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ECONOMIC NEWS UPDATE

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26 September 2006

Ben Bernanke and his Federal Reserve Board monetary policy colleagues must have had the words of Ronald Reagan ringing in their ears when they met last week, "Don't just do something, stand there." Which is about all they could have done, given the fact that the slowing economy calls for an interest rate cut to prevent the housing-market slide from turning into an avalanche, and the inflation indicators call for a boost in rates. So best to do nothing, and continue the current "pause" while promising to remain alert to inflation should the Fed's guess that it will soon abate prove incorrect.

The Fed is to be forgiven its decision not to choose between the inflation doves who see a recession around the corner, and want to keep rates from going up, and the inflation hawks who see rising labor costs generating inflationary pressures. The numbers are on the side of the hawks. There are lots of ways to measure inflation, all of them flawed, but all until very recently pointing to an annual rate of around 3%, well above the Fed's "comfort range" of 1%-2%. That means

that when we correct the Fed's current short-term rate of 5.25% to subtract out inflation, the real rate of interest is a mere 2.25%. That isn't high enough to qualify as an inflation-fighting rate, even given the scare created by a weak economic activity report from the Philadelphia Fed.

The Fed is counting on two things. First is the slow-down in the housing market, which it has stopped describing as "gradual", and which now seems to be spreading even to the Midwest, which did not participate in the boom. Slowing sales and rising inventories are reducing the upward pressure on prices and, in some markets, driving prices down. Steadier prices and higher interest rates make it less attractive for consumers to cash in the equity in their houses, which should slow consumer spending. The slowing market is already causing some lay-offs in the construction industry and in the offices of property agents, mortgage writers and other companies dependent on a high rate of house sales.

The Fed is also counting on a continued drop in gasoline and natural

gas prices, which are headed down, easing cost pressures on airlines, truckers, chemical companies and other energy-intensive industries. That, Bernanke reckons, will bring the inflation rate down to an acceptable 2% before very long.

A look at gasoline prices shows just how difficult the life of an economic forecaster can be. Yes, cheaper gasoline lowers cost pressures on many industries. But it also frees up consumer purchasing power, and makes it cheaper to visit the mall, where the frequency of customer visits to such as Wal-Mart have dropped as the cost of driving to the shops has gone up. Increasingly frequent visits translate into higher sales, which should give the economy a fillip that will in part offset the downward drag of a slowing housing market.

The balancing of plusses and minuses is made more difficult by the fact that in a globalized economy developments in the US tell only part of the story. Economists at Merrill Lynch are predicting a sharp slowdown in growth in America, from 3.4% this year to 1.9% in 2007. But "The good news is that there are strong sources of growth outside the US that should prove resilient to a US cyclical slowdown." That should keep the worldwide growth rate at above 5%, the firm predicts, as the Japanese, Chinese, Indian and European economies move ahead. John Connor, of the Third Millennium Fund Russia would add Russia's economy, which he says is driven not only by international demand for commodities, but by a booming consumer sector. All of which buoys markets for US exports.

The implication of the disparity in growth rates of the slowing US, if it is indeed slowing, and the growing

economies of Asia and other countries is clear: the dollar will fall as those growing countries raise interest rates to cool things down, and the Fed lowers rates, to stimulate growth. That will make dollar assets less attractive relative to those of other countries, and reduce the inflow of dollars that the US needs to sustain its rising trade deficit. Indeed, that is already happening, which has the international lending agencies sufficiently nervous to convene a meeting of leading trading nations to "manage" the dollar down, rather than watch it collapse.

All of this esoteric detail is of little interest to most Americans. They see Ford and General Motors laying off tens of thousands of workers, read that nutters in Venezuela and Iran are plotting to cut off supplies of oil, get depressed about the situation in Iraq as the nightly television news casts a pall over dinner tables, and see American foreign policy impotent in the face of a drive by America's old adversary, France's Jacques Chirac, to thwart President Bush's efforts to prevent Iran from acquiring nuclear weapons.

According to the latest poll, 50% of Americans expect the economy to get worse, and only 14% expect it to get better (the balance see things remaining about the same). If by "worse" the majority means "to grow more slowly", the majority is right. And that seems to be what they do mean, since 57% of Americans tell ABC News/Washington Post pollsters that their own finances are excellent or good. That may be why the National Retail Federation, not normally a hotbed of optimism, says that Christmas sales will exceed last year's by a healthy 5%.

If some analysts of the housing market are right, the retailers might

indeed smile as they down their turkey and Christmas puddings. Consumers did not spend all of the money they extracted from their houses. A good portion went to pay down credit-card debt, or to buy stocks, bonds and real estate, or to finance home improvements, all of which strengthen consumers' balance sheets. Meanwhile, continued strength in the job market, and rising real incomes should cushion the effects of the housing market's problem. In the end, it would be a big surprise if the economy failed to grow by at least 2% next year, with an emphasis on the "at least", hardly the end of the world.



THE SUNDAY TIMES

A version of this Update appeared in
The Sunday Times (London)