Money is defined as the money supply, while velocity is the number of times that money circulates. The right side of the equation defines nominal GDP -- the price of all goods (P), times the quantity of all goods (Q). Typically, economists use the equation to solve for V, or velocity.

For example, in 2002, the M1 money supply, which includes currency and checking deposits, stood at \$1.191 trillion, while nominal GDP or total spending equaled \$10.446 trillion. Dividing GDP by M1, we find that velocity was 8.771 -- every dollar in the M1 money supply was spent almost nine times.

In the 1960s and '70s, Beryl Sprinkel, a Milton Friedman protégé and eventual Reagan cabinet member, became a successful forecaster using this formula. But then, in the early '80s, following the deregulation of banking, measures of the money supply changed. As a result, and by definition, velocity became unstable.

Most forecasters have lost faith in the money supply as a forecasting tool. Even Mr. Friedman recently said that, "The use of quantity of money as a target has not been a success." Still, there is no reason to throw the baby out with the bath water. The formula still has much to teach us -- especially in recent years. One thing the formula says is that money-supply growth alone may not always be enough to boost GDP. For example, in the past year, M2, which includes M1, plus savings deposits, CDs and money funds, has grown at a 6.9% annual rate. But nominal GDP has grown just 3.8%. This means that velocity has declined by 3.1%. When velocity falls, the impact of easier money is eroded.

In theory, a "liquidity trap" can develop in which the Fed becomes impotent. Usually this is attributed to deflation. Consumers won't borrow or spend, because they know prices will be lower tomorrow. Alternatively, some argue that after a bubble in equity prices, entrepreneurs have either gone bust and cannot act, or become risk averse and will not act. According to the theory, a quagmire like that of the Great Depression or Japan results and monetary policy becomes useless. So what the Fed must do is pump money into the system before a "liquidity trap" can develop. Unfortunately, this argument is myopic and misses the point. Monetary policy is not the only game in town. Fiscal policy also has an important impact.

The Great Depression was preceded immediately by Smoot-Hawley, and Herbert Hoover more than doubled marginal income tax rates in 1932. World trade imploded, and so did entrepreneurial risk-taking. Japan is the same sad story. In 1990, the capital-gains tax rate was increased from 0% to 20%. A national sales tax was implemented in 1989 and was increased in the mid-'90s. Japan also subsidizes failure, by supporting bankrupt banks and companies.

Today's experience in the U.S. is in no way similar. President Bush just signed the most pro-growth tax cut since 1981. Tariff increases last year were a huge mercantilist mistake, but now free trade is on the agenda again. In addition, while war and terror boosted uncertainty, those ambiguities have lessened considerably.

Nonetheless, there are some negative developments. High oil and natural-gas prices and a continued desire on the part of Congress to spend could hurt the economy. In particular, the new drug benefit in Medicare is worrisome. But by and large, the major uncertainties of the past two years have faded, the tax cut has realigned incentives and easy money is coursing through the system. The economy is poised for barn-burner growth.

Regarding deflation, never in history has an economy experienced deflation when gold and commodity prices are rising and currencies are weakening. With gold near \$360 per ounce and the dollar weak, the risks of deflation in the U.S. are nonexistent. Moreover, consumer spending has been the strongest part of the economy -- a clear sign that consumers have not been immobilized by deflation. The market capitalization of U.S. stocks is up by \$2 trillion since last October and Wall Street deal-making has blossomed. At least a dozen big deals have been announced in just the past few weeks. Cutting rates at this point would be overkill.

Don't forget, there are two sides to the interest-rate coin.

If the Fed cuts rates to 1.0% or 0.75%, the fees on many money-market funds would exceed the yield -- creating negative returns. Retirees, on fixed incomes, are already experiencing reduced cash flow -- another rate cut will hurt even more. Insurance companies face lower returns on bond investments, which could drive up the cost of premiums. Corporations will be forced to increase contributions to pension funds because of low interest rates. Mortgages are prepaying at an alarming rate, which is great for consumers, but bad for lenders who face contracting durations. To top it off, banks may become more reluctant to make loans, because at low rates, recovering from a bad loan takes longer.

Drastic Hikes

Finally, like 1993-94, further rate cuts will eventually lead to more drastic rate hikes, and all the damage that they do, at some point in the near future. The economy would be better off if the Fed signaled that the rate cutting is over. Expectations of Fed action give decision-makers another reason to hold off. It is not a lack of money that is the problem, but a reduced desire for risk-taking. The Bush tax cuts and the end of the war have taken care of that problem. It is not money we should worry about, but velocity.

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