World growth locomotive runs out of steam

ECONOMIC VIEWPOINT

The next US rebound will be steady, not spectacular, predicts Dr Gerard Lyons

HOW weak is the US economy? This is the key issue ahead of the Federal Reserve Board's key policy meeting on 5 and 6 July. US interest rates will fall, the only question is when.

The US economy gathered momentum throughout 1994, prompting the Fed to raise rates to 6%. By the final quarter, the economy was growing at an unsustainable pace of 5.1%. But the economy has slowed, growing at 2.7% in the first quarter, and it will weaken further.

A few months ago, the Fed took credit for this slowdown as a soft landing, involving a more sustainable pace of growth, appeared likely. Now the fear is recession and the Fed no longer congratulates itself. There is open disagreement on policy.

The shift in market expectations has been equally dramatic. Last December, when the Fed funds rate was 5.5%, the market expected official rates to rise to 8.25% by this September. Now, the market expects a half-point cut to 5.5% by September.

There are two schools of thought. The first is that the US is experiencing a typical mid-cycle inventory correction. Firms are cutting back on excess stocks and the economy will bounce back. The second is that the economy is fundamentally weak. Reality lies between the two.

There has been an inventory correction, after a sharp rise from the spring of last year to the end of March. Across a wide range of industries, firms have cut production to reduce excess stocks. Many had been too optimistic about demand prospects. They are not going to make that mistake again.

What we are witnessing in the US is typical of the disinflationary pressures affecting Britain and other industrialised countries.

US firms are facing intense international competitive pressures. They are keeping costs and wages down. The dollar's performance has not relieved this pressure, as many low-cost, industrialising countries have their currencies tied to the dollar.

The immediate recession danger is a self-feeding downturn, as sluggish spending prompts cutbacks, threatening job security and a renewed spending downturn. To break out of this, there needs to be a policy response.

A fiscal boost is not on the cards as the aim is to balance the budget. In fact, this will add to caution and trigger an eventual rise in personal savings. Hence the pressure on the Fed to cut rates. This, and lower long-term rates, should thus halt the economy's decline as debt levels still remain high.

The consumer holds the key. Confidence is high, although in the past that has not always been a good guide to spending patterns. The jobs market is crucial. In recent years, many jobs have been created but they are relatively low-paid.

Last year, the Bureau of Labour Statistics said that those who moved from one full-time job to another saw their wages fall on average by 23% and one in three who had health insurance in their previous job no longer had it in their new one. More recently, jobs have been shed, pointing to continued weakness.

Fed vice-chairman Alan Blinder and some governors favour an immediate rate cut. Some regional Fed members do not, as some areas of the US economy are growing healthily. Press reports suggest they will agree with chairman Alan Greenspan's decision on rates. But he is undecided and it is easy to see why.

His fear is that if he cuts rates now, the economy will rebound strongly and he will be forced subsequently to tighten policy. That would not be good for the Fed's credibility or Greenspan's re-election prospects in March.

The balance of risks suggests that Greenspan and the Fed will decide to ease, although it may take some more data to convince them of the need. Eventually, I think, they will cut the funds rate to 5%.

The risks from not easing are that the US economy will go into recession. But the inflation risks from easing are minimal. Even when the US economy was growing strongly last year, there was limited inflation.

Firms could not make price increases stick. Moreover, companies appeared efficient, using existing capacity more efficiently and employees more effectively. Productivity was healthy, and underlying inflation low.

In my view, a near-term recession is possible but the economy should then rebound. But when the US economy does bounce back, it will face steady and far from dramatic growth. It will certainly not be the strong locomotive for world growth that it once was.

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