

A blunt Tool?

THE quarter-point cut in interest rates by America's Federal Reserve on June 27th takes the total reduction in rates over the past six months to 2.75 percentage points--one of the most aggressive easings in Fed history. Yet it seems to have done little, so far, to revive America's economy. Monetary policy always needs time to take effect. This time the wait seems especially nerve-wracking.

The latest batch of economic statistics paints a mixed picture. The economy may yet avoid recession, but hopes of a quick, strong bounce-back have faded.

One reason why interest-rate cuts may have been less effective than expected this year is that they have actually done little to ease financial conditions. The Fed's main policy tool is the federal-funds rate, the rate at which banks lend overnight to one another. However, this rate has little direct impact on the economy, since neither firms nor households pay it. The transmission mechanism through which changes in the federal-funds rate affect the economy is a good deal more complex. The size of a cut in the rate can be a poor measure of the likely impact of monetary policy.

Broadly, monetary policy affects the real economy through three channels:

*Through the cost of borrowing in the market which, if reduced, could be expected to spur consumer spending and investment. Interest rates on short-term loans do indeed tend to move in line with the federal-funds rate. But much other borrowing, by both firms and households, is linked to bond yields, which hang more on market expectations about future interest rates and inflation than on changes in short-term rates.

*Through the exchange rate. In theory, looser monetary policy should push down the the dollar, so boosting exports.

*Through the prices of financial assets, especially equities. If lower interest rates lift share prices, this may boost consumer spending as private shareholders feel wealthier, or spur corporate investment by reducing the cost of capital.

If changes in the federal-funds rate do not feed through into market rates, the dollar or share prices, they will have little effect upon the economy. Bruce Kasman at J.P. Morgan Chase has analysed the Fed's macroeconomic model of the American economy, derived from past behaviour. According to the model, a one percentage-point reduction in the federal-funds rate should raise the level of GDP by 1.7% after two years, but by only 0.6% after one year. This may suggest that America simply needs patience.

However, the model also suggests that, if lower interest rates are to revive the economy, a cut of 2.5 percentage points (the size of the cut until this week) would normally be expected to have lifted share prices by 22% within a year, reduced long-term bond yields by three-quarters of a point, and left the dollar 5% weaker. Yet since the Fed first started to slash interest rates on January 3rd, the S&P 500 has actually fallen by 10%, the dollar's trade-weighted value has gained 7%, and both bond yields and mortgage rates have remained broadly unchanged.

This is neatly summed up by the "financial-conditions index" which Goldman Sachs calculates every day. This is a weighted average of short-term interest rates, corporate-bond yields, share prices and the trade-weighted dollar, with the weights derived from the Fed's model. The index has fallen only modestly since the start of this year, because the stronger dollar and lower share prices have offset lower short-term interest rates. Stiff levers

In previous economic cycles, as much as two-fifths of the total impact of interest-rate cuts on GDP, on average, has come through the stockmarket and the dollar--two channels that now appear to

be blocked. This suggests that the Fed will have to push even harder on the monetary lever to revive growth.

The Fed has another concern. Not only have long-term borrowing costs failed to follow short-term rates down, but households and firms may also be less responsive to lower rates. They may not want to borrow any more because they are already up to their ears in debt. With capacity utilisation in manufacturing at its lowest for 18 years, firms will also be reluctant to invest more.

Yet there is no need for too much gloom about the dwindling powers of the Fed. The economy does look fragile, but what if the Fed had done nothing? Share prices would have fallen more sharply, as would business and consumer confidence. As it is, consumer confidence has not, so far, been greatly dented. And the Fed's easing has helped to prop up the housing market. In other words, the Fed still carries clout.

Central bankers certainly think so. In April, the Federal Reserve Bank of New York held a conference on the monetary transmission mechanism. One paper* observed that, since the early 1980s, changes in the federal-funds rate seem to have had a smaller impact on output. However, the authors concluded that there was no evidence that firms and households had become less sensitive to changes in interest rates. Instead, the impact of changes in monetary policy seems to have declined because the conduct of policy has improved over the past two decades. The Fed now responds more quickly to changing economic expectations, which has helped to smooth out the effect of interest-rate shocks, reducing the variability of output and inflation. A reassuring conclusion for central bankers--but it will need revisiting in a year's time.

* "The Monetary Transmission Mechanism: Has it Changed?", by Jean Boivin and Marc Giannoni.