Interest Rate Goes Down, Economy Goes Up?

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At the time of writing this article, the Fed has just reduced the rate by half percent (0.5%) and the Hang Seng Index shot up dramatically. According to financial commentaries as expressed in the media, this signifies the Fed does not wish to see a recession and a reduction in rates reduces the cost of businesses thereby ensuring better corporate financial health which in turn enhances stock performance and so on. In short, the USA economy will be sustained.

Not being an economist, **the author ponders the following question**: if interest rate adjustment is all that is needed to achieve a good economy, then how come the Japanese economy (or its stock market) remains sluggish despite its almost non-existent nominal interest rate and much effort by her government? Or an analogy on a more home economics level: does that mean a family (economy) would "feel" or react exactly in the same way irrespective of whether it was their mortgage rate which went down OR it was their family income that rose up, given all other things being equal? Perhaps not and this relates to a bit of psychology e.g. people seem happier to see a pay rise under an inflationary environment (which eats into the pay amount in real terms) than a pay freeze under a deflationary environment (which enhances their real buying power).

Hence, while a rate reduction may be conducive to having a better (than would-be) economy, this in itself is **NOT the full picture** and its effectiveness may vary under different circumstances. **Reasons**:

A) **Interest rate is not the only factor influencing the economy** (on a macro level) or you (on a very micro level) = would you go right out now to buy a car, a yacht, or a Rolex now that your interest payments are reduced? It depends i.e. you may or you may not = economic activity (or inactivity) is not assured. On the other hand, someone rewarded with a handsome year end bonus will likely buy some expensive toys even in a recession.

B) **Spending whether for consumption or investment has a limit** = say you would consume a good bottle of red wine when it is priced at $1,000. Now say its price is slashed to $500, you may well buy two, to $250, you may buy four and so on. Yet beyond a certain price and after a certain quantity (number of bottles), you may not wish to consume more as it brings no more satisfaction (or no marginal utility). Naturally, beyond a certain price, you may start to see the label as an investment asset, yet the investment size is limited by your own budget and the quantity available for purchase. The USA economy has been spending quite a lot for a while.

C) **A good business thrives on making profitable sales** = it is very rare to hear would-be entrepreneurs start a business because interest payments are low (though this helps), they do so because they figure that there is sufficient demand and that profit can be made. Likewise, a good economy thrives on having produced goods and services which are required and can bring in revenues. Hence, a reduction in interest rates is an added benefit in good times but may not be a savior in bad times (if such are to come). Moreover, while financial leveraging is highly common in the USA, it may not be evenly spread. This in turn implies heavily indebted operations may still find their interest payments formidable despite rate decreases* which may not be enough to offset any reduction in sales revenues. (* In the case of home owners, many have opted for fixed rate mortgages and thus any reduction may be meaningless until the mortgages are up for renewal).

By no means is the above comprehensive and we would welcome comments or enlightenment from economists. It is that we sometimes find **the market perhaps may be a bit too fixated on certain simplistic presumptions** where the detail footnotes are not often said enough.