

HUDSON INSTITUTE



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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“Gloom”, “turbulence”, “volatility”. A small sample of the adjectives festooning the business pages as America, and indeed the world, reaches what is being called “the end of the era of easy money”. Result: a worldwide “flight to safety”, as investors end their wild speculation in commodities and in the stock markets of places they probably can’t find on the map. But as heavyweight champion Joe Louis once said when told his next opponent was fleet of foot, “He can run, but he can’t hide.” A knockout followed.

Investors can indeed run from places and commodities they now deem unbearably risky, but there seems to be no place to hide. True, US share prices have done relatively well, and provided something of a safe haven for nervous money, but only when compared with those of markets in developing countries. That’s because, as the gang members in West Side Story informed the local policeman, “We’ve got troubles of our own.”

One such trouble seems to be uncertainty as to whether Ben

Bernanke, the chairman of the Federal Reserve Board, is up to the job. Not that anyone doubts his credentials as an economist, or the Fed staff’s ability to do as good a job as can be done in forecasting the economic outlook. Rather, it is because some observers doubt Bernanke’s ability to communicate his intentions to the markets in an orderly way. First he hints that the series of rate increases might end, or at least be suspended temporarily; then he lets slip an unguarded remark to a television journalist at a dinner party, suggesting he had been misunderstood; then he attempts to burnish his credentials as an inflation fighter by publicly restating his determination to keep the inflation genie bottled up; finally he ends a rather confusing few weeks but suggesting the problem is not all that dire, and the Fed will be able to handle it.

Another problem is that investors fear a return to the bad old days of stagflation, with inflation rising and the economy sinking. Their fears about resurgent inflation were fanned last week by the

release of data that show that in the last three months the core rate of inflation (excluding food and fuel) has risen at an annual rate of 3.8%, far above the 1%-2% that the Fed chairman and his colleagues have been trumpeting as their “comfort zone”.

So, the Fed cannot end the ratcheting up of rates, and will have to go beyond its current “5% solution” if Bernanke is not to be seen as so rattled by recent market turmoil that he throws in the towel and lets inflation get out of hand. The markets are now certain that another increase, the seventeenth, will bring short-term rates to 5¼% at the end of this month, and are assigning a 50-50 probability to a further increase in the summer.

It is not only the crowd that traditionally worries about Fed “overshoot” – rate increases that not only slow the economy but throw it into recession – that is on edge. A new crop of Fed critics is abroad in the post-Greenspan land. They make three points.

First, it is not the Fed’s job to look in the rear view mirror, which is what it will be doing if it gets spooked by recent inflation data. It has to look ahead. And this is one instance in which the past is not prologue.

That is because, second, the economy is already slowing, and doesn’t need the Fed to tramp down harder on the brakes. As the Fed’s

growth of consumer spending has slowed. That, say economists at Goldman Sachs, can be traced to MEW – an acronym with which readers might want to become familiar as they will see more and more references to it.

MEW is mortgage equity withdrawal – the cashing out of the rising equity value of a home. American consumers have loved their MEWs, and used their homes as ATM machines to fund their visits to the malls and shops. That process seems to be slowing, partly because consumers’ appetites for new automobiles and home furnishings have waned in response to rising interest rates and to high energy prices; Bernanke last week said the latter will be a permanent feature of our lives. A slowing housing market also has knock-on effects on total construction, which in turn is reflected in recent weak employment data. That’s another reason consumers might be prepared for a bit of belt-tightening.

The third criticism of the Fed is that its models are excessively parochial. The Fed worries that our blessedly low 4.6% unemployment rate is setting the stage for a round of wage increases, and that increasing pressure on America’s productive capacity means that we are about to see the return of corporate “pricing power”. But in a globalized economy, with millions of

ball would tell the Fed to stay its hand. The slowing of the economy will ease inflationary pressures, and further rate increases will only throw a slowing economy into recession.

There is a voice in the wilderness. Too many Fed governors and regional bank presidents – about a dozen at last count – have spoken out in recent days to join Bernanke in signaling that investors have at least one, and probably two further interest rate increases in their futures. That will slow not only the American economic locomotive, but the economies it drags along. Not enough to trigger a recession in our still-robust economy, but enough to keep investors on the edge of their seats.



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