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ECONOMIC NEWS UPDATE

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Economic theory is clear about one thing: increase the supply of a good and, other things being equal, its price will fall. So the US government massively increased the supply of its bonds in order to finance its deficits, and their price rose. (When bond prices rise, their yields, or interest rates, fall.) When the government was running surpluses of some \$200 billion in 2000, retiring bonds and reducing their supply, the interest rates on ten-year treasury bonds was above 6%. Last week, when President Bush sent to congress a budget projecting a deficit for fiscal 2007 of well over \$400 billion, portending a further increase in the issuance of treasury IOUs, the yield on ten-year bonds was not higher, but lower -- around 4.5%.

Fortunately for economists, this performance only seems to stand economic theory on its head. The explanation of this apparent flying-in-the-face of economic theory is that the "other things" that economists hold "equal" when they forecast such

variables as interest rates, aren't equal at all.

America has now become the country of choice for overseas investors. They find the combination of safety provided by a stable political system, and a central bank intent on raising interest rates, attractive. So high-saving Chinese and other foreigners, their coffers overflowing with dollars earned from exporting to America, snap up US treasuries, keeping US interest rates low.

The rapid growth of the American economy, which in the past would have set off inflation-alarms, has not caused panic because globalization makes available to American industry a huge supply of labor and productive capacity. In past years, the 4.7% unemployment rate now prevailing would have signaled a labor market so tight as to generate substantial wage inflation. But a pool of low-cost foreign labor, and rising productivity have kept increases in wages and benefits within acceptable bounds. Or at least within bounds

investors, ever on the watch for hints of inflation, find comforting.

Then there is the Fed. By raising the short-term interest rate, the only one it directly controls, Greenspan's central bank showed that it intended to keep inflation bottled up. So investors' enthusiasm for long-term bonds was not cooled by inflation fears, adding to their willingness to keep the price of bonds high, and interest rates low.

Exit Greenspan, enter Bernanke, who now has to decide just how many more times to raise short-term interest rates. Until recently, traders have been guessing that he would use his first meeting of the monetary policy committee next month to impose one more one-quarter point rise, and then declare victory against incipient inflation. They are no longer certain that victory will come so easily and so soon.

True, some of what Greenspan called "froth" has been blown off the housing market, where "for sale" and "vacancy" signs are increasingly common, and mortgage applications are down. Average house-price increases are expected by Fannie Mae to taper off to about 3% this year, from the double-digit rate of the recent past. That development, along with higher interest rates, will slow so-called cashouts from \$243 billion in 2005 to \$117 billion this year, according to Freddie Mac, biting into the growth in consumer spending power. (Fannie Mae and Freddie Mac are quasi-government mortgage lending institutions.)

True, too, the rise in credit-card debt last year was the lowest in many years, an indication that consumers might finally be taking a holiday from the shops. But before Bernanke decides to stay his hand he will have to weigh those signs of cooling against some

compelling indications that the US economy might be about to go on a growth tear, after its fourth-quarter pause.

It is now clear that the Christmas sales season was a success for the nation's retailers. And, with happy recipients of Santa's largesse cashing in their gift cards last month, sales of a sample of 60 retail chains started the new year with a jump of almost 5% over last January's rate, according to Retail Metrics, a market-research firm. There is more to come. Economists at Goldman Sachs captioned their latest report, "The US Consumer Roars Back".

Consumers, after all, know one important thing – the jobs market is about as good as it gets. Monthly job growth in November, December and January averaged 229,000, driving the unemployment rate to 4.7%, its lowest level in more than four years. All signs are that hiring will continue at a rapid rate for the balance of the year.

Business investment is also likely to remain strong. The National Association of Business Economists reports that a majority of its members are experiencing increasing demand for their products. A PricewaterhouseCoopers survey found that 76% of large manufacturers are optimistic about the US economy. As they should be, having racked up growth of 4.8% and 3.8% in 2004 and 2005, respectively. "All in all", as Business Week's James Cooper puts it, "it is more a picture of acceleration than moderation, and one likely to cause some discomfort among Fed officials if the data in coming months confirm that the economy remains strong enough to make future inflation a threat."

Meanwhile, investors seem unworried that such growth will uncork

inflation. The Treasury reintroduced its 30-year bond to investors last week after a 5-year absence, and it got a good reception, selling high enough to yield only around 4.5%. That suggests fears that a booming economy will ratchet up inflation may be confined to the Fed's board room.

Indeed, bond buyers seem to be signaling that they expect the economy to soften markedly, and perhaps even slip into recession, especially if there is another energy-price shock. The economic data are telling the opposite story. All Bernanke has to do is to decide whether he believes the bond market, which is predicting inflation-free, slow growth, if not a recession, or the raft of economic data that seem to foretell a red hot 2006.

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