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ECONOMIC NEWS UPDATE

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This may be the year in which we get some proof that we should be careful what we wish for. The chorus of those demanding that we correct what have come to be called “imbalances” is rising to a decibel level at which it might actually affect policy.

The most prominent of the worrying imbalances is our trade deficit. Now running at over 6% of GDP, even after declining in November, it is said to be unsustainable. To correct the imbalance members of congress and some EU policymakers are demanding limits on Chinese exports of shoes, apparel and a host of other products, and an upward revaluation of the Chinese yuan.

Such restrictions would indeed correct the imbalances. So would a substantial depreciation of the value of the US dollar. Experts are guessing that a 40% decline in the value of the dollar relative to the currencies of our trading partners would bring our exports and imports into approximate balance by making US goods cheaper abroad, and foreign-made cars, televisions sets, sneakers and t-shirts dearer in America.

Exports up, imports down, imbalance gone.

Unfortunately, such a correction doesn't come cheap. If barriers are erected to low-priced foreign goods, or if the dollar declines, the prices of foreign goods would rise. Trips to Wal-Mart would be a lot more expensive. Adding to inflationary pressures would be the fact that domestic producers would be relieved of competitive pressure, and be free to raise their prices. Meanwhile, with fewer dollars to invest, China would reduce its purchases of US bonds, driving their price down and interest rates up. That might well produce a recession that would make Americans long for the old trade imbalance, and other countries remember fondly the day when Americans buoyed their economies by acting as consumers of last resort.

Then there is the imbalance between wages and profits. In recent years, a soft labor market has enabled employers to add to their work forces without raising wages. This has allowed businesses to grow their profits at double-digit rates, without raising prices,

and sop up an ever-larger share of GDP.

The unemployment rate has now fallen to 4.9%, a tad below the 5% level that the Federal Reserve Board worries will trigger a round of wage increases. That would restore labor's share of the total national income to historic levels, eliminating an imbalance. But employers would be tempted to pass along those higher costs by raising prices, and might be able to do so if the competition from imports is made less severe by policies to end the trade imbalance. That would ratchet up the pressure on the Fed to take tougher anti-inflation measures, increasing the possibility that it would "overshoot", and bring the economy down.

Two other imbalances have critics of US economic performance calling for correctives. The federal budget deficit, created by the imbalance between expenditures and receipts, has been grist for the mill of those who want to raise taxes to pre-Bush levels. If such tax increases did indeed reduce the budget deficit, which supply-siders say is far from certain, they would do so by taking money out of consumers' pockets at a time when those consumers might anyhow be reining in their spending in order to correct their own imbalances -- the ones they see on their credit card statements.

Then there is housing, and the imbalance between that sector and the rest of the economy. The housing industry tail has been wagging the total economy dog. Consumers withdrew \$400 billion in equity from their houses last year, and spent \$250 billion of it, equal to 2.5% of GDP. With the housing market cooling, that source of financing will start to dry up. Good thing, say the imbalance opponents; it's about time

that we stopped letting the wildly inflating value of this asset finance a consumer binge.

Perhaps. But the resulting slowdown in consumer spending, combined with a rising wage bill, would shrivel profits, just at a time when rising business investment would be needed to offset slowing consumer spending.

Clearly, not all of these things can happen at the same time. But the basic point remains: correcting imbalances, desirable though it may be, will carry costs -- many of which are difficult to foresee.

All very complicated, and all awaiting action by the Fed's soon-to-be chairman, Ben Bernanke. Bernanke knows a lot about monetary policy, but he has two problems, not including the fact that Alan Greenspan is a tough act to follow. First, the tools at his disposal are limited. As Greenspan learned, there are times when the Fed can raise short-term interest rates -- the only rates it controls -- without causing long-term rates to rise. That limits its ability to cool the housing market, since long-term mortgage rates, beyond its immediate control, are the key to cooling the economy.

Second, he cannot know just how far to push policies that might be desirable to contain inflation. Raise rates too much in an effort to keep house prices from escalating and to make it more expensive to borrow against the equity in houses, and the economy might tip into recession. Abandon Greenspan's policy of increasing rates at "a measured pace" too soon, and high fuel and labor costs might combine with renewed corporate pricing power and continued consumer spending to unleash inflation.

So raising rates too much, too soon, results in deflation. Raising them too little, too late results in inflation. The possibility of getting rates just right, of steering the economic ship safely between these two reefs, certainly exists.

But that perfect rate cannot be found by studying econometric models, even models as sophisticated as those developed by the Fed. In the end, Bernanke will have to rely on his own judgment. Which makes any guess as to what he will decide particularly hazardous, including mine -- that he will take rates close to, or even to 5%.

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