

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 year that ended a few days ago was a pretty good one in America -- unless you built GM or Ford cars, piloted Delta airplanes, or lived in the path of Katrina. And, sadly, unless you had a loved one killed or maimed in Iraq.

Most people got richer. Yes, share prices disappointed, but more people own houses than shares, and, with the exception of a few areas, house prices remained, to put it mildly, elevated. Corporate profits chalked up double-digit gains, continuing a three-year run of such increases. The jobs market strengthened to a point where just about anyone serious about finding a job could find one: economists at Goldman Sachs estimate that when the final tally for the year is in, over two million new jobs will have been created, and the unemployment rate, which began the year at 5.2%, will have fallen to 4.9%.

Despite a slowing in the last quarter, the economy racked up another respectable growth rate -- around 3.5%, driven in part by a housing industry that built close to two million new homes for immigrants getting on the first rung of

the housing ladder, Americans who decided that they can afford bigger homes with the now-requisite media centers, and baby boomers who are snapping up second homes in which to spend part of what will undoubtedly be their golden years.

Investment bankers returned to the glory days, closing almost \$3 trillion worth of deals, putting revenues from these deals for each of the big four banks above the billion-dollar mark for the first time. And that doesn't include revenues from trading and other activities, all of which contribute to record bonus pools. Individual bonuses of six-, seven-, and in a few cases eight-figures are bringing smiles to the faces of high-end property salesmen, busy days in Porsche showrooms, and, less publicized, substantial increases in charitable giving.

Equally important, lots of bad things didn't happen. The dollar didn't collapse under the weight of a record trade deficit. House prices didn't collapse under the weight of rising interest rates. The economy didn't collapse under the weight of \$70 oil and

a hurricane that ravaged a large part of the nation's oil and transport infrastructure. And President George W. Bush did not appoint an incompetent to succeed the fabled Alan Greenspan as chairman of the Federal Reserve Board.

So much for the past. Is it prologue? Probably, but with a disclaimer. Economic forecasters were invented to make weather forecasters look good. Skilled analysts have trouble interpreting what has already happened, much less predicting what will happen. Consider this: on the day after the Federal Reserve Board's monetary policy committee met and raised interest rates last month, The Wall Street Journal headlined its story, "U.S. Fed raises rates, indicates more to come." The equally respected Financial Times captioned its report, "Fed signals end to rate tightening era."

So take the following with the appropriate pinches of salt.

Consumer confidence, buoyed by gasoline prices that have descended from \$3 to close to \$2 per gallon, has recovered to pre-Katrina levels. Although confidence levels are not the best predictor of consumer behavior, combined with a strong job market these data suggest that consumer spending might cool, but is unlikely to collapse.

Meanwhile, all signs point to a major surge in business spending. A survey by the Institute for Supply Management and Financial Executives International shows that US companies plan to increase purchases of equipment, software, and other items by 9% in the New Year. The cash piles accumulated in the past few years will provide the wherewithal, balance sheets are in good shape, and every measure of CEO confidence is at or near record levels, despite rising shareholder

protests at executive compensation levels that are far from transparent and often seem unrelated to company performance.

All of this cheer despite the likelihood that the Fed will continue to ratchet up interest rates. The new chairman, Ben Bernake, will not want to use his first day in the chair to bring the round of rate rises, thirteen so far, to an end. Good thing. Inflation, although not threatening to get out of hand, is close to the top of the Fed's 1%-2% comfort range, despite the advent of \$100 laptops, cheaper flat-screen television sets, and wild discounts on your favorite gas-guzzling SUV. An unemployment rate of 5%, or even lower, indicates a tight job market in which wage pressures are mounting, especially for skilled workers. Capacity utilization rates are now high enough for many board rooms to be treated to Power Point presentations about the return of pricing power, and for supply chain bottlenecks to be popping up. And OPEC has decided that, although \$70 oil might threaten a demand-reducing recession and a shift from fossil fuels, \$50 is a good, safe target number, more enriching than the \$28 per barrel price the Saudis not so long ago promised to maintain as a ceiling.

So it would not be surprising if the Fed called a halt only after pushing rates to 5%, to the consternation of critics who fear Fed overshoot. They correctly point out that the housing market is slowing, with mortgage applications down and inventories of unsold homes up, and orders for durable goods other than aircraft have been disappointing. True, too, we have not seen an end of the productivity miracle that continues to allow output to expand in a widening number of

industries while unit labor costs are contained. And it is also true that the relationship between short-term and long-term interest rates is now such that many observers see a recession in the offing.

Those undeniable facts are grist for the mill of Greenspan's critics, who say that further increases in interest rates will repeat a frequent Fed error of raising rates further than is required to contain inflation, thereby spinning the economy into recession.

But the history of the past 18 years suggests that it is better to bet on Greenspan and the Fed than on his critics. Look elsewhere than the Fed boardroom if you want something to worry about in the New Year. A loony left-wing Venezuelan president shuts down his oil industry; China decides to unload some of its dollar hoard, driving the greenback down and interest rates to recession-producing levels; Congress continues to match trivial spending cuts with generous tax cuts, forcing interest rates still higher; the president's critics force a premature withdrawal from Iraq, leaving neighboring oil-producing countries at the mercy of anti-Western Islamists; the opaque hedge-fund industry precipitates a systemic banking crisis.

My advice: don't worry about things you can't do anything about. Have a Happy New Year.

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