

## ECONOMIC NEWS UPDATE

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### **Down Come Houses, Up Goes Spending**

This past Friday was the twentieth anniversary of the stock market crash of 1987, when the Dow Jones Industrial average fell by over 500 points, or 23 percent in a single day. That was almost 60 years after the great crash of October 1929, when share prices also fell 23 percent, but over a two-day period.

Here we are in October 2007, and its *déjà vu* all over again to borrow from that great philosopher, Yogi Berra. Or almost. On Friday, exactly 20 years after the 1987 crash, the Dow dropped by 360 points, only 2.64 per cent, but enough to cause investors to wonder what might come next. The credit crunch has forced some big banks in America to form a \$75-\$100 billion bailout consortium to avoid a fire sale of troubled financial assets in which they are heavily invested, with CitiGroup the most exposed. The deal was hammered out at a meeting convened by Treasury Secretary Hank Paulson and put together under the watchful eye of his top aide, Bob Steel. Goldman Sachs,

where both men earned their spurs before joining the government, comes to Washington. Not a good idea, says Alan Greenspan, as it will delay the market-pricing of these assets, and prolong uncertainty and tight credit. Which it most certainly will if the consortium tries to set artificially high prices and values on the assets it acquires.

Paulson, it seems, has become worried about the economic outlook. He told students at Georgetown University that “the ongoing housing correction is not ending as quickly as it might have appeared late last year ...and it now looks like it will continue to adversely impact our economy ... for some time...”.

He is right about the housing market. Rising inventories of unsold homes have driven new construction to a 20-year low. Some 200,000 workers in the residential construction industries have been laid off, as have thousands more from firms that write and service mortgages. Some one million subprime loans are at least 30 days delinquent; more will be added to that list when two

million subprime loans reset to higher interest rates in the next 18 months. Foreclosures will follow.

That much is clear. What is less clear is the impact that the housing market turmoil will have on the broader economy. Paulson is right that the economy is slowing, as the Federal Reserve's recent survey of activity in its twelve regional districts confirms. But slowing to something like a 2 percent growth rate is not a recession. Growth in the construction of commercial properties is picking up some of the slack in the residential sector. Exports are growing at a double-digit rate, buoying industrial output, which rose at rate of 4 percent in September.

The export boom is likely to continue. For one thing, the world economy is set to continue growing, at the quite satisfactory rate of 4.75 percent in 2008, according to the International Monetary Fund. For another, the weak dollar is making American goods cheaper in overseas markets, and diverting American consumers from, for example, expensive European hotels to Florida, California, and in some cases American cruise ships that gladly take their dollars. Indeed, the finance ministers and central bankers from the G-7 industrialized nations who have just departed Washington after their annual meeting expressed more than a little annoyance with a \$2 pound and a \$1.43 euro that is starting to hurt exporters and tourism in the UK and in euroland.

But American exporters are smiling. So when Bush administration officials reiterate the standard position -- a strong currency is in America's interest -- take it with more than the usual pinch of salt. Many in the administration would like to see the

prediction of outgoing head of the International Monetary Fund, Rodrigo Rato, come true: he says the dollar is still "overvalued" and will depreciate further. They might put it differently, and say they want other currencies, most notably China's, to strengthen against the dollar. Same thing. Indeed, no one in the US government would mourn if the dollar fell to \$1.50 euros, and \$2.15 to the pound sterling. That's why Paulson shot down his international colleagues' efforts to include a let's-raise-the-dollar clause in their communiqué. Dollar down, domestic economy up, trade deficit down. And right before the 2008 presidential and congressional elections.

Meanwhile, unemployment remains low even in the face of slower hiring, real wages continue to rise, and consumers continue to spend. September sales were up 2.7 percent on last year, adjusting for inflation, even though retailers were hard hit by warm weather that made it difficult to move autumn apparel. Even sales of autos proved a pleasant surprise.

It may well be that the pessimists have over-stated the impact of the mortgage and housing market problems on the economy. Unlike 1987, when the Fed was tightening credit, the central bank is now in a rate-cutting mood, and profits reports, with the exception of many banks are not all gloom-and-doom: earnings of such as Intel, Yahoo, and even J.P. Morgan are surprising on the upside. Whether fears that profits are headed down for the rest of year will be borne out we just cannot yet predict.

It is important to keep fear of resets and foreclosures in perspective. The mortgages of the great majority of American homeowners are at long-term fixed interest rates -- no re-set problems

there. The drop in home values means that some people won't be able to use their residences as ATM machines for awhile, but most are still way ahead of the game: their homes are worth a lot more than when they bought them. Throw in the fact that the average value of shares has increased by more than half in the past five years, and that share prices are not significantly different now than they were at the beginning of the year, despite the credit and housing problems, and you have an anomaly. Consumers tell pollsters their confidence is falling while their balance sheets are in great shape, their incomes are rising, and they continue to spend.

A similar anomaly exists in the business sector, where chief financial officers profess themselves worried about the general economy, but confident enough in their own companies' performance to continue with most capital spending programs.

This wouldn't be an article about economics if there were no "on the other hand". Oil prices have breached the \$90 per barrel level before falling back a bit, and credit markets, although improving, remain fragile. Unemployment is likely to increase. Many banks are hurting, and a major financial institution might implode. Investors, fearing further dollar depreciation, are dumping US securities. That's why Fed chairman Ben Bernanke says the outlook "for the broader economy remain[s] uncertain," But as the man said after jumping off the 102-storey Empire State Building, "So far, so good." He had reached the fiftieth floor at the time.

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