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ECONOMIC NEWS UPDATE

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Federal Reserve Board Chairman Ben Bernanke and his monetary policy committee should allow some time at their meeting on Tuesday for a round of self-congratulation. They have been raising interest rates at every meeting, continuing Alan Greenspan's program of putting paid to the era of low interest rates and cheap money. Their goal: to slow the economy, in part by taking the housing sector off the boil.

That, they have done. The government reported that sales of new home fell by 3% in June. And the National Association of Realtors reported that sales of existing, previously owned homes fell in June by 1.3%. Perhaps even more significant, mortgage applications are at a four-year low, and building permits, another indicator of future construction activity, fell 4.3% in June to a level almost 15% below a year earlier.

Some economists say the housing market is on a glide path to a soft landing, others see in the data an early indication of a collapse in prices and in sales. But no one doubts that the market is cooling.

So is the economy as a whole, probably in part due to the housing slowdown, by some reckoning a sector that accounts for 16% of the entire economy. Orders for non-defense capital goods (excluding the volatile aircraft sector) increased only 0.4% in June, well below May's 1.3% rise. Most important, the overall annual growth rate dropped to 2.5% in the second quarter from a torrid 5.6% in the first quarter.

Now, a 2.5% rate of growth is nothing to be sneezed at, but after a long period of much more rapid growth, it will feel uncomfortably like a recession, especially to the Bush administration as it contemplates the congressional elections, now only 100 days away.

The slowdown should make Bernanke & Co.'s job easy -- simply stop raising rates, eschew what would be the eighteenth consecutive increase. Indeed, economists at Goldman Sachs are so impressed with the speed with which the economy is slowing that that they are expecting "that the housing downturn will push real GDP growth below trend and will require a

substantial easing of monetary policy in 2007.” If the drop in house prices already being felt in parts of the country spreads, consumer confidence and with it consumer spending, already showing signs of slowing, might just fall a lot more than is consistent with a very soft landing.

Unfortunately, the life of a central banker in these uncertain times is not so simple. For one thing, Bernanke has pointed out that several sectors of the economy “retain considerable momentum.” Construction spending, for example, hit a record high in June. For another, the Fed’s preferred inflation index, the index of core personal consumption, is 2.4% above last June’s level, well above the 2% that the Fed says is the top of its “comfort range”.

So much past inflation is already “baked into the cake” that no matter what the Fed does we are likely to see reports of above-comfort-zone-inflation for several months at least. Past increases in oil prices are only now starting to feed through to trucking costs, airline fares, construction costs, and railroad rates. That run-up in inflation might decline when recent rate increases, also already “baked into the cake”, begin to make themselves felt, making further rises unnecessary.

The big unknown in this mix is the price of oil. Experts figure that about \$15 of the current approximately \$75 price of crude oil represents a risk premium, the cost of the uncertainty surrounding political developments in the Middle East and Nigeria. But that premium has to be paid until the world becomes a more certain place, not very likely in the foreseeable future. So the Fed will have to assume that high oil prices are a more-or-less permanent part of economic life in America.

If you want to understand just how difficult it is to forge a sensible monetary policy, consider the implications of high oil prices. Gasoline prices are now averaging about \$3 per gallon, with \$3.50 common for premium grade unleaded gasoline in the West. As noted above, this tends to drive up business costs and increase pressure on businessmen to raise prices. But higher gasoline prices also cause consumer spending to drop by draining money from consumers, especially those with annual incomes of less than \$50,000. Wal-Mart reports that high gasoline prices have caused its customers to drive to its stores once-per-week instead of perhaps three times, causing a drop in per-customer sales.

Profits of 70% of US companies in the second quarter exceeded expectations, but the inflation in oil and raw materials prices, plus faster growth in employee compensation, is going to put pressure on profit margins. Only half of the businesses reporting that their costs have risen say they will be able to raise prices. That will put pressure on them to wring still more output from existing staffs, and ease up on hiring. Indeed, the jobs market report late last week suggests that hiring is already easing. Despite the creation of 113,000 new jobs in July, the unemployment rate inched up from 4.6% to 4.8%, a level not seen since February.

That report has increased the probability that the Fed will pause on Tuesday, and give its monetary policy gurus time to appraise incoming data. My own guess is that a Fed pause is less certain than the market is predicting. But if it does indeed pause, the Fed is likely to find that the rising backlog of factory orders, wage

increases that are now starting to appear, a softening dollar, and what most businessmen assure me is a still-robust economy will create price pressures that will soon force a resumption of the ratcheting up of interest rates.



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