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FEDERAL RESERVE EASES TOO LITTLE, PERHAPS TOO LATE

Risk of Deflation Warrants Further Interest Rate Cuts

ANNANDALE-ON-HUDSON, N.Y.--Given the strong evidence of deflationary pressures around the globe, the Federal Reserve's recent quarter-point reduction in the federal funds rate is too little and, perhaps, too late, according to Dimitri B. Papadimitriou and L. Randall Wray of The Jerome Levy Economics Institute.

In a new Levy Institute Policy Note, Papadimitriou and Wray outline clear evidence of deflationary pressures in calling for the Federal Reserve to ease monetary policy further, and to do so quickly to help avert a global economic downturn.

The authors cite the United Nations Conference on Trade and Development (UNCTAD) forecast that: Hong Kong's output will contract by 2 to 3 percent next year; Thailand's economy will contract by 8 percent; Indonesia will have negative growth of more than 12 percent; and Malaysia and the Philippines will probably slip into recession. Further, the authors contend that Japan will continue to suffer severe recession and China's growth will slow, as will that of Latin America and Europe. World output for 1998 and 1999, as projected by J.P. Morgan, will grow by approximately 1.5 percent and 1.7 percent, respectively, falling far short of the 4 percent average posted in 1996 and 1997.

They also point out that in the United States:

- The August producer price index declined by .4 percent.
- Prices of intermediate goods fell by 2.1 percent during the 12 months that ended in August.
- The crude goods index fell by 2.7 percent in August, following a 1.8 percent drop in July.
- Prices for crude foodstuffs and feedstuffs fell by 1.1 percent in August and 2.8 percent in July.
- Corn prices fell by 5.1 percent in August and are likely to drop further due to this year's bumper crops.
- The CPI for all urban consumers rose by a 1.2 percent annual rate in August. Factoring in the widely accepted Boskin Report estimate that the CPI overstates inflation by 1.1 percent, inflation now is essentially zero.

These deflationary pressures are chronic, according to Papadimitriou and Wray, and are not simply the result of what might be only temporary financial problems in Asia, Russia, and some Latin American economies.

While the Federal Reserve has focused almost exclusively on the dangers of inflation for most of the past two decades, there is reason to believe that the real costs of deflation would be quite high. "Deflation increases real interest rates and debt burdens, and discourages investment, research and development, and technological advance because firms cannot be reasonably sure that their expenditures can ever be recovered in an environment in which prices are falling," the authors say. Deflation also discourages home ownership and reduces homeowners' ability to accumulate equity.

"Under current Federal Reserve policy, real interest rates in the United States are still quite high," Papadimitriou and Wray write. "Adjusting nominal rates by the inflation rate, we find the current 3-month Treasury bill rate is 3.39 percent, the highest since 1986 and nearly double the average since 1970. Factoring in the Boskin Report's 110 basis point bias in the CPI, real interest rates are even higher. In Boskin-adjusted real terms, the corporate bond rate is 6.1 percent and the federal funds rate is nearly 5 percent, well above the long-term average.

"Current high U.S. interest rates are contributing to the world crisis and hurt our abysmal and unsustainable trade imbalance," the authors say. "Lower U.S. interest rates and depreciation of the dollar would be good for the world economy, especially for world financial markets.

"If the United States goes into recession and reduces its imports, it is likely that world output also would fall. The challenge to policymakers in the United States and elsewhere is to cut interest rates and loosen fiscal policy," Papadimitriou and Wray say. "It is the only remedy to avert a deep global recession."

Policy Note 1998/5, *The Fed Should Lower Interest Rates* More

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