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ECONOMIC NEWS UPDATE

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Will he or won't he? The guessing about whether the Federal Reserve Board's monetary policy committee will continue to ratchet interest rates upward has not stopped with the retirement of the enigmatic Alan Greenspan. The clues provided by the financial markets, says Federal Reserve Board chairman Ben Bernanke, "are not at all clear-cut ... The bottom line for policy appears ambiguous".

So, concludes the chairman, he must rely on "multiple sources of information," one of which is surely data on the housing market. Experts waiting to hear the "pop" of the housing bubble will have to wait awhile longer. Sales of existing homes rose by 5.2% in February, after five consecutive months of decline. And average prices continued to rise at double-digit rates, despite relatively high inventories of unsold homes. Surveying the trends in incomes, interest rates and inflation, William Poole, president of the Federal Reserve Bank of St. Louis, concludes that "housing activity will stabilize and remain at a high level this year."

The market for new homes seems to be cooling, especially in the West, but a cooling is not a collapse. And it seems that office building is set to grow by about 9%, offsetting some of any weakness that might develop in the residential market.

A relatively robust housing market is only one force that should keep the inflation fighters on the alert. Energy prices may be off their highs of a few months ago, but they remain stubbornly high. China needs ever-more oil to fuel its 9-10% growth rate, which should make an interesting topic for president Bush to discuss during Chinese president Hu Jintao's April 20 White House visit. Russia's destruction of Yukos has made investors somewhat nervous about pouring in the billions needed to step up production in its hard-to-reach fields; Nigeria remains an uncertain source of oil; Iraq is unable to control terrorists attacks on its pipelines; Iran is already experiencing cutbacks in foreign investment as it proceeds with its nuclear program; and OPEC is producing at full tilt, or almost so. American regulators are adding upward

pressure to petrol prices by insisting that it be formulated differently for different markets, depending on local atmospheric conditions. Some experts say prices will reach Katrina-like levels of \$3 per gallon during the summer driving season.

Even if the Fed chooses to discount the importance of energy prices, it has to face the fact that “core price pressures [excluding food and energy] were firmer than expected” last month, according to a report by Goldman Sachs. Core prices are now 2.1% above last February’s level, which puts their increase slightly above the top of the 1%-2% Fed “comfort range”.

Also weighing in the Fed’s calculations is the finding of its latest survey of the economy, conducted by the Federal Reserve Bank of Chicago. Some of the findings: “consumer spending continues to expand... expenditures for business services continued to rise.... Employment continued to increase in most locations and in many sectors of the economy.” Little support here for those expecting a major slowdown in 2006.

The Business Roundtable, representing the CEOs of America’s largest companies, is equally optimistic. Its quarterly CEO Economic Outlook index rose to the second-highest level in the survey’s three-year history. Hank McKinnell, the organization’s chairman and chairman of Pfizer Inc., told the press that the nation’s business leaders “foresee a vibrant and expanding

markets are tightening, both in the US and in the Asian markets that produce all those low-priced imports that have helped to dampen inflation. The rate of increase of hourly earnings is accelerating, and hit almost 5% at an annual rate in recent months. That would be less worrying if productivity was continuing to exceed its 2¼%, so that rising wages do not translate into rising unit labor costs. Until recently, companies have been able to increase output without adding very many new workers. Productivity growth, however, has slowed as companies find they can no longer meet demand with existing staff, and the bargaining power of the pool of available skilled workers is increasing, especially in the financial services, construction and manufacturing sectors. The benign behavior of unit labor costs might be about to end.

Throw in a weaker dollar that is raising the price of imports, and CEOs feel they have found their Holy Grail – pricing power. To the Fed that means a greater threat of inflation as what it calls “resource utilization” rises to rates that force employers to bid for workers, raw materials, and parts. Even last month’s fall-off in capital goods orders is probably given less weight by the Fed than the fact the unfilled orders for non-defense capital goods continues to rise, suggesting that production bottlenecks just might be rearing their inflation-producing heads.

Those who think the Fed will not

long-term rates to rise in parallel with short-term rates -- the flat yield curve -- means that the market is anticipating a cooling of economic activity that will prevent inflation. No threat of overheating and inflation, no need to raise rates.

Back to Bernanke, who told the Economic Club of New York, "I would not interpret the currently very flat yield curve as indicating a significant economic slowdown to come...". He may be wrong and the flat-yielders may be right, but it is Bernanke who has to decide whether to continue Greenspan's steady tightening of monetary policy. He might well decide to stop raising rates, but betting on such an outcome could prove a costly error.



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