

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

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The economy avoided two looming problems last week. First, the Federal Reserve Board's monetary policy committee decided not to bow to pressure from the housing industry and some investors. Ben Bernanke and colleagues refused to announce a halt in its series of interest rate increases. Instead, they took short-term rates to 5%, its 16th consecutive ¼-point increase. More important, the Fed pointed out that "some policy firming may yet be needed to address inflation risks", and then added the unexceptionable statement that it would study incoming data before deciding what to do at its next meeting. I would hope so, the alternative being to ignore the deluge of new data that will become available when the monetary policy committee again reviews its interest rate policy next month.

So, rather than give in to the increasing crowd of nervous economy watchers who see a slowing housing market as a forerunner to a major general economic softening, and announce that it would hold the line on rates, the Fed chose not to unleash inflationary expectations. With good reason. Most indicators suggest that when the Fed's monetary policy

committee next meets, inflation will be above Chairman Bernanke's comfort zone of 1%-2%. Consider these offsets to a softening housing market:

- commodity prices are soaring;
- high gasoline prices are starting to ripple through to air fares, freight rates and other prices;
- retail sales are slowing a bit, but remain buoyant;
- wage rates are starting to rise;
- the economy is continuing to grow at something like an annual rate of 3½.

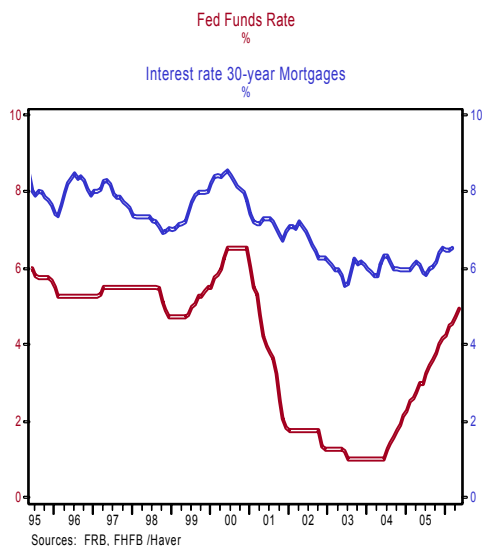
So this is not the time for the Fed to decide that its work is done, and announce that it is packing up its rate-rising tools. Better to let markets know that it is keeping its options open.

The second problem that policy makers avoided was the perennial one created by China's refusal to allow the value of its currency to rise. Treasury Secretary John Snow told reporters that he finds China's policies "deeply concerning", but nevertheless refused to use his department's mandated semiannual report to brand China a currency manipulator. His deputy, Tim Adams justified the inaction by reporting that on his recent visit to Washington, China's president Hu Jintao gave

President Bush a “positive reaffirmation that they will embrace the kind of reforms we have been proposing.” China feels it has demonstrated its good intentions by allowing the yuan to appreciate by about 6% in real (inflation-adjusted) terms since ending its dollar peg.

For the moment, New York Senator Chuck Schumer has decided to hold off on introducing his bill that would load a 27.5% tariff on imports from China, perhaps because he and his colleagues don’t want to take time off from posturing about gasoline prices.

Either the unleashing of inflationary expectations or the triggering of a trade war would have come at a time when American consumers are absorbing a new, unpleasant reality. The successive rises in short-term interest rates have finally fed into mortgage rates, which have risen by almost a full percentage point from the low of 5.5% in mid-2003. Never mind that only half- dozen years ago rates on these 30-year mortgages were over 8.0%.



Consumers’ memories are short, and the current level is high enough to have two dampening effects on spending. First, cashing out on home equity is now more expensive, which may explain why firms that specialize in remodeling homes – that’s what many consumers used the loans for -- are hurting. Second, homeowners who used variable rate mortgages to finance the purchase of their homes find their monthly payments rising just as the cost of filling their gasoline tanks has jumped by around 30%. That is likely to produce some gloom, making it necessary for the Fed to weigh against the bright-side data listed above, the possibility that consumers will decide to zip their purses.

None of these economic data can do more than inform policy-makers’ judgments as to the shape and direction of the American economy in the near term. The longer-term outlook is not for the Fed, but for the Bush administration and the congress to ponder. Unfortunately, both of these institutions are amazingly ponder-free these days.

Three-dollar gasoline is hardly America’s major energy problem, painful as it is for motorists as the driving season gets under way. More fundamental is America’s continued dependence on unfriendly nations for the fuel to keep its 200 million cars and trucks rolling, its homes heated and many of its factories running. Venezuela’s Hugo Chávez would love nothing better than to divert his oil from US to Latin American markets; the Saudis refuse to allow foreign capital and know-how into their country to help it increase production, and use the funds from \$70 oil to finance terrorist teachings around the world; Iran can cock a snook at the US because it

thinks the President dare not interfere with the flow of its oil onto world markets.

America's politicians respond to these pressures by calling for investigations of oil companies, and refusing to expand domestic exploration. Better to pander to voters by promising to do something about \$3 gasoline, about which they can in fact do nothing, than to take the tough steps needed to wean America off what the President calls its addiction to oil.

Meanwhile, Americans continue to send mixed signals. On one level, they seem terribly unhappy. Only about one-third think the President is doing a good job, and an even smaller number think congress deserves their approval. Consumers fret about \$3 gasoline, and rising mortgage rates, but profess satisfaction with their own financial circumstances, and go on spending. Businessmen may be nervous, but they are doing deals and continuing to invest in equipment.

No wonder the Fed needs more data to dispel the fog in its crystal ball.

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