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ECONOMIC NEWS UPDATE

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At long last it's come, the day of reckoning for the US economy. That's what some experts are saying as they study the data that have been published since Katrina struck the oil, gas and shipping industries. True, those data contain more good news than bad. It is now clear that the economy was growing at a relatively rapid clip before the storm, with activity high and the jobs market strengthening, and that Katrina did not derail the economy.

But the inflation hawks have been circling for some time, and the good news has given them reason to pounce. The Federal Reserve's latest survey of business conditions notes that "business activity continued to expand in September,...retail sales of general merchandise increased in most districts,... employment has been rising,...service activity expanded in almost all the [Federal Reserve] Districts that reported on this sector, ...manufacturing activity rose in all Federal Reserve Districts except St. Louis...all the Districts reporting on

commercial real estate conditions noted rising demand for office, retail, or industrial space."

There were, to be sure, a few caveats scattered throughout the report (auto sales were slow, the rise in retail sales was "moderate"), but its general tone can only be characterized as cheery. But not to the hawks, who focused on the fact that the Fed survey noted "a pickup in cost pressures,...a general escalation of costs for manufacturing inputs." These cost increases would not result in higher prices if companies were forced to absorb them. But boardroom talk, mere whispers at the moment, is of the return of "pricing power", the ability to pass these cost increases on to consumers.

The hawks have already noted that in September soaring energy prices caused a 1.2% increase in consumer prices, the largest jump in 15 years. In the past, such energy-led increases have been dismissed as mere volatility, likely to be reversed. But it would be imprudent in the extreme to base

monetary policy on the assumption that oil and natural gas prices have merely spiked, rather than reached some new plateau.

Add to the mix of data that is fuelling the concern of the inflation hawks the inability of congress and the unwillingness of the President to control spending. Republicans want to cut food stamp, health care, and other aid for the poor, while Democrats want to raise taxes on the "rich". The result, at least so far, is a stalemate: the spending goes on and the deficits continue as Republicans who want to cut spending scramble to do just that without denying themselves the platters of pork on which they have been gorging.

All of which means that there is almost no chance that the Fed will reverse its policy of steady, quarter-point rises in interest rates so long as Alan Greenspan is its chairman. That means that Greenspan will exit with the fed funds rate at 4.50%. Enter his successor, who is unlikely to upset markets by calling a sudden halt to the rate increases at his first, or even his second meeting.

Indeed, if that successor turns out to be Donald Kohn, who has been with the Fed for over three decades, first as a staffer, more recently as a Governor, the inflation hawks will have control of the nest. Kohn, whom Washington insiders say Greenspan has urged President Bush to name as his successor, took the opportunity provided by a conference in Pittsburgh to note that "the risks may be skewed a little toward the upside on inflation. Because ... activity is most likely on a solid upward track, my focus at this time is naturally on keeping inflation contained.... We are not yet at a point where we can stop" raising rates.

Add all that up and you get a fed funds rate of 5% by May 2006.

That, most experts agree, will drive long-term rates up, cool the housing market and the "mortgaging out" that financed as much as 40% of the growth in consumer spending last year, force consumers to take notice of the increase in the debt charges on their variable mortgages and their credit card balances, and almost certainly prevent the economy from continuing to grow at anything like the 3.5-4% rate that it has been chalking up. Some think the Fed will have overshot, as it has in the past, and thereby produce a recession. Others disagree, and see growth slowing to something like an annual rate of 2%.

If either the over-shooters or the two-percenters are right, 2006 will see the beginning of a correction to the imbalances that have so many policymakers worried. American consumers will spend less, reducing their outlays not only on made-in-America products but on imports. That should begin to whittle down the trade deficit, now running at around 6% of GDP, believed to be unsustainable. A reduction in imports inevitably means that China's exports will drop, and with it China's growth rate. Result: an easing of demand pressures on international oil and commodities markets.

All a bit painful, but a not unwelcome adjustment if it does not become too severe or too protracted, which it won't if Kohn is right that the deceleration in consumption spending will be at least partially offset by growth in business spending on capital equipment.

To say that this scenario should be taken with a large dose of uncertainty is to put it mildly. Too many things are

happening that economists cannot explain. The US trade deficit mounts, but the dollar fails to collapse. A survey by Merrill Lynch shows that “American equities are most unpopular investment class in the world”, but net capital inflows are rising as US residents sell off their holdings of foreign-issued securities. The Fed keeps raising short-term rates, but longer-term rates refuse to rise proportionately, creating the “conundrum” that has Greenspan so puzzled.

All of which should make life interesting for Kohn or whomever ends

up in Greenspan’s chair just 100 days from now.

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