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## ECONOMIC NEWS UPDATE

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The storm clouds that darkened the skies over New Orleans and then Houston have lifted, but those that are darkening the economic outlook remain threatening. Some related directly to Katrina and Rita, and will pass sooner rather than later. But other clouds might, just might, prove to linger far longer, long enough to create as much economic havoc as the hurricanes created physical havoc.

The storms did have enough impact on the energy system, from offshore platforms, to refineries, to pipelines to persuade two-thirds of the CEOs of America's largest companies that their operations will be negatively affected for from three months to a year. Hank McKinnell, chief executive of Pfizer and chairman of the Business Roundtable, foresees "a significant but not catastrophic national effect", and the 97 CEOs surveyed dropped their forecast of annual economic growth this year from a 3.5% to a 3.3% rate. To this economist, who has always believed that economic forecasters use decimal points to

prove they have a sense of humor, this isn't much of a change.

It is obvious that Katrina and Rita added to upward pressure on energy prices, and that higher-cost gasoline and, this winter, natural gas and heating oil, will put a dent in consumers' wallets. This has made always-nervous retailers even more worried than usual as they approach the holiday season. But with inventories of gasoline surprising on the high side, and the reconstruction of damaged facilities proceeding apace, gasoline prices are likely to ease. Add to that the effect of the President's decision to spend whatever it takes to restore New Orleans to its former -- one would hope for better than that -- condition, and for all intents and purposes the effects of the hurricanes can be filed under the "this, too, will pass" category. James Cooper and Kathleen Madigan, economists at Business Week, estimate that the initial funds authorized by Congress, \$62.3 billion, will add some two percentage points to economic growth in the third and fourth quarters. And there is more money

to come, although it now is likely that the President, smarting from conservative criticism of his spendthrift ways, will work with Congress to keep the outlays well below the \$200 billion originally estimated.

The storms and their effects are not what have serious economy-watchers on edge. Some see a renewed bout of inflation -- US and worldwide -- in our near-term future. Higher fuel prices are already feeding into higher trucking and transport costs. The spurt in natural gas prices is forcing chemical producers, who use natural gas as a feedstock, to raise prices: Rohm & Haas, a manufacturer of specialty chemicals, says it is raising prices "to offset the jump in raw material, feedstock, energy and freight-related costs...." The prices of lumber and cement, in great demand as the rebuilding process gets underway in the Gulf Coast region, are rising.

Even more worrying is the recent rise in inflation expectations. In August, consumers were expecting the inflation rate to be 3.1%; now, they are expecting prices to increase at an annual rate of 4.6%. And the price of gold, an historic inflation hedge, is at an 18-year high.

Then there is Alan Greenspan, the chairman of the Federal Reserve Board. Greenspan is warning that consumers might be forced to the sidelines if rising interest rates make it difficult for them to continue borrowing against the value of their homes.

A bit of arithmetic shows why Greenspan has set retailers' teeth on edge. He estimates that the value of

what he calls "home equity extraction" added \$600 billion to consumer spending power last year, equivalent to 7% of personal disposable income, half of which was used to finance trips to the malls and shops. If consumers can no longer "cash out" some of the value of their homes, their spending might drop by an amount equal to 3.5% of GDP. All figures approximate, of course: some put the possible drop at 2.5%.

This disturbs retailers more than it does Greenspan. He will still exit, smiling, in January, if he is right that this reversal of consumer spending might actually help to increase savings, and cut purchases of imported goods, reducing America's massive trade deficit. That would come in handy right now, since several forces are at work that will drive the trade deficit even higher than its current level of over 6% of GDP, believed by most analysts to be unsustainable.

For one thing, higher prices of imported crude oil and greater reliance on imports of gasoline until US refineries are fully operational will contribute to a greater outflow of dollars. For another, the approximate 10% rise in the dollar relative to both the euro and the yen will make American goods dearer overseas, and imported goods cheaper here, cutting exports and increasing imports. To fund the higher trade deficit, America will have to attract something like \$80 billion per month from foreign investors, not impossible -- but achievable only if they are offered higher returns on their investments. That means higher long-term interest rates, especially since the Fed intends to continue

raising short-term rates, and a slowing of the economy.

So much for worries. Fortunately, the prospects for dispersal of the clouds hanging over the economy are relatively good. A survey by the National Association of Business Economists shows that its members expect the economy to grow 3.5% this year and 3.4% in 2006 -- a "solid expansion" -- in part because they expect oil prices to drop to \$63 by year end, and to \$55 by the end of next year.

We do know that business spending was accelerating before Mother Nature expressed her displeasure with the US Gulf Coast. In August, durable goods orders rose by 3.3%, after falling in July. Orders for nondefence capital goods, excluding aircraft, are the most-watched component of the durable goods series, as they are an indicator of investment in productivity-enhancing technology. Such orders were up over 12% from last year.

Finally, there is a good possibility that business spending will offset any decline in consumer spending. Thomson First Call, the authority in these matters, predicts that earnings for the companies in Standard & Poor's list of 500 large companies will be up 12% in the third quarter, 13% in the fourth quarter, and 9% in the first quarter of 2006. With sales rising, interest rates relatively low, and depreciation charges falling because of lower investment in recent years, cash flow is at record levels.

Now, if better weather, cheaper flat-screen television sets, and an easing of gasoline prices

prevent the holiday shopping period from becoming a winter of consumers' discontents, forecasters might be scrambling to raise their growth forecasts by early next year.  
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## **THE SUNDAY TIMES**

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