

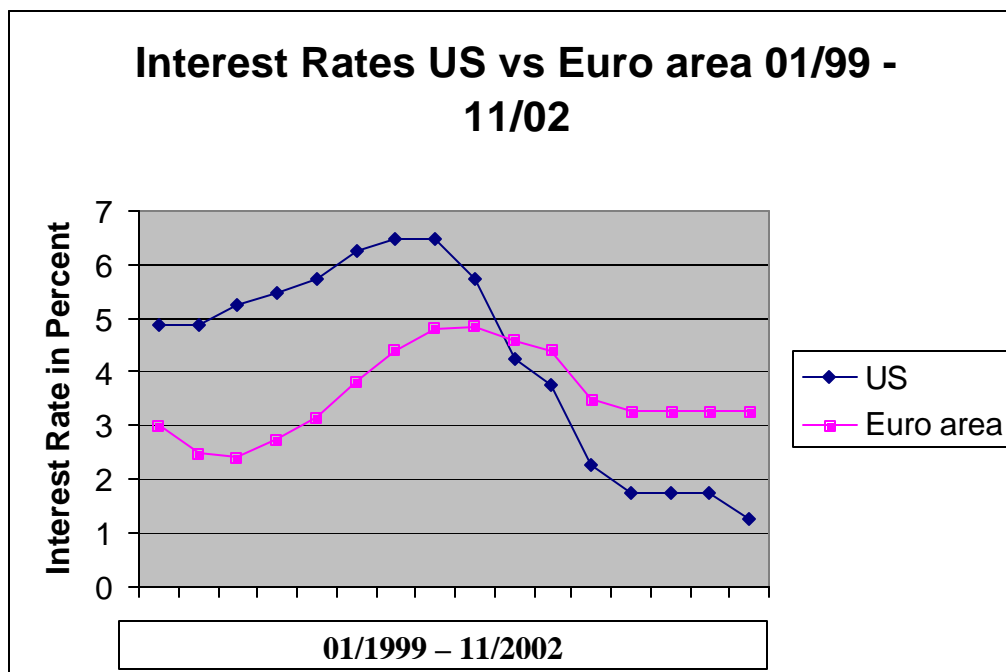
## Introduction:

As of October 6<sup>th</sup>, 2002 the Federal Reserve under Alan Greenspan lowered the Fed Fund Target rate to 1.25 %, the lowest for more than 40 years. At the same time the European Union left the interest rate for the Euro area unchanged at 3.25 %, although Wim Duisenberg, the head of the ECB, hinted that interest rates might drop next month. At the last meeting of the ECB there was big disagreement between the individual board members.<sup>1</sup>

Constant uncertainties about the way the economy will go, about future wars and terrorist attacks, a nearly 3 year lasting bearish stock market caused by the burst of an asset price bubble and the danger of deflation in the US, but especially in the Euro area raise the question if previous and current interest rate changes are appropriate for the current situation.

Exhibit 1 shows the interest rate moves set by the Federal Reserve and the European Central bank between the beginning of 1999 and now.

### Exhibit 1



<sup>1</sup> Financial Times Deutschland, 11-08-2002

# 1. Consumer spending and household debt

After the stock market bubble and the following economic downturn the Federal Reserve decreased interest rates in big steps as can be seen in Exhibit 1. A main reason for that was to keep the consumer spending money. Consumer spending comprises roughly two-thirds of GDP. Therefore changes in consumer spending have a big impact on the economy as a whole.

## 1.1. Housing prices and property wealth as a source of consumer spending

Property is the world's biggest asset class. American households for example own about \$ 11 trillion worth of share, compared with almost \$ 14 trillion in housing. In other countries housing wealth is even more important. In rich countries as a whole, individuals own \$ 23 trillion in equities, but around \$ 40 trillion in property.<sup>2</sup>

Consumers used the opportunity of steadily decreasing interest rates to refinance their mortgages and locked in much lower financing costs for the future. Lower interest rates on mortgages mean lower monthly payments to creditors. Suddenly consumers felt additional wealth in their pockets and kept up spending even at a time when the economic outlook worsened.

In addition consumers took on additional mortgages on increased property values.

House prices increased tremendously in nearly every advanced economy. Exhibit 2 shows yearly house price increases by country over the last two years.

