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ECONOMIC NEWS UPDATE

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The ordinary nervousness of investors and market watchers has been converted into advanced paranoia by the business media's preference for bad news. Consider this headline in The Wall Street Journal, "Economy's Surge Stirs Questions About When Slowdown May Come".

Share prices are driven to a six-year high by rising corporate profits, and commentators trot out stories about bubbles and irrational exuberance, the latter a phrase used by then-chairman of the Federal Reserve Board Alan Greenspan to describe share prices – after which they doubled. Germany and Japan finally shake off their decades-long economic lethargy and show signs of recovery, and all talk is that, like rising share prices, this will force a recession-inducing rise in world interest rates.

There is worse. New home sales rose 13.8% in March from the previous month, bad news to pessimists who moan that this will prompt the Fed to keep raising interest rates. Indeed, read beneath

the somewhat gloomy Wall Street Journal headline cited above, and you can dig out these facts: "The economy surged in the first quarter..., The housing market is holding up better than many skeptics predicted and consumer confidence remains surprisingly strong..., Solid job creation and wage gains are providing a cushion for consumer spending..., Orders for capital equipment are picking up..., Business spending broke out of a recent slump..." Oh, woe.

Then there is the dollar, which is weakening. That, say the fearful, will trigger inflation. Never mind that a weaker dollar is required if the trade imbalances that have seen America's deficit soar to 7% of GDP are to be corrected gradually, rather than with a disruptive heave.

This spin on financial news is only one reason 77% of Americans tell pollsters they are uneasy about the economy. The other is the surge of gasoline prices to and through the \$3 per gallon level. That naturally troubles Americans every time they fill their tanks, which from many

Americans is at least once-a-week. But their irritation is increased by the political posturing of both the President and congress.

Instead of talking to the voters "as if they are grown-ups", as Bill Kristol, the editor of the politically important Weekly Standard is urging, politicians of both parties have joined forces to demand an investigation to uncover any conspiracy of oil industry executives to gouge consumers.

Instead, President Bush might be using what Theodore Roosevelt famously called the "bully pulpit" of the presidency to explain that the price of oil is being driven up by two factors.

The first is the fear of a supply interruption. Iran is threatening to attack shipping routes, Nigeria is in turmoil, Russia is using its oil and gas to bring the West into line with its new geopolitical ambitions, and Venezuela's Hugo Chavez has begun to nationalize his country's oil industry. These moves have built a risk premium into crude oil prices. As BP chief Lord Browne has been trying to explain, there is no shortage, and inventories are on the rise.

A politician talking to grown-ups would add a second reason. Prices of all commodities are rising -- oil is not unique. The reason: the world economy is booming, hardly a reason for hand-wringing. And, if brave enough, he might say that high prices are not necessarily a bad thing. They will encourage American consumers to use less oil, and make it more attractive for innovators to develop alternative fuels that will help Americans to overcome what

President Bush calls their "addiction" to oil.

Step back for a moment from reporters' spin and politicians' disingenuousness, and consider where the American economy is heading. The Fed's recent survey of business conditions concludes that "Economic activity continued to expand in March and the first half of April." Its economists' best guess is that the expansion will slow from the torrid first-quarter pace, and settle down in the long run to a growth rate of between 3% and 3½%, with inflation moderate. As Chairman Ben Bernanke told congress late last week, "The prospects for maintaining economic growth at a solid pace in the period ahead appear good....Inflation...has remained roughly stable....Long-term inflation expectations ...appear to remain well-anchored."

The housing market, he notes, is important enough in its overall impact on the jobs market and on consumer confidence to bear special watching. The hottest markets (Boston, Miami, Los Angeles) are cooling, but areas previously overlooked by house hunters and investors (Texas and some cities in the South) are attractively priced and seem to be picking up the some of the slack. But the inventory of unsold houses is up, and mortgage applications are down. So Bernanke is right to demonstrate his characteristic modesty by confessing that "significant uncertainty attends the outlook for housing," and to remain on the alert lest the current cooling accelerates into a "drag on growth this year and next."

The energy market is also being closely watched by monetary policy-makers. Keep in mind that even at \$3 per gallon gasoline prices, on an inflation-adjusted basis, are still not at the highs they reached in the 1980s. Also, these prices have not yet fed into a rise in the general inflation rate, with “yet” the operative word. Airlines are raising fares to offset the increase in the price of jet fuel, trucking companies are raising rates, and so are pizza deliverers. Bernanke has to keep an eye on these and other clues as to whether the economy can continue to grow without triggering inflation. The betting is that he will raise rates again in May. But many punters are discounting all the good economic news and betting that the economy will slow, forcing the monetary policy committee to stay its hand after that. That latter bet may well turn out to be a loser.



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