

Suite 502

1150 Seventeenth Street, N.W., Washington, D.C. 20036

Telephone: (202) 777-3000 Facsimile: (202) 777-3010

ECONOMIC NEWS UPDATE

IRWIN M. STELZER

04 December 2005

The war in Iraq, hurricanes in the Gulf, the unsettling prospect of a change at the top of the Federal Reserve Board, a president unable to persuade the majority of Americans that he can lead them to peace and prosperity, a Doha trade round that seems more rather than less likely to fail, high budget and trade deficits, consumers deeply in debt -- and an economy that continues to grow at a remarkably rapid rate. That's the news from America this week.

The upward revision of earlier reports of the third-quarter growth of the economy took some analysts by surprise. The government originally put the growth rate at 3.8%; it now says that the economy grew considerably more rapidly, by 4.3%. It seems it underestimated the actual increase in both residential and business investment.

As if to underscore the imperviousness of the economy to the various negative forces abroad in the land, the so-called beige book -- the Federal Reserve's monthly summary of business conditions around the country -- reported, "Economic activity continued to expand between from mid-October

through mid-November...". This, say economists at Goldman Sachs, "foots fairly well with our sense that consumers have managed to work through the earlier increase in energy costs without significant retrenchment."

And we already know that consumers, their confidence buoyed by falling gasoline prices (the driver who took me from a Manhattan hotel to JFK had filled his tank in Jersey with off-brand gasoline at \$1.98 per gallon), continued spending in the current quarter: on Black Friday -- the bargain-hunters' bonanza that the day after Thanksgiving has become -- consumers stormed the electronics and big discount stores, leaving 22% more dollars in their wake than the year before. Luxury retailers are also smiling: Tiffany's third-quarter profits exceeded those in the like 2004 period by 37%, as affluent consumers stocked up on colored diamonds and platinum jewelry. Only apparel retailers are pulling faces.

Meanwhile, in the important housing market, a bit of cooling has not degenerated into the bubble-bursting that some analysts feared would drag the economy down along with the

housing sector, which now provides almost five million jobs, 60% more than the once-mighty auto sector. It is true that sales of existing homes in October declined by 2.7% from the previous month, pushing inventories of unsold existing homes to the highest level in 19 years. But such sales were nevertheless 3.7% above the October 2004 level, and the median price of existing houses that were sold jumped by almost 17%, the largest one-month gain in 26 years.

Hardly a market collapse, especially since sales of new homes (about 15% of all sales) rose by 13% in October to a record -- and the largest one-month gain in 12 years. Sales in such red hot areas as Phoenix (prices up 50% in the past 12 months) remain robust as the enormously mobile American population moves from the much higher-priced California market -- and its dysfunctional political system, dominated by public sector trade unions -- to Phoenix and Las Vegas.

All of this good news is, of course, worrying to the Fed monetary policy gurus who want to make certain that an overheating economy does not ignite a round of inflation. So far, so good: the inflation indicator preferred by the Fed is increasing at annual rate of only 1.8%, within Chairman Alan Greenspan's comfort range, and the 1%-2% range his successor, Ben Bernanke, plans to target.

But that will not deter the Fed from continuing its policy of steady increases in short-term interest rates. For there are some signs that inflationary pressures are gathering force. The "gold bugs", as believers in the predictive power of the price of the yellow metal are known, say that all we need do is notice gold's soaring price (\$500 an ounce, double its price six

years ago) of this traditional inflation hedge, to know that the value of paper dollars is about to decline.

Those who want a bit more proof need look only to the beige book. Some Federal Reserve districts report "a slight tightening of labor markets", with labor shortages cropping up in the energy, financial, construction, health-care and trucking industries. The result is "modest overall upward pressure on wages." Add in increases in the prices of energy-related and other inputs -- the labor and material businesses must buy -- and you have developments that confirm the inflation hawks in their resolve to nip any inflationary pressures in the bud.

The situation, then, seems to be one in which input prices are rising, but the prices consumers pay for the goods and services produced by those businesses are not, or at least not as rapidly. That suggests that we are likely to see an erosion in profit margins. Indeed, even mightily efficient Wal-Mart has had to accept slightly lower margins to meet competition in this pre-Christmas shopping season. And Microsoft, desperate to buy its way into the nation's living rooms, has had to take a loss of \$126 on each of its \$399 Xbox 360s, according to researchers at iSuppli, a "market intelligence" firm.

But before worrying about the health of American businesses consider this: profit margins are now at sufficiently handsome levels to give businesses room to tighten their belts without unduly constricting their ability to keep shareholders happy with handsome payouts (dividends and share buybacks will come to \$500 billion this year, up 30% on last year), while at the same time increasing investment in new hi-tech equipment by 25% during the past year.

So the economy continues to move ahead, thanks in part to the Bush tax cuts, but that doesn't seem to be doing much for the president's standing with the voters. Over 60% of Americans say they are dissatisfied with the way things are going, and 58% say they expect economic conditions to worsen. For Bush, there is no balm in Washington.



THE SUNDAY TIMES

A version of this Update appeared in
The Sunday Times (London)