### Exhibit 2

| House prices, % change on year ago |        |          |
|------------------------------------|--------|----------|
| Country                            | Aug-02 | mid-2001 |
| Britain                            | 20.9   | 9.4      |
| Australia                          | 17.3   | 8.2      |
| Spain                              | 15.7   | 15.5     |
| Canada                             | 9.9    | 4.9      |
| Italy                              | 9.5    | 8.9      |
| France                             | 8      | 8.1      |
| United States                      | 7      | 9        |
| Netherlands                        | 6.4    | 10       |
| Belgium                            | 5.9    | 5.7      |
| Ireland                            | 5.2    | 15.1     |
| Sweden                             | 3.6    | 8.4      |
| Germany                            | 1.6    | 1.6      |
| Japan                              | -4.4   | -4.1     |

source: The Economist, 08-31-2002

<sup>2</sup> Compare "The Economist" 08-31-2002, p. 57.

Several households used this additional money to finance their consumer spending. Therefore those households are betting that the housing prices will sustain their current level. If they did not do so, many people would be left with higher debt than their property is worth and the difference would already be invested in a car or a stereo sound system.

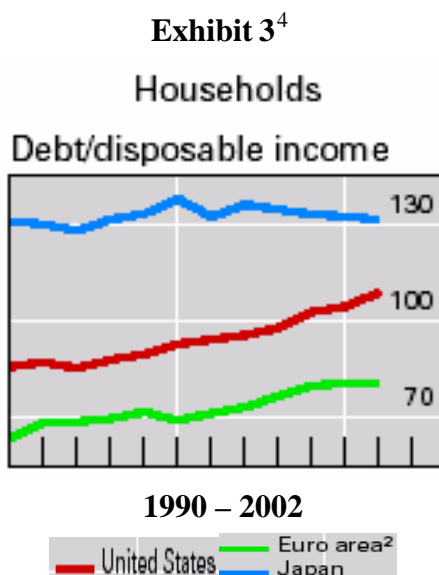
But one has to see the reasons why housing prices soared. Traditionally, shares and houses have risen and fallen together. But in the last two years house prices have risen as equity values decreased. The reasons are two-fold. Interest rates are, as mentioned above, at 40-year lows. Furthermore investors might have used property investments as an alternative to equity investments.

This implicates that as long as interest rates do not rise sharply in the near term, housing prices should not drop like a stone. Although housing prices will probably not keep rising at today's pace, economists acknowledge that prices will rather flatten off than collapse.<sup>3</sup>

## 1.2. Debt burden of households

Due to those low levels of interest rates, households were able to keep up spending partly because of increasing house prices. But households increased their debt load in relation to their disposable income tremendously over the last years.

Exhibit 3 shows how household debt has developed over the last decade in the US, the Euro area and in Japan



<sup>3</sup> "The Economist", 08-31-2002, p. 58

<sup>4</sup> Bank for International Settlements, Annual Report 2002, 72<sup>nd</sup> annual report

This leads us to the question if a further interest rate cut like seen on October 6<sup>th</sup>, 2002 makes sense for households and even more for business. Consumer spending has already showed signs of weakness. By cutting interest rates, one could argue that the Federal Reserve is moving forward to prevent a bursting of a possible housing bubble. For house prices to sustain their levels or at least to flatten off it needs further investment in property and people willing to buy at current price levels. Lowering interest rates can make a lot of sense in this respect.

