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The Fed's Self-Fulfilling Prophecy

An Interview with Richard Salsman

By Robert Tracinski

Richard M. Salsman is founder and President of InterMarket Forecasting, Inc., an investment research and forecasting firm based in Cambridge, MA.

The Intellectual Activist: There has been a lot of talk recently about a slowdown in economic growth and a possible recession. Do you think these fears are justified?

Richard M. Salsman: Yes, to a point. The precursor to this slowdown was the 50% decline in technology stocks last year and the generally anemic returns from the broader equity market. Economists generally define a recession as a minimum of two straight quarters of declining GDP (Gross Domestic Product). By this measure the last recession in the US ran from June 1990 to March 1991. I don't think we'll get a recession this year—but it will feel like one, because the economic growth rate will decelerate from five to six percent down to zero to one percent. Corporate layoffs are accelerating. The unemployment rate is rising, after falling for five years. A quarter of a million manufacturing jobs have been lost since last June. These are just some of the signs of weakness.

But I don't place much weight on the National Income Accounts, which are the source of GDP and other backward-looking, flawed government statistics. The stock market is a far more realistic and earlier indicator of economic conditions. People don't own "GDP" in their investment portfolios; they own companies like IBM. In this sense, we've already had a recession, since the stock market fell so significantly last year. But it should do much better this year.

TIA: What is the cause of this economic slowdown?

RMS: The main cause was the sharp increase in the federal funds rate imposed by the Federal Reserve, an increase of 1.75 percentage points from 4.75% in the summer of 1999 to 6.5% last spring. In raising the cost of capital, the Fed punishes business investment and depresses the stock market. In time, with a lag of about a year and a half, the Fed's interest rate increases cause a slowdown—or a decline—in corporate profits, output, and employment. Every recession in US history has been preceded by such a policy.

The antitrust assault on Microsoft has played a role as well. That company's stock price was cut in half in the months after the April court ruling, as were the stock prices of many other technology firms. In the past decade, tech-oriented companies have made it possible for the entire economy to become more prosperous and productive. So assaults on this sector have an unavoidably negative impact on the rest of the economy.

A third factor I would name is the new policy initiated in mid-March by then-President Clinton and Britain's Prime Minister, Tony Blair, which undermined the patent protections available to biotech companies. The stock prices of those firms crashed by 40% in the two weeks after the announcement.

The Clinton administration also went on a regulatory rampage in the past year, imposing a vast array of rules by fiat and by executive order. On top of this, uncertainty surrounding last fall's election outcome didn't help foster market confidence.

But it is Fed policy that has done the most damage to markets and the economy.

TIA: For years, Fed Chairman Alan Greenspan has been decrying "irrational exuberance" and declaring his desire to slow economic growth—

RMS: He got his desire, didn't he? His policies sabotaged the stock market last year and are now causing the economy to grind to a halt. He said the unemployment rate was "too low" when it reached a 30-year record low of 4%. Now unemployment is rising—and he still receives accolades from economists, Congressmen, financial commentators, and biographers. For years they've been prodding the Fed to raise interest rates.

TIA: Has Greenspan been keeping rates artificially high?

RMS: Yes. Greenspan and his colleagues accept—as all central planners must—the premise that the economy is inherently unstable and that without manipulation of interest rates the economy will grow "too quickly" or "too slowly", that the stock markets will rise "too rapidly" or "too high" and that unemployment will go "too low," spurring "excessive" wage demands that allegedly cause "cost-push" inflation. This is all just Keynesian nonsense, taken straight from the textbooks.

TIA: Greenspan indicated that it was necessary to pop a market "bubble." Does the past year's decline in technology and Internet stocks prove that there was such a "bubble"?

RMS: Not at all. A "bubble" implies that stocks are priced with no rational basis, based on pure emotion or the "greater fool" theory, not on facts and rational projections. The stock market was no "bubble" when it increased fairly steadily from 1995 to 1999. Its rise was based on sound fundamentals. Inflation and interest rates were relatively low and stable. Productivity and profitability grew steadily. The Republican-dominated Congress limited the growth of spending and regulation. In 1997, the tax rate on capital gains—which impedes capital formation and undermines the health of the stock market—was cut, from 28% to 20%. And the Fed was relatively inactive—until late 1999 and early 2000.

One of the key fundamentals underlying stock prices—interest rates—turned negative in late 1999. That wasn't the fault of markets or investors; it was solely the fault of Greenspan and the Fed, following faulty economic doctrines. The transcripts of private Fed meetings are very revealing in this regard. In one exchange with his colleagues Greenspan argued for rate hikes, to prick what he thought was a stock market "bubble." He said: "If we have the capability of having a Sword of Damocles over the market, we can prevent it from running away. In order to simmer down this market, I think we should just very gradually raise interest rates. You want to hit a market when it needs to be hit." I submit that this is irrational, vicious, and destructive.

TIA: In January, Greenspan called an emergency meeting of the Fed and cut the Fed funds rate by half a percentage point. Then, just three weeks later the Fed cut rates another half point, to 5.5%. Greenspan also reversed his position on taxes, telling Congress recently that he now favors tax cuts, as opposed to having the federal government accumulate surpluses or pay down the national debt—his earlier position. What caused these policy shifts?

RMS: I believe Greenspan realizes, at root, that he and his policies caused the market plunge last year and the near-recession conditions this year. He doesn't admit this publicly—and very few people accuse him of it, as they should—but this doesn't change the facts. Greenspan doesn't want to be blamed for bad news. He is used to being praised for all that's good in the economy.

But he is, ultimately, a political chameleon. When President Reagan appointed supply-side Fed governors who advocated targeting the gold price, Greenspan endorsed that approach. When President Clinton appointed Keynesians to the Fed, those who jettisoned the supply-side approach and claimed that inflation is caused by too low an unemployment rate, Greenspan endorsed that view. When Clinton imposed tax hikes in 1993, Greenspan heartily endorsed that policy. Now that Bush has won the election and advocates tax cuts, Greenspan endorses that policy. Those are the actions of a pragmatist dedicated to preserving and extending his political power and prestige.

TIA: Will the new policies help avoid a recession—or is it too little, too late?

RMS: Cuts in interest rates and marginal tax rates certainly will be good for the US economy and for investors. But if these cuts are delayed, they will only induce people to delay economic activity and the reporting of income, making near-term conditions worse. If interest rates are cut quickly and the tax cuts are made retroactive to January 1, the US might avoid a technical recession—but barely.

TIA: From what you have seen so far, do you think the Bush administration's policies will be any better for the economy than those of the Clinton administration?

RMS: Yes. There will be cuts in marginal tax rates on personal income and less regulation, including, I would guess, less enforcement of antitrust laws and environmental regulations. This change in direction, plus Fed rate cuts, should improve our economic and financial climate. In time we might also get phase-outs of the marriage penalty tax and the estate tax—as well as further cuts in the capital gains tax.

Don't get me wrong: the Bush cabinet is not filled with advocates of laissez-faire capitalism. But they are much better than the last bunch.