

The Evidence Backs Greenspan

IN his testimony this week on the midyear state of the economy, Alan Greenspan, chairman of the Federal Reserve Board, seemed to be tiptoeing through a mine field, spread with the dangers of recession, inflation, a worsening budget deficit and a weakened financial structure in the private sector.

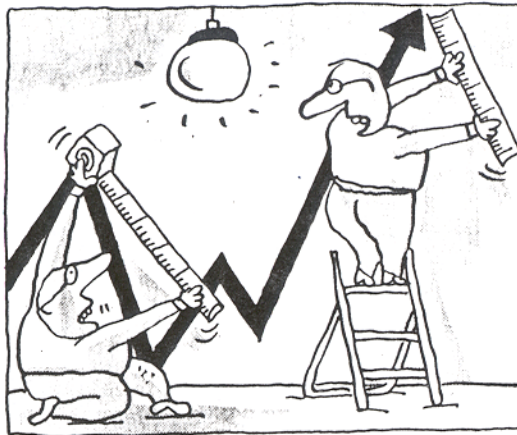
The biggest danger is that if a recession once got under way it would cause the failures of a host of debt-ridden corporations and financial institutions. The savings and loan disaster happened while the economy was growing steadily; a recession would harm many other sectors. With the nation's precarious debt structure, a recession now could cumulate into the worst of the postwar period.

Mr. Greenspan responded to such anxieties by saying that the Fed was prepared to ease credit if it was necessary to prevent a recession. It would ease, he implied, if policy makers put together a budget deficit-cutting package. But he does not believe further easing is necessary right now, insisting that he sees no signs of a recession yet.

At the same time, inflationary worries persist. Indeed, just before Mr. Greenspan testified, the Labor Department reported that consumer prices jumped five-tenths of 1 percent in June, more than twice the rate of the preceding two months. The Fed view is that too stimulative a monetary policy would worsen inflationary anxieties and send interest rates spiraling upward, jeopardizing the expansion itself.

The cardinal issue facing the Fed is how serious is the threat of recession and whether it would cause a serious crack in the nation's financial structure.

James J. O'Leary, economic consultant of the



Niculae Asciu

United States Trust Company of New York, argues that the threat of recession is real and the danger to the financial structure grave. He contends that the Fed has overstayed its policy of heading off rising inflation by trying to encourage sustained low economic growth without precipitating a recession. "This strategy, laudable as it has been, now seems in danger of tipping the economy into a recession, given the pervasive and very serious problems in our financial system," Mr. O'Leary said.

The economy, he warned, is "very highly leveraged," with total outstanding debt having soared to \$12.1 trillion from \$4.2 trillion a decade ago. The substitution of debt for equity has led to a sharp increase in fixed interest payments as a share of corporate earnings: In the 1950's and 1960's it took 17 cents of every \$1 of pre-interest earnings to service debt. In the 1970's the figure rose to 35 cents, and has now reached 61 cents.

With this year's decline in cash flow and profits, many companies are finding it hard to meet their fixed charges. Lenders, including both banks and life insurance companies, are experiencing high delinquencies and foreclosures on commercial

mortgage and home mortgage loans. Delinquencies have also been rising on consumer loans.

There are signs, Mr. O'Leary says, that "the constant din of troublesome developments in the financial system" is starting to have a negative effect on consumer confidence. The American Express Bank Review supports that position, declaring that three factors are adding to the risks of recession: growing corporate debt, the savings and loan crisis and the need to cut the budget deficit.

Nevertheless, Mr. Greenspan is holding to a no-recession, moderate-growth forecast for the rest of 1990 and through 1991. He forecast economic growth of 1.5 percent to 2 percent for 1990 and 1.75 percent to 2.5 percent next year.

Is he whistling in the dark? The weight of the evidence is on his side. The structure of interest rates indicates that there is no credit squeeze, and none is likely. A forecasting model developed by Prof. Campbell R. Harvey of Duke University, based on the spread between short- and long-term interest rates, generates forecasts very close to those reported by Mr. Greenspan.

Last June the Harvey model predicted real economic growth of 1.7 percent through the next four quarters; that prediction looks right on target for the rest of this year.

And the model, based on the difference between the five-year bond yield and the three-month Treasury bill, now predicts real growth of 2.4 percent during the next four quarters; the economy is likely to be sluggish until mid-1991 and then turn gradually upward. Applied retroactively to the business cycle over the last 25 years, the Harvey model has called every recession correctly, and it foresees no downturn in the coming year.

Policy blunders could blow this outlook. The best way to assure stable growth in the year ahead would be a Fed policy of easing short-term rates down gradually as the Administration and Congress move to narrow the budget deficit. And that is the best prescription for avoiding a devastating shock to the nation's financial structure.