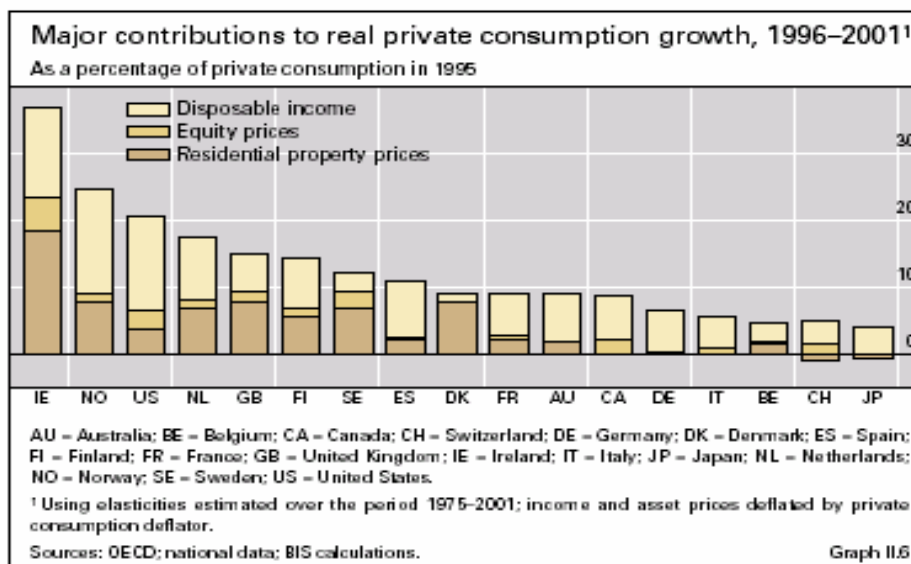
But this also means further increasing debt burdens for households. This is still a potential threat to consumer spending. Once households do not feel increasing wealth due to rising house prices anymore they might tighten their belt accordingly. The worst case scenario would be households left with higher mortgages than their properties are worth.

### 1.3. How much did housing prices contribute to consumption growth?

One might argue that house prices did not contribute much to private consumption. This is true for several countries, but not for all.

Exhibit 4 shows how much different wealth factors in different countries have contributed to the growth of real private consumption over the last 5 years.

#### Exhibit 4<sup>5</sup>



We can draw the conclusion that consumers in several important economies of the world relied partly on rising housing prices to finance their spending. Especially Great Britain's

<sup>5</sup> Bank for International Settlements Annual Report 2002, 72<sup>nd</sup> annual report

consumers financed more than half of their consumption growth based on rising house prices. But also US consumers relied partly on rising housing prices. For 2002 the contribution of housing wealth to consumption growth might even be bigger.

Looking at Germany justifies these assumptions even more. As we have seen in Exhibit 1 German Housing Prices barely increased over the last years. Therefore Germans did not rely on rising housing prices to finance their consumption. British house prices increased tremendously and therefore housing prices comprise a big share of British private consumption growth.

#### **1.4. Are interest rates really as low as consumers think?**

It is true that nominal interest rates are at record lows. But are real interest rates really as low as consumers think? Interest rates are also at record lows because inflation is low. But since inflation is not very high, especially in major European economies, real interest rates might be higher than consumers think. This leads us directly to an other related danger the world economy is currently facing.

## **2. When Deflation comes into game**

### **2.1. Why is deflation dangerous?**

Deflation is not only dangerous for the economy because of private household's debt burden. Deflation is probably even more dangerous because of its effect on business' debt.

Inflation is good to a certain extent. Inflation helps households and businesses erode their debt burden. Basically inflation eats away debt over time. If inflation is low or if deflation comes into game households and businesses cannot rely on inflation to help them manage their debt burden. If prices decrease debt levels increase even if interest rates are at zero and no additional borrowing takes place. Hence, household's and businesses' real debt burden increases.

Moreover deflation gives an incentive to consumers to delay spending because of hopes of even lower prices in the future. This leads to even lower GDP growth and probably higher deflation. It could be called a self-perpetuating cycle.

## 2.2. Is deflation possible?

Exhibit 5 shows a comparison of three major economies of the world. It is comparing symptoms of the US and Germany to Japan, which finds itself in a deflationary state since years.

**Exhibit 5: Comparing symptoms of three major world economies**

| Symptom                      | Japan | US | Germany |
|------------------------------|-------|----|---------|
| Size of asset-prices bubble  | **    | ** | *       |
| Corporate overinvestment     | **    | ** |         |
| Risk of deflation            | **    | *  | *       |
| Large private-sector debts   | **    | ** | **      |
| Weak banking system          | **    |    | *       |
| Severe structural rigidities | **    |    | *       |
| Political/Socail parlalysis  | **    |    | *       |
| Shrinking/Ageing population  | **    |    | **      |

