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ECONOMIC NEWS UPDATE

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Ben Bernanke thinks the economy is strong, and that inflation remains a danger. The equities market believes the Federal Reserve Board chairman, so share prices hover around record levels. The bond market doesn't, and expects that he will soon have to recognize the economy's underlying weakness by lowering interest rates, not this week when the monetary policy committee meets, but almost certainly by the spring. The currency market is siding with the bond market, its players guessing that the Fed will indeed have to lower interest rates, making the dollar less attractive relative to the euro and sterling. So the dollar is weak, which should add to inflationary pressures by making imported goods more expensive and giving domestic manufacturers room to raise prices, thereby forcing Bernanke to raise interest rates even if the economy is slowing. We used to call that stagflation.

Confused? With good reason. So is the Fed, and so are the markets. But be kind -- the economic situation is characterized by cross currents that are difficult for even the most experienced economist to navigate.

Start with housing. Everyone agrees that the bubble, if it was a bubble, has burst. Or, to use former Fed Chairman Alan Greenspan's formulation, that the froth has come off the brew of speculation. If you prefer Bernanke's turn-of-phrase, we are witnessing a "correction."

A slowdown by any other name means the same thing. Sales are down; inventories of unsold homes are up by 50% over the average in the past decade even though construction of single-family homes is down 35% since its peak earlier this year; and prices have softened.

So far, so agreed. But the impact of this development is unclear. Some think the slowdown will frighten consumers into reining in spending, especially as they can no longer repeatedly borrow against the rising value of their homes. Others argue that rising share prices are repairing consumers' balance sheets, that there are no signs that the service sector boom will taper off, and that the strong jobs market and growth in real wages will buoy spending, especially as Christmas cheer begins to permeate consumer attitudes. The difference

results in widely varying forecasts -- a 2007 recession by pessimists who think the housing sector's problems will wash over the general economy, growth in the 2% range by those who expect a ripple from housing rather than a wave, 3% growth by what we might call the economy's cheerleaders. The latter point to the fact that slowing residential construction is being accompanied by a mini-boom in the construction of offices and factories: non-residential construction in the last quarter jumped 27% over year-earlier levels, the greatest gain in over a quarter-century.

The housing sector's impact on the economy is not the only unknown. As the American economy slows, many economists are relaxed because they believe Europe will take up the slack. Consumers in Germany are more optimistic than they have been for five years, and the European Central Bank is so certain that the eurozone is headed for decent growth that it is planning to continue raising interest rates, as it did last week, lest inflation get out of hand. Inbound investment is growing in response to high returns on equity, and labor markets are improving.

But this recent past will not be prologue if the US slowdown hits the eurozone hard. Optimists say that the EU is far less dependent on the US than it once was. The tourist trade has diversified so that increasing numbers of bewildered and perhaps uncomprehending Japanese and, increasingly, Chinese tourists can be seen plodding through the churches and palaces of Europe, following signs only recently translated into their languages. And don't try to muscle the army of Japanese tourists away from the Hermès counter in Paris unless you are

willing to risk a response that is much more than a courteous bow.

Euroland is also less dependent on the US market than it once was. Only 8% of the exports of the EU25 now go to the United States, so a fall-off in consumer demand in America shouldn't hit the EU economy too hard.

Unfortunately for the EU optimists, that is only part of the story. Many European companies now serve the US market through subsidiaries located in America, so their sales (five times EU exports, according to The Financial Times) do not go into Europe's export totals. But if they are hit with falling demand, their repatriated profits will decline, eventually affecting demand in Europe. Indeed, if the American market were of little importance to Europe's exporters, French authorities would not be as disturbed as they are by the decline in the dollar (rise in the value of the euro) that is making European products more expensive in the US, and British merchants, hoteliers, and cab drivers wouldn't be moaning about the absence of American tourists. Visitors from other countries are fine, but they don't spend like the Americans do -- rich Arabs and cash-toting but unpoisoned Russian émigrés excepted.

So the conclusion must be that we just don't know how much of a boost the US economy can reasonably expect to get from growth in Europe, even if it is sustained at the current 2.5%-2.9% rate next year, which the ECB deems unlikely.

So it will be several months before we find out whether Bernanke's relative cheerfulness about the economic outlook is well founded, or whether he will have to do what the Fed did almost exactly five years ago. At the end of 2001 it professed great concern

about inflationary pressures, just as Bernanke has done at the end of 2006. Two months later, it cut interest rates, the first of thirteen reductions.

Perhaps it is best to keep in mind the observation Fed Vice Chairman Donald Kohn shared with a Washington audience earlier this month. He said, "Policymakers always face an uncertain economic environment.... We are uncertain about where the economy has been, where it is now, and where it is going." If, after 36 years with the Fed, Kohn suffers from uncertainty, we should be permitted to share that condition.



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