www.nytimes.com
The New York Times ON THE WEB

December 14, 2001

Eleven and Counting

By PAUL KRUGMAN

Embarrassing but true: Just one month ago the James A. Baker III Institute presented Alan Greenspan with its Enron Prize. I'm not suggesting any impropriety; it was just another indication of how deeply the failed energy company was enmeshed with our ruling elite.

And yet Mr. Greenspan also finds himself in Chapter 11. That is, the Fed has now cut interest rates 11 times this year, and has yet to see any results. What's going on?

One answer is that something has gone wrong with the monetary "transmission mechanism," the drive train that normally links the Fed's actions with the real economy. And one of the people who stripped the Fed's gears is Mr. Greenspan himself.

The Fed's direct power over the economy is actually more limited than is widely appreciated. People often say that the Fed controls interest rates, but what it actually controls is only an interest rate, the rate in the overnight federal funds market. And this interest rate is, in itself, of very little economic importance.

Normally, however, a fall in the federal funds rate indirectly affects financial variables that do matter; it leads to higher stock prices, a weaker dollar and — above all — lower long- term interest rates. Goldman Sachs economists have incorporated these variables into a "financial conditions index" that, they show, has historically done a very good job of predicting future economic performance.

Based on past experience, you would have expected the Fed's dramatic rate cuts since January to lower the Goldman Sachs index by about five points — enough to produce a roaring 2002. In fact, however, the index has fallen only about half a point, largely because long- term interest rates have not fallen at all. The Fed, in other words, is getting almost no bang for its bucks. Why?

Part of the explanation is self- defeating optimism. Bond traders continue to believe, despite mounting evidence to the contrary, that Mr. Greenspan is a magician — that he will soon conjure up another dramatic boom, and will then raise interest rates to cool a red-hot economy. Ironically, this very belief helps keep long-term rates high, and thus ensures that no such boom seems imminent.

And then there's the federal budget. Just months ago we were dazzled with projections of huge federal surpluses; there was enough money, the Bush administration insisted, to have a big tax cut, increase spending and still pay off the federal debt. But on Tuesday Paul O'Neill quietly asked Congress to raise the federal government's debt ceiling — something he had previously said would not be necessary until 2008 at the earliest.

Has the sudden return of federal deficits had an impact on long-term interest rates? Of course it has. Just a few months ago everyone expected the federal government to pay off its debt, drastically reducing the supply of bonds; now it turns out that it will actually be borrowing money. Inevitably this depresses bond prices, which is the same as raising long- term interest rates. So the rapid deterioration of federal finances is part of Mr. Greenspan's problem. (Has the negative impact of the tax cut on the economy via its effect on interest rates outweighed the positive effect on consumer spending? Yes, on any reasonable calculation.)

Mr. Greenspan, then, finds himself with much less ability to move the economy than anyone expected. And it's partly his own fault. After all, he did much to cultivate the mystique that now turns out to be a handicap. And let's not forget that he intervened decisively on behalf of large tax cuts back in January, when he urged Congress to prevent what he then saw as a great risk: that surpluses would be too large, and that the federal debt would be paid off too quickly.

It might be helpful if Mr. Greenspan would now say something to dampen self-defeating belief in a sudden economic turnaround. It would be even more helpful if he would concede, however indirectly, that he gave Congress bad advice last January; that might prepare the ground for an eventual return to fiscal responsibility. But the Fed chairman, who was quite willing to intervene in fiscal politics when that was helpful to the Bush administration, has gone oddly silent on the subject now that those surplus projections turn out to have been bad science fiction.

Maybe Mr. Greenspan deserved that Enron Prize after all.