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## ECONOMIC NEWS UPDATE

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This week's Valentine's Day may be the last on which lovers of low interest rates will find their love requited. It is increasingly likely that short-term interest rates will be above 5% when sweethearts next exchange vows of undying devotion.

Ben Bernanke, only two weeks in the Federal Reserve Board chair, told congress that he intends to continue Alan Greenspan's policy of raising short-term interest rates. Many on Wall Street believe the increase that will almost certainly come late next month – the 15<sup>th</sup> one-quarter point rise -- would merely be the new chairman's demonstration that his anti-inflation bona fides are in order, rather than a reflection of any real concern that inflation is a threat.

They are wrong. Although making clear that he would watch "incoming data" before deciding – when did a Fed chairman ever ignore incoming data? – Bernanke noted that demand is rising so rapidly that "output could overshoot its sustainable path, leading ultimately – in the absence of countervailing monetary-policy action – to further upward pressure on inflation." He then went on

to endorse prior projections of the Board's monetary policy committee: growth of 3.5% this year and 3%-3.5% in 2007, inflation as measured by the Fed's preferred indicator at "about 2%" this year and 1¾%-2% next year.

The first thing to notice is that the growth projection is pretty close to the top of what the Fed has always thought the economy could manage without triggering inflation. The second thing to notice is that the projected inflation rate is at the top of Bernanke's 1%-2% comfort range. Taken together, they create a presumption in favor of further increases.

As does last week's bullish Report of the President's Council of Economic Advisers. Bernanke was chairman of that Council until the president nominated him to succeed Alan Greenspan, at which point he resigned. Although he recused himself from presenting the Report, he probably participated in shaping it in its early stages. That Report "calls for the economic expansion to continue in 2006 ... [and] in subsequent years." Not a prescription for a relaxed attitude towards the threat of inflation.

Neither are the recent data the Fed says it is watching closely. Retail sales rose 2.3% in January, helped by the cashing in of gift certificates. The January report on factory output was also “very strong”, producing a “tightening of capacity [that] parallels the tightening in the labor market”, according to economists at Goldman Sachs. Housing starts surged to levels not seen for over 30 years. Warm weather helped both retail sales and home building, but it would be unreasonable to assume that all of the strength was due to the temperature.

The January spurt in sales and output surely got Bernanke’s attention. As did the report that net inflows of capital in December fell to \$56.6 billion, from \$91.6 billion in November, and for the first time in seven months failed to cover America’s burgeoning trade deficit. That means that more dollars left the country to pay for cars and t-shirts than were returned by investors buying US assets. If that becomes a trend, the Fed might have to raise rates to induce greater foreign investment, and thereby prevent the greenback from depreciating so fast and so far as to exacerbate inflationary pressures.

Add to this new worries that the safety valve the Fed has been relying on to relieve inflationary pressures might be about to become a thing of the past. Greenspan persuaded his monetary policy colleagues that globalization has made worldwide, rather than only domestic capacity available to US consumers and producers. No matter if US labor markets tighten; there are all those low-wage Chinese and Indians eager to turn out the goods Americans want and, in the process, prevent American workers from driving their compensation to inflation-producing

levels. No matter if US factories are at capacity; Asian and Latin American factories will come on line and prevent American companies from raising prices.

The availability of that worldwide capacity, along with rising productivity (itself induced in part by the threat of foreign competition), has indeed kept compensation and prices restrained. And the large pool of Chinese labor will continue to prevent the wages of many American workers from rising at an inflation-threatening rate.

But rapid growth of domestic demand in China, the snowballing recovery in Japan, growing demand from oil-rich Russia and Middle Eastern countries, along with a continued willingness of American consumers to shop until they drop, might just be sopping up a good deal of the worldwide capacity that has restrained US inflation. Janet Henry, global economist at HSBC Global Research, has found that when growth in output in the rest of the world exceeds past trends by 1 percentage point, which it may be doing in most major economies other than the moribund eurozone, the US inflation rate rises by nearly 0.5%.

Bernanke might, just might, have taken charge just when the Greenspan safety valve has been made inoperative by overseas growth. That would put even more pressure on the chairman to move rates up, not only to 4.75% at the March 27-28 meeting, but to above 5% at subsequent meetings. Debt-ridden consumers, and the millions who recently converted to or bought their homes on the basis of variable-interest-rate mortgages, would be decidedly unhappy, but not the Democrats, who already sense an opportunity to reclaim congress in the November elections

because of voter unhappiness with the administration's conduct of the war in Iraq.

A final straw in the wind: Bernanke doesn't believe that because long-term interest rates are below short-term rates, a slowdown in economic activity, and hence an easing of inflationary pressures, is imminent. He dismissed such forecasts with an unGreenspanian verbal shrug, "The yield curve is not now signaling a slowdown."

Greenspan once predicted that anyone betting that interest rates would remain low is doomed to lose some money. Bernanke may be the man who imposes that loss on those who failed to take Greenspan's advice.

Unless ... But that's for another column.



## **THE SUNDAY TIMES**

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