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ECONOMIC NEWS UPDATE

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If Everything is Good, Why Do We Feel So Bad?

Share prices hit record highs; corporate profits are coming in at what only the greedy would consider unsatisfactory levels; jobs are plentiful; real wages are rising -- and six out of every ten Americans are expecting a recession.

The economy added 180,000 new jobs in March. The service sector, which accounts for over 80% of all payrolls, continues to grow, fueled by the health care, information services and hospitality industries. After 43 consecutive months of job gains, during which the economy added 7.8 million new jobs, the unemployment rate is down to a virtually irreducible 4.4%, despite the loss of more than 100,000 jobs in the residential construction industry. Household incomes from wages and salaries are rising well above the reported rate of inflation.

But Americans nevertheless worry. Difficulties in Iraq are souring the national mood, and most of us can no longer cheer ourselves up by regaling our dinner companions with tales of the

latest increase in the value of our homes, tales that we somehow persuaded ourselves were proof of our investing acumen. Then, there is a general feeling that foreign competition is putting every job at risk, a view exacerbated by press reports of layoffs by large firms while hirings, concentrated in smaller firms, go unreported.

Finally, there is the matter of inflation. Where you stand often depends on where you sit. Federal Reserve Board chairman Ben Bernanke sits on the Fed's monetary policy committee, and he looks to the overall inflation rate as one of the guides to interest rate policy. He is pleased with the data showing inflation to be close to nil.

But many consumers sit not in the Fed board room, but in the drivers' seats of their SUVs and other vehicles. They pay less attention to the overall inflation rate, or to declines in one-time purchases such as flat-screen TVs, than to gasoline prices, which they confront

daily. Prices have jumped over 10% in the past month alone, and at an annual rate of over 20% in the first quarter of the year. With prices above \$3 per gallon in many areas, consumers just don't believe that inflation is not a problem, and feel more beleaguered than they in fact are.

Despite all of these worries, the very same consumers who say they fear a recession also say their own personal finances are very or fairly secure. So perhaps it is best to ignore those polls. After all, despite all the recession fears, retail sales in March were 3.8% above year-earlier levels, suggesting that even nervous consumers continue to find relaxation in the nation's malls and shops.

Still, there is little question that the US economy is slowing. The debate about the outlook for the housing sector is now between those who are predicting a collapse, and those who say that they see light at the end of the tunnel -- but that "light" is merely a bottoming out. Almost no one is predicting an uptick.

Not all housing markets, of course, are equally hit by the current combination of rising inventories of unsold houses, falling prices, and increasing difficulties in the mortgage markets. Donald Trump, the celebrity builder famed for his glitzy properties and brutal manner of firing potential apprentices, says that Chicago, New York, Los Angeles and "most cities are doing very well at the very high end of the market."

But that's little comfort to builders looking for buyers who are not considering taking up residence in super-pricey Trump Tower. The number of housing starts last month was 26% lower than last year, and some

respected analysts are predicting a 40% drop in average home prices before the market stabilizes. Add problems in the mortgage markets as lenders over-react to problems in the subprime sector, and it is little wonder that Goldman Sachs reports that "builders' sentiment worsened in April from an already low level".

Indeed, the question of whether the economy will continue to grow at a moderate rate, or slip into recession, comes down to whether the problems in the housing sector will spill over into the economy as a whole. If consumers have to rein in spending because they are no longer able to withdraw equity from their homes, or if the number of jobs lost in construction overwhelms gains in the service sector, the expected return to 3% growth by year end will prove unattainable.

In that case, all eyes will be on the Federal Reserve Board's monetary policy committee, which will be under pressure to cut interest rates. Bernanke, however, is impervious to the sort of pressure brought by teary-eyed businessmen and panicky politicians.

He has to worry about the inflationary effect of the falling dollar, which drives up the cost of imports and relieves some of the pressure on domestic manufacturers to keep prices down so as to meet foreign competition. And that decline seems set to continue, precluding an interest rate cut soon. Meanwhile, higher inflation in Britain and the EU will force the Bank of England and the European Central Bank to move rates up, increasing the relative attractiveness of non-dollar assets. Add the decision of some central banks to lighten up on their dollar holdings, and the persistent US trade deficit, and you have a prescription for a further drop in

the dollar. A \$2.25 pound and a \$1.45 or higher euro might well be in our future. Unless you like \$7 bottles of beer, \$6 cups of coffee and a bill for pizza-for-two with two cokes that closes in on \$50, start planning a vacation in the good old USA.

Which might be good news, although not for Europe's manufacturers. Exporters will find it tougher to sell in the US as prices of made-in-Europe goods rise in America, and European firms catering to their domestic markets will find their customers increasingly attracted to made-in-the-USA products. Our imports will fall and our exports rise. The world has been calling on us spendthrift Americans to rein in our spending so as to reduce what are called "imbalances". That's just what will happen, proving once again to Europeans who might have forgotten it that it is well to be careful what you wish for.



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