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ECONOMIC NEWS UPDATE

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“Don’t just do something, stand there,” Ronald Reagan is reported to have told over-zealous legislators and regulators. Many on Wall Street are wishing that Federal Reserve Board chairman Ben Bernanke would follow that advice and leave interest right where they are, at 5% after 16 consecutive increases, rather than raise them later this month.

Bernanke’s predecessor, the fabled Alan Greenspan, didn’t have to exercise his legendary ability to peer into the future to know that interest rates had to rise about the 1% level to which he had brought them. Bernanke’s job is harder: he has to decide when enough is enough, when rates have reached that “neutral” level that will keep inflation bottled up without tipping the economy into recession. Until recently, the word among money men was that “the 5% solution” would do the trick. Now, they are not so sure.

The core Consumer Price Index (CPI, excluding food and energy) rose at an annual rate of 3% in the first four months of this year,

the fastest four-month jump in over a decade. And the Fed’s favorite measure of inflation, personal consumption expenditures (PCE) is rising at a rate of around 2.5%. Both rates are well above Bernanke’s “comfort zone”.

As usual, those figures should be read with a bit of caution. For one thing, it is not clear that it makes sense to exclude energy prices. Those were dropped long ago, because they were volatile from one month to the next. But an up escalator has replaced that volatility, and there are signs that higher energy prices are seeping into the economy through increased rates for trucking goods around the country, higher air fares, and price increases by energy-intensive industries. With Nigeria in thrall to terrorists who specialize in kidnapping oil-field workers, Iran threatening to close off the Persian Gulf, Venezuela brandishing the oil weapon, and Saudi Arabia quietly cutting back production lest inventories rise to price-threatening levels, Greenspan was right to use his first congressional testimony since

leaving office to warn that the demand-supply balance is too precarious for Fed officials to count on price relief any time soon.

So the inflation measures understate inflation? Well, not certainly. They also include a rather contorted measure of housing costs that most experts believe is now overstating the rate at which rents are rising.

As a result, even as he looks in his rear view mirror to see where prices have been going, Bernanke can't get a clear view. And he has to look at more than just prices: he has to decide just where the American economy is headed. That is no easy chore.

Some things are clear. The economy grew at a sizzling rate in the first quarter. Despite interest rate increases, consumers continue to borrow. Corporate profits continue to surprise on the up side, and are now claiming a record 12 percent of national income, up from 7 percent in 2001 and the highest level since the government began recording these figures in 1947. The construction of commercial property rose 12 percent in the year ending in April, offsetting some of the decline in residential construction. The richest one percent of American households tell pollsters from the US Trust bank that they are expecting an 8 percent return on their stock market investment in the next twelve months, driving the "Affluent Investor Index" to 63 from 48 one year ago. The combination of prices rising at a rate that exceeds the comfort level, the soaring "animal spirits" (to borrow from John Maynard Keynes) of investors, and a still-buoyant

economy must mean that the Fed has no choice but to raise rates for the 17th time later this month. It can't just stand there.

Unfortunately, life on the cutting edge of economic forecasting is not so simple. The economy is already coming off the boil. Sales of cars and trucks dropped last month, with consumers so spooked by high gasoline prices that Ford is offering \$1,100 in free gasoline to any customers who will relieve it of unsold vehicles. Sales of existing homes are running at about 6% below last years' level, and sales of new homes are down a bit. With newly constructed homes hitting the slowing market, there are now one million more unsold houses looking for buyers than there were at this time last year.

The manufacturing sector continues to grow, but at a much reduced rate. In response to a weakening housing market, private residential construction chalked up its largest decrease in over two years. Goldman Sachs' economists reckon that construction will fall at an annual rate of 10%-15% over the next year. Along with flattening prices that will reduce the amount of equity taken out of homes to be spent elsewhere ("deequitisation"), that might reduce GDP growth by 1.5 percentage points.

Add to all of that the facts that job growth is slowing and consumer confidence, battered by petrol prices and, less obviously but most certainly, by the problems in Iraq, is dropping. Best of all for those who want the Fed to stay its hand, unit labor costs are more or less stable, as the pressure of global competition

forces workers to keep their wage demands at moderate levels, and their productivity up. And gold prices are dropping.

Despite all of this evidence of a slowdown, the Fed is signaling that it will raise rates once again. Susan Bies, a Fed governor, announced that she is “uncomfortable” with the current above-2% inflation rate. So is William Poole, president of the Reserve Bank of Dallas. He told the press that policy should have an “upside bias” to interest rates, and “I do not believe we can count on a slowing economy to bring inflation down, by itself, quickly.” Donald Kohn, Bernanke’s newly nominated no. 2, agrees: he finds recent inflation data “somewhat troubling”. More significant, Bernanke used the occasion of a speech to international bankers to label the recent rise in core inflation “unwelcome.” In ordinary times, that would be a clear signal that he intends to follow the course set last week by the European Central Bank, and ratchet rates up. But the markets are so volatile that an incoming flood of data between now and June 29, when the Fed’s monetary policy committee meets, might just change his mind.

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