Central banks have reduced interest rates to their lowest levels for decades. But have they done enough to revive the sickly world economy?

AMERICA’S Federal Reserve cut interest rates by another half-point this week. The federal-funds rate is now 2.5%, down from 6.5% at the end of last year, and is at its lowest in almost 40 years. After recent rate cuts around the world, the average real interest rate in America, Japan and the euro area (the G3) has fallen to its lowest level since the 1970s.

This aggressive monetary easing, combined with a large fiscal stimulus in prospect in America, has led some economists to predict a future upsurge in inflation. Rising long-term bond yields signal that investors are worried about inflation, they claim. However, comparisons with American index-linked bonds suggest that the main worry for investors is not inflation but that the supply of bonds will soar as the government borrows more.

That real interest rates in the big economies are at their lowest for decades may appear to suggest that monetary policy is exceptionally loose. A closer examination, however, shows that this is somewhat misleading. Using headline consumer-price inflation, American real interest rates are now close to zero. But by the Fed’s favoured measure of inflation, the core personal consumption expenditure deflator (excluding food and energy), real interest rates stand at almost 1%, well above the lows of previous recessions. Moreover, inflation on all measures is expected to fall again next year, which will push up real interest rates.

Average real interest rates across the G3 are historically low because of the extraordinarily synchronised global downturn. The last time American real interest rates were this low, in the early 1990s recession, real rates in the then booming euro area were 6.5%. Now the euro area and Japan are also in trouble. Surveys this week confirmed that business and consumer confidence have slumped sharply in Europe and Japan as well as America. In The Economist’s latest poll of forecasters, GDP growth forecasts for the big economies have been cut dramatically for next year (see article). CSFB now forecasts that global growth in 2002 could fall to its lowest in half a century.

A better way to gauge the tightness of monetary policy is to compare nominal interest rates with nominal GDP growth. An old rule of thumb is that, when interest rates are higher than the rate of
growth in nominal GDP, monetary policy is restrictive; when interest rates are lower, policy is expansionary. A crude way to understand this is to see, say, America's nominal GDP growth as, in effect, the average return from investing in America Inc. If the average return as measured by nominal GDP is higher than the cost of borrowing, investment will expand.

A recent analysis by UBS Warburg finds that by this yardstick monetary policy is not particularly loose. In the year to the second quarter, nominal GDP growth in the G3 was 2.7%, roughly the same as the average interest rate. In the fourth quarter, as economies contract and inflation falls, nominal GDP growth could well slow to barely 1%, its lowest since the 1930s. If it does, interest rates need to fall further.

Japan is largely responsible for the dangerously low rate of nominal GDP growth: its nominal GDP has fallen by 2% over the past year, yet nominal interest rates cannot go below zero. But in America too, nominal GDP growth looks likely to fall towards 1% early next year as the economy shrinks. That is alarming. As inflation and nominal GDP growth approach zero, central banks' ability to loosen monetary policy becomes limited, as the Bank of Japan has painfully discovered (see article).

Not only is monetary policy not yet sufficiently loose; it is also possible that, in this downturn, interest rates may be less powerful than usual in spurring demand. Massive excess capacity and the heavy debt burdens of firms and households may discourage new borrowing and spending. The unprecedented nature of the terrorist attack and its impact on confidence may also make consumers even less responsive to interest rates. If so, rates may need to fall by more than in the past to generate enough demand for a recovery.

Two-armed bandits

In recent years, it has become accepted wisdom that monetary policy is more appropriate than fiscal policy for stabilising economies. Monetary policy is much easier to reverse than spending increases or tax cuts, a crucial point given many countries' worrying long-term budgetary positions. This is why Alan Greenspan, the Fed's chairman, has advised caution on a fiscal stimulus. If a big increase in government borrowing pushes up bond yields, it will undermine cuts in short-term rates.

Nevertheless, America is going to get a fiscal stimulus. Fiscal easing from tax cuts equivalent to 0.6% of GDP was already planned before September 11th. Now a further package with a total of up to $130 billion (over 1% of GDP) may be added, tipping America's budget from surplus to deficit. On top of extra defence spending and emergency disaster relief already approved by Congress, there is strong support for more spending and tax cuts.

Bigger tax incentives for investment and a rebate for low-income earners seem likeliest, but there is no guarantee that either would boost spending anytime soon. Firms with excess capacity might not want to invest more and workers could simply save any tax cut. A better idea has been suggested by Alan Blinder, an economist at Princeton University. He proposes that Congress should reimburse states for a temporary reduction in sales tax. This has the advantage that, because it is temporary, it would encourage people to buy now, not later, and it would not damage America's long-term budget position.

At least America starts with a budget surplus. Japan already has a vast deficit, thanks to years of wasteful public-works projects funded in a vain attempt to revive its sick economy. Japan now has little room for a further stimulus. The euro area is also constrained by its needlessly restrictive
“stability pact”, under which budget deficits can exceed 3% of GDP only in exceptionally severe recessions.

This rules out significant fiscal stimulus. Indeed, if governments were to meet their intermediate targets for 2002, set in the framework of the stability pact, fiscal policy would need to be tightened in the euro area by an average of 1.5% of GDP next year. But there are no penalties for exceeding these intermediate targets. So, thankfully, Europe’s governments have said that they will set them aside and allow automatic fiscal stabilisers to work. Germany’s target for 2002 was to reduce its deficit to 1.0% of GDP. Because of slower economic growth, it is now more likely to reach 2.5% of GDP—uncomfortably close to the 3% ceiling. Unless common sense kills the stability pact, Europe will have to rely largely on further monetary easing.

The ECB and the Fed still have ample room to cut rates. Will they? Central banks are by nature cautious. But with inflation relatively low and falling, caution may now be more about ensuring that there is not a depression. The price, if they overdo it, may indeed be somewhat higher inflation in two years' time. But better that than a deep global slump.