

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

26 May 2006

Alan Greenspan's reputation for perspicacity mounts by the day. The former Federal Reserve Board chairman could easily have persuaded the president to extend his term by a few months so that he could break Truman-appointed William McChesney Martin's record as longest serving chairman. He didn't. Instead he handed the baton to Ben Bernanke just as the markets gave new meaning to the word volatility, turning the mist that always clouds the Fed's crystal ball into a dense fog.

The bank's monetary policy committee has to decide in the next few weeks whether to ratchet interest rates up for the 17<sup>th</sup> consecutive time, to above the 5% mark that analysts have until recently seen as the natural end point of the rate-increase policy. It would have good reason to heed the pleas of the "stop the ratchet, I want to get off" crowd.

Bond market interest rates are rising in belated response to the Fed's tightening of short-term rates. The housing market shows signs of cooling, with the inventory of unsold homes up to levels that have builders offering free golf club memberships and finished

basements in order to entice newly reluctant buyers to sign on the dotted line and trudge down to their banks to negotiate increasingly costly mortgages.

Orders for durable goods – those that last more than three years – fell by 4.8% in April, surprising economists who had been predicting a more modest decline of only 0.5%. And the rise in inventories of these durable goods leads economists at Goldman Sachs to reiterate their forecast of "a deceleration in factory activity in coming months."

To these signs of slowdown add mounting uncertainty. Financial markets are in turmoil, with investors unable to decide whether the recent drop in share prices is a bump on the road to further long-term rises, or a sign that the bears have finally vanquished the bulls. The looming congressional elections just might result in Democrats' control of congress, and a period of legislative gridlock as the President and his sworn enemies square off for a bitter and paralyzing battle just as tough decisions must be made about Iraq and Iran. July's G-8 meeting in Moscow is likely to reveal just how vulnerable Europe's fledgling recovery is to Vladimir Putin's

willingness to continue supplying the natural gas that fuels that recovery. And Latin America's newly belligerent radical leaders are threatening the steady flow of the region's oil onto world markets by engineering government takeovers of important oil fields.

Surely all of this suggests that the Fed should pause, and stay its hand when the monetary policy committee gathers next month. Such a pause would recognize that the economy has slowed, and that the outlook is so uncertain that it is better to do nothing, than to overshoot and turn an adjustment into a serious downturn.

Or would it? There are, after all, significant signs that the economy is stronger than the recent data suggest, and that the threat of inflation is greater than the pause-pleaders recognize. Consider the 4.8% drop in durable goods orders. Most of the decline is accounted for by an approximate 30% drop in both of the two most volatile components – aircraft and communications equipment.

The housing data are also a bit more ambiguous than they at first seem. Yes, markets are cooling, and yes, that will knock perhaps one percentage point off the growth rate. But new home sales rose 4.9% in April, surprising economists who had penciled in a 5% decline. And the average price of new homes rose.

When all is said and done, the forces sustaining growth seem to be outweighing those acting as brakes on the economy. Consumers' incomes are rising, which may be why they seem unfazed by what may be the end of the double-digit increases in the value of their homes. Business profits and cash flow continue to grow at rates that satisfy the greediest of corprocrats.

Investment spending grows, even though corporations are returning record sums to shareholders as cash flows exceed businesses' ability to find uses for those funds. Net exports are growing. And the successive round of interest-rate increases has not (yet?) dampened the economy's growth rate, which clocked in at 5.3% in the first quarter and should average between 3% and 4% this year.

More important for a Fed that has as its primary responsibility keeping the inflation genie bottled up are signs that that monster is pressing hard on the cork. There are several measures of inflation, but the two that the Fed watches most closely are the core PCE (Personal Consumption Expenditure) and CPI (Consumer Price Index). Both are at the top of the Fed's comfort range. Add to that a weaker dollar that is making imports more expensive, and a rise in inflation expectations, and it becomes more rather than less likely that Bernanke will feel that he must assure markets that preventing inflation is his first priority.

The good news is that he and his fellow central bankers have learned from history how to cope with high oil prices. When the first round of oil shocks hit America some thirty years ago, the response was to raise interest rates and clamp down on credit so that higher oil prices would not trigger a general inflation. The result was stagflation – rising prices, a failing economy, and the introduction of a "misery index" to measure the combination of high inflation and high unemployment.

Even bankers can learn it seems. Greenspan did not panic, and Bernanke has not panicked when oil and petrol prices hit headline-making highs.

Instead, they stuck to their program of raising interest rates slowly and deliberately, in search of that elusive “neutral rate” that would sustain job-creating growth without unleashing inflation. If the Fed’s hunt succeeds, the bulls might once again gore the bears.

[ET



**THE SUNDAY TIMES**

A version of this Update appeared in  
The Sunday Times (London)