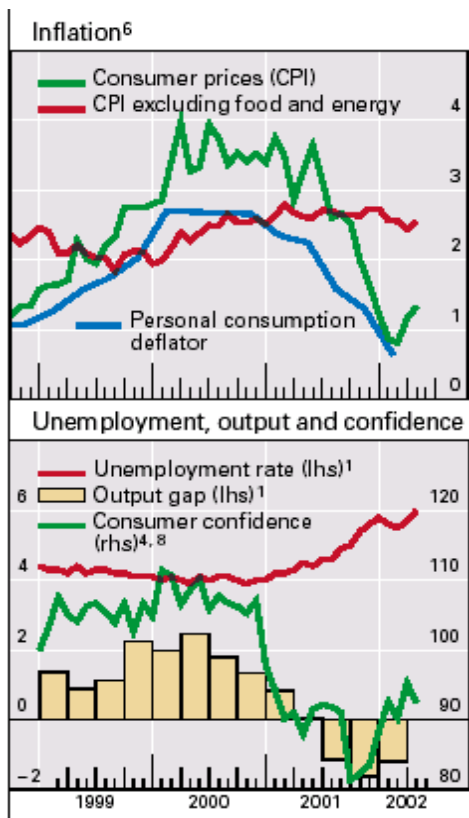
Source: The Economist, 11-09-2002

As we can see Germany shows more similarities to Japan than does the US. But it still looks that Germany is not in the same bad stage like Japan. On the other hand certain symptoms are worse in the US than in Germany, like corporate overinvestment and the size of the asset-price bubble. The US population increases, while Germany's decreases and ages. This could be an indicator for a shrinking German economy.

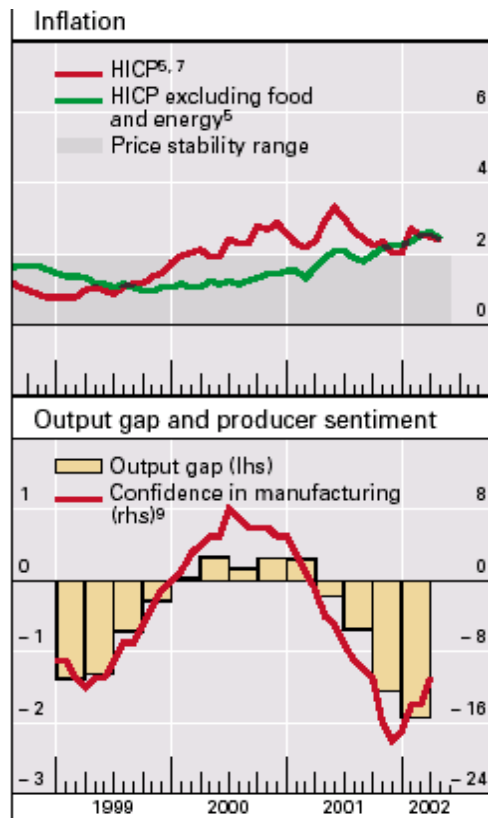
In Exhibit 6 I want to focus on Consumer Prices, the output gap and consumer confidence.

### Exhibit 6: Relationship between Output Gap, Prices and Confidence Measures

#### United States<sup>6</sup>



#### Euro Area<sup>7</sup>



Due to excessive business investment at the end of the 1990s and the subsequent bursting of the asset bubble the economy is left with a lot of overcapacity.

Overcapacity means that the potential GDP is higher than the actual GDP. This is called output gap. Common theory says that as long actual GDP remains below potential GDP, inflation will keep falling.

This makes sense. If a company has overcapacity they try to utilize it to cover their fixed costs. It is better for them to sell at lower prices and cover fixed costs than producing and selling nothing and bearing the fixed costs on their own.

This is also consistent with the charts in Exhibit 7, at least for the United States. Total Consumer Prices have fallen and consumer confidence moved in the same direction. Although there is currently no deflation in the United States it is for sure worth to keep an

<sup>6</sup> Bank for International Settlements Annual Report 2002, 72<sup>nd</sup> annual report

<sup>7</sup> Bank for International Settlements Annual Report 2002, 72<sup>nd</sup> annual report

eye on it. The US's inflation rate, measured by the GDP deflator, is currently running at only 1 %. If America's recession were to resume, the Fed's ability to act would be limited.<sup>8</sup>

Moreover Germany's banking system is left with huge amounts of bad debt. This might remind us on Japan's banking system. It is probably not as bad as Japan but it is a threat towards a deflationary state.

The charts for the Euro Area are a little distorted for the following reasons:

### **2.3. Special Case Euro Area**

The Euro area is, unlike the US, comprised of 12 countries with different economic structures. The inequalities in structure are much bigger between those European countries than between regions in the United States. Furthermore, individual Euro countries have power over issues like their social system etc.

