A MIDAS TOUCH DIMS
Thomas Homer-Dixon
Toronto Globe and Mail
August 10, 2002

There's a whiff of desperation in the air. By this point in the world's business cycle, the American economy – that powerhouse of global capitalism – was supposed to be rebounding sharply, and stock markets everywhere were again going to be making everyone rich. Instead, things have gone haywire: the US may be tipping into another recession; four years of growth has evaporated from North American markets; and economies around the world are in trouble.

How could this happen? Interest rate cuts by the U.S. Federal Reserve are supposed to be an economic elixir. Indeed, because of his skill in manipulating these rates, the Fed chairman, Alan Greenspan, has been widely regarded as the maestro of the American and global economies. Greenspan's eleven consecutive interest-rate cuts in 2001 should have rejuvenated the American economy and propelled the world into a new round of expansion, right?

Well, it seems not. At the end of July, the US Commerce Department reported that the recent American recession was deeper and longer than originally thought: American output shrank through the first nine months of 2001, not just in the summer. More disturbingly, US output in the past three months has fallen off a cliff: a combination of wary consumers, budget slashing by state governments, and a ballooning trade deficit knocked growth from 5 percent in the first quarter of 2002 to1.1 percent in the second.

For more than a year, spurred by the Greenspan's lower interest rates, consumers heroically sustained the American economy. Now, though, they may be running out of steam: between the end of last year and the end of June, growth of consumer spending plunged from 6 to 1.9 percent.

But here's the really striking news in the report: the total value of all goods and services sold in the U.S. actually fell in the second quarter. In fact, almost all of the U.S. economy's feeble growth came from businesses boosting their output to maintain (but not increase) inventories. Overall, business spending dropped for a record seventh consecutive quarter.

Last week, markets surged as investors speculated that the Fed would cut interest rates again. But let's not fool ourselves that more cuts will make much difference. Money is already very cheap, and we've probably already seen most of the economic gains that cuts can produce. Moreover, the 2001 economic downturn in the U.S. was precipitated by a collapse of business investment, and business investment is not very sensitive to short-term interest rates.

But there's a bigger and more important reason why further cuts probably won't make much difference. Economic trends of growth and contraction aren't only a product of "objective" economic conditions, like interest rates; they're also a product of the whims of psychology and sentiment – that is, of our "animal spirits," as John Maynard Keynes called them. And, as Keynes famously wrote, "if the animal spirits are dimmed and the spontaneous optimism falters . . . enterprise will fade and die."

Among the general public, and even within the business community, spontaneous optimism is faltering, to say the least. Mass sentiment has shifted from ebullience to skepticism, and it may be on its way to profound pessimism. Just yesterday we marveled at the wonders of the new economy powered by ideas and demanding radically new ways of thinking about corporate value and the creation of wealth. An Atlantic Monthly cover story declared that the Dow was on its way to 36,000. Governments were awash in budget surpluses, and for the first time in years we were thinking about rebuilding our ravaged health-care, education, and social-housing systems. Unemployment was at levels we hadn't seen for decades.

But the dot.com revolution, it turned out, was a mania powered by hubris, bragging, and outright self-delusion; the US budget surplus vanished overnight; and the boundless possibilities occasioned by the boom's wealth now seem far over the horizon. When the bubble burst, it left behind an enormous psychological void. We haven't even begun to see its full effects yet, because the rot of doubt and skepticism takes time to set in.

Much depends on the general public's attitude towards the stock market: investments in stocks by a growing numbers of average people helped power the economy over the last decade, and the sense of prosperity produced by soaring markets boosted personal con-

sumption. But, given the tidal wave of accounting scandals, corporate fraud, and executive malfeasance, the general public may be reaching a fateful conclusion: that the stock market is an elaborate exercise by which economic elites fleece the middle class, and that it's a mechanism for a huge transfer of riches from the modestly wealthy to the preposterously wealthy.

These negative sentiments of fear, resentment, and anger could forestall a rebound. In fact, if they lead to a more generalized skepticism about our economic system, they could cripple growth for a long time to come. We've seen something like this happen in Japan: the implosion of the '80s property bubble rocked Japan's economic system to its foundations and produced widespread fear and insecurity in the Japanese public. As a result, Japanese consumers don't spend enough, so prices fall; and as prices fall, consumers put off their spending even more, because they think they'll get even better prices in the future. This is called a deflationary spiral -- and it's an economist's nightmare. The U.S. economy may be closer to such a situation than most experts are ready to admit.

As Paul Krugman, the economist at Princeton University, has pointed out, the best way to avoid a deflationary spiral is to crack negative sentiments before they have a chance to take root. This requires decisive action on a variety of fronts. In particular, the central bank should announce big, dramatic cuts in interest rates that act like electric shocks to shift public and corporate attitudes. But in the U.S., Greenspan has piddled away this opportunity with 11 micro-cuts. Now, with short-term rates at 1.75 percent, he has very little downside space to create such a psychological surprise.

In fact, the Fed may have reached a point at which further interest rate cuts erode market confidence more than they boost it. Cuts may be interpreted as an act of desperation and an acknowledgment of a deep, underlying crisis. And if they don't produce a recovery, then Alan Greenspan’s aura of omnipotence will be shattered. What effect that outcome will have on our animal spirits is anybody’s guess.