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## **U.S. Economy: Fed May Acknowledge a Weakening U.S. Recovery**

*by Craig Torres*

Washington, Aug. 7 (Bloomberg) -- Federal Reserve policy makers meet next week and may take a step toward a cut in interest rates by saying the U.S. economic recovery is threatened by a new slowdown.

Manufacturing and services stalled in July, and the economy added 6,000 jobs, less than a tenth as many as were created a month earlier. The economy had already slowed in the second quarter to a 1.1 percent annual rate, down from a 5 percent pace in the first three months of the year.

"Something new and disturbing is happening," said Lou Crandall, an economist at Wrightson Associates, a New York research firm. "At a minimum, we expect the Fed to acknowledge the shift in the climate by returning to a weak growth bias" at the Aug. 13 interest-rate policy meeting, he said. Since March, the Fed's Open Market Committee has said that risks are balanced between economic weakness and accelerating inflation resulting from faster growth.

Stocks surged yesterday on expectations that by yearend the Fed will lower the benchmark overnight bank lending rate, currently at a 41-year low of 1.75 percent. Economists at eight of 22 banks and securities firms that trade with the Fed said central bankers are likely to change their stance to reflect growing concern about the recovery.

Deutsche Bank Securities, Dresdner Kleinwort Wasserstein Securities LLC, Lehman Brothers Holdings Inc. and Goldman, Sachs & Co. say they expect reductions. Investors are betting on a quarter-point cut by yearend, judging from the implied yield of 1.53 percent on the December federal funds futures contract.

### ***No 'Double-Dip'***

So far, Fed policy makers say they see few indications that the economy is sliding back into recession. "The odds of a so-called double-dip recession are very, very small," said William Poole, president of the St. Louis Fed Bank, in a speech Sunday. "Everything I know says the economic recovery will continue."

The Standard & Poor's 500 stock index jumped 25 points yesterday, or 3 percent. That left it down 25 percent for the year, which may wind up as the third straight annual decline, leading consumers to curtail spending and businesses to leave investment plans on the shelf.

Fed officials say the stock market may not be the best indicator of the strength of an expansion that probably began about the beginning of the year. "There are some good reasons why we shouldn't be surprised that equity markets have fallen," said Robert Parry, president of the San Francisco Fed Bank, in a speech Friday. "Even with these concerns, it is important to remember that there are several factors that are boosting growth and that are very likely to boost growth in the future."

### ***Growth Forecast***

Fed Chairman Alan Greenspan told Congress on July 16 the economy would probably grow by 3.5 percent to 3.75 percent from the last quarter of 2001 to the final quarter of this year. That forecast now looks difficult to attain, economists said.

**“The Fed staff has to be working on a downward revision,” said Nancy Roman, managing director at the G7 Group Inc., a Washington-based consulting firm. “They certainly weren't expecting 1.1 percent growth in the second quarter.”**

A lower growth forecast is likely to include a lower inflation forecast and that would give the Fed room to reduce rates. Still, the Fed will want stronger evidence beyond what's already known to suggest that the recovery is in trouble and lead them to cut rates, economists said.

“A rate cut in response to economic weakness is not out of the question, but we think the evidence would have to be compelling over a period of several months,” Wrightson's Crandall said in a commentary on the Fed.

### *Surprises*

Recoveries are often fragile and the Fed has been surprised in the past by sudden downdrafts in the economy. On July 1, 1992, Fed officials voted 10-2 to leave interest rates unchanged with a directive to lower them if new signs of weakness appeared. Transcripts of the meeting show Fed officials were unsure if an expansion that began more than a year earlier was faltering.

The following day, policy makers reduced the overnight rate by a half percentage point after the government reported that the economy shed 117,000 jobs in June, lifting unemployment to 7.8 percent, the highest monthly rate of the 1990s.

Less than two months earlier, at a May 19 policy meeting, the central bank had been more convinced that the recovery was taking hold and shifted its stance to reflect the view that risks were balanced between weakness and inflation, transcripts of that meeting showed. That change had suggested there was little chance of a rate cut in coming months.

### *Recession Psychology*

In a recession “there is this psychological element, this increasing pessimism that you don't always capture” in forecasts, said Laurence Meyer, who served as a Fed governor until January and is now a senior adviser at the St. Louis economics firm he helped found, Macroeconomic Advisers.

Other hazards stem from corporate behavior in the wake of accounting scandals. “The largest risk is that companies may just decide not to invest,” said Gerald Cohen, senior economist at Merrill Lynch.

And then there are consumers. Typically, Americans save during recessions and boost their spending as recoveries take hold. Personal spending rose in all but four of the 18 months through June, and economists wonder if consumers are reaching the end of their need and ability to spend.

“Consumer spending was so strong in the recession that it” may not have much ability to rise further, said Alice Rivlin, an economist at the Brookings Institution and a former Fed vice chairman. “There is reason to worry that the recovery is not very strong.”