But since the introduction of the Euro, monetary policy is not set by the national banks anymore. It is now set by the European Central Bank (ECB). The ECB's primary goal is price stability. Their self-set inflation target is 2 % for the whole Euro-area.

It is true that consumer prices lately rose by 2.2 % in the Euro area on an annualized basis. But due to the structural differences in the 12 Euro countries an interest rate according to the average inflation rate of the whole Euro-area seems to have totally different impacts on those economies. While Spain currently faces an inflation rate of 3.5 %, Germany only has 1.3 %. But since all the Euro countries comprise the average of 2.2 %, which the ECB focuses on, the current interest rate of 3.25 % might be appropriate for Spain and much too high for Germany.

Germany recently barely missed a recessionary state with a GDP growth of only 0.1 % from year to year. Germany might need much lower interest rates to prevent a recession or –even worse- a deflationary state like in Japan.

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<sup>8</sup> "The Economist", 09-28-2002, "A survey of the world economy", p. 17

Exhibit 7 shows consumer price changes in several countries for the purpose of comparison.

#### **Exhibit 7: Comparison of inflation and GDP growth in different countries**

| <b>Region</b> | <b>latest Consumer prices changes in %</b> | <b>GDP change in % 1 year</b> |
|---------------|--|-------------------------------|
| Austria       | 1.6  | 0.4                           |
| Belgium       | 1.3  | 0.3                           |
| France        | 1.8  | 1                             |
| Germany       | 1.3  | 0.1                           |
| Italy         | 2.7  | 0.4                           |
| Spain         | 3.5  | 2                             |
| Euro area     | 2.2  | 0.7                           |
| United States | 1.5  | 3                             |

source: The economist, 11-09-2002, Economic & financial indicators

### **2.4. Why Germany could become a big problem for Europe**

Because of the reasons given above, problems of the banking system, structural flaws and an interest rate suited to an average of inflations of 12 countries, Germany is under tremendous pressure to keep its economy going. Bankruptcies hit record levels and estimates of Germany's budget deficit already hit 3.8 % this week.<sup>9</sup>

Furthermore estimates say that the state of Germany will approximately receive 31 Billion Euro less in taxes this year. In addition Germany is going to take on the second highest net increase in household debt. This will amount to approximately Euro 34.6 Billion net additional debt for 2002.<sup>10</sup>

#### **2.4.1. Fiscal Stabilizers**

Ideally, budget deficits should be broadly balanced over the cycle, but automatic fiscal stabilizers should be able to work. If GDP falls, people have to pay automatically less taxes because of lower incomes. Therefore there is nothing wrong with a budget deficit in a recession, so long as it moves into surplus during the boom.<sup>11</sup>

But first Germany did not have a budget surplus during the boom because of structural rigidities and a tremendous costly social security system. Instead Germany now has lower

<sup>9</sup> [www.manager-magazin.de](http://www.manager-magazin.de), 11-13-2002

<sup>10</sup> [www.n-tv.de](http://www.n-tv.de), 11-20-2002

<sup>11</sup> The Economist, 09-28-2002, "A survey of the world economy", p. 13

tax income, has to increase the budget deficit and the government in addition increases taxes in several areas. Therefore the effect of built-in fiscal stabilizers is partly diluted.

Second, the countries of the Euro area are not allowed to exceed the limit of 3 % budget deficit. Portugal has exceeded it last year and has to tighten its belt although it finds itself in a bad economic state. Germany will run, as mentioned above, at least a 3.8 % budget deficit in 2002. Under the Euro stability pact it will have to decrease spending heavily, although it finds itself in a precarious economic state. In addition, the German government poses additional taxes on its people.

Germany's recently reelected left-wing government does not seem to be willing to restructure Germany's economy. Instead they increase taxes for businesses and securities investments. The hope is on several state elections in spring. If the conservatives can increase their majority in the lower house the government cannot do anything without the conservatives. This could lead to some improvement.

## **2.5. Conclusion: Why this is important to US Investors**

Since Germany comprises approximately 35 % of the Euro area GDP this situation poses a serious threat for the whole European community. If Germany reaches a deflationary state it would harm Europe as a whole. Since the dollar would probably sharply appreciate against the Euro and Europeans would probably save even more US exporters and the US economy would suffer too.