

ECONOMIC NEWS UPDATE

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Recession Talk So Far Is Just That -- Talk

Add \$100 oil to billions in bank write-offs and it should come as no surprise that the word “recession” is being heard with increased frequency. As is the view that circumstances have combined to neuter the Fed, making it powerless to use its monetary policy weapon to prevent a downturn.

It’s not the write-offs so much as the inability of the chiefs of the major banks to come close to estimating the magnitude of the problem. In “Evita” Juan Peron complains that “The knives are out, would-be presidents are all about.” That about describes what is going on in the board rooms of major financial institutions. Stan O’Neill might have survived at Merrill Lynch, and Charles O. (Chuck) Prince III at Citigroup, if their first public estimates of the extent of their firms’ exposure to losses from subprime and related lending had been correct. Or almost correct. It turns out that original reports were massive understatements, leading the boards of these institutions to doubt that the CEOs were in control of events, and the markets to believe that enough shoes to fill Imelda Marcos’ closets have

yet to drop. Morgan Stanley is less exposed -- estimates are in the \$6 billion range, which is small by the standards of Merrill’s \$8 billion and Citigroup’s \$11 billion (going on \$13 billion according to CreditSights Inc.), but enough so that CEO John Mack might just be wondering if he will be able to negotiate a golden goodbye as generous as those pocketed by O’Neill and Prince. Julian Jessup, chief international economist at Capital Economics expects to see more heads roll, “It looks like it will require a change of management for banks to come clean and admit the full scale of their losses.”

The path to recession thus became clearly marked. The nation’s banks will sooner or later have to write down the value of these assets, perhaps to the tune of \$600-\$800 billion, seriously impairing their ability to lend to even credit-worthy firms and consumers. Indeed, a recent Fed survey already shows that credit availability has been reduced by a tightening of lending standards not only in home mortgage markets (including to prime borrowers), but in the consumer, industrial and

commercial real estate sectors. With credit crunched, fewer factories and office buildings will get built, fewer jobs created, fewer tills filled with credit card receipts. This will add to the downward pull already exerted by the slumping housing market, where rising inventories of unsold and repossessed houses, and falling house prices (the August drop was the largest since the 1991 property crash, and brought the drop from the July 2006 peak to 4.5 percent) will further weaken consumer confidence, already at a two-year low.

The interaction of the slumping housing market, the unsettled financial markets, and, eventually, the general economy is now clear. Alan Greenspan put it this way in a Tokyo speech, "The critical issue on the whole subprime, and by extension the whole financial system, rests very narrowly on getting rid of 200,000 to 300,000 excess [housing] units in the United States." A bit of an overstatement, perhaps, but you get his point: the housing market, which has a long way down still to go, affects the financial markets, the labor market, and the macroeconomy.

Adding to the recession-is-around-the-corner chatter is a rush by forecasters to lower their estimates of 2008 growth. Goldman Sachs economists are predicting a downward revision in the very strong jobs numbers reported two weeks ago, and expect tightening credit to slow the construction of commercial buildings, hitherto a bright spot in a darkening picture, shaving perhaps ½ point off GDP growth over the next year. The manufacturing sector seems to be slowing, as is consumer spending, and inventories in shops are on the rise; retailers are expecting an unmerry Christmas.

Not to worry: Ben Bernanke and the Federal Reserve Board's monetary policy committee will ride to the rescue with still another stimulative cut in interest rates. Except that it won't. Or might not. That's where \$100 oil comes in. Rising fuel prices are creating inflationary pressures as all industries that rely on oil either to move their trucks and planes, or as inputs in manufacturing petrochemical products, begin to raise prices.

At the same time, food prices are rising at an annual rate of something like six percent. Corn prices have doubled this year, in part because land is being diverted from producing products for the table to producing substitutes for oil; wheat prices have soared because farmers have diverted land from wheat to corn; milk and dairy product prices are at their highest level in nominal terms since the beginning of World War II, as rising demand in China presses on supplies reduced by the Australian drought; and Procter & Gamble has announced price increases on several products, most notably the Folgers-brand coffee that bankers and lawyers are scarfing down during their all-night hunts for some cure for their self-inflicted wounds -- and not incidentally some way to save their year-end bonuses from the 10-15 percent cuts now being penciled in.

Then there is the small problem of the sinking dollar. Its six-year decline, which has taken it to a 26-year low against sterling and a near-record low against the euro, seems to be accelerating. That has had the positive effect of stimulating US exports and bringing down the nation's trade deficit. But it is also making imported goods more expensive, and frightening away foreign investors who have no desire to

acquire dollar-denominated assets that are sinking in value.

More worrying than the recent more-or-less gradual decline is a possible rout of the dollar. The European Central Bank and the Bank of England are holding interest rates steady for now, while investors expect the Fed to continue to cut rates to relieve pressures in the financial markets and give a flagging economy a bit of a boost. That is prompting investors to switch out of dollars and into higher-yielding assets in other currencies. It is no secret that the Chinese are planning to switch more of their \$1,340 billion reserves away from US bonds, and that several Middle Eastern countries are thinking of abandoning their peg to the dollar, which would remove them as major purchasers of our currency.

Had enough gloom and doom? Then consider this. The job market remains strong, not as strong as in the recent past, but strong enough to keep unemployment at low levels and to have Goldman Sachs' economists call it "robust". Productivity rose at the robust annual rate of 4.9 percent in the third quarter, causing labor costs to fall. Core inflation remains low. Most CEOs I meet are expecting profits to grow at double-digit rates in 2008. Personal incomes continue to rise. The economy did grow at a healthy pace in the third quarter. The World Economic Forum ranks America number one in competitiveness, up from sixth last year.

The International Monetary Fund expects the world economy to grow at close to five percent, which bodes well for US exports. And Ben Bernanke, while at the same time warning of downside risks to any projection, told the Joint Economic Committee late last

week that "most businesses appeared to enjoy relatively good access to credit,... the overall economy remained resilient in recent months", and that he expects growth to resume in the second half of 2008 after a "sluggish" first half, "as the effects of tighter credit and the housing correction begin to wane."

One more note of caution when wading through panicky press reports. Much of the bad news is coming from sources that are eager to stampede the Fed into cutting rates, and cutting them again. Not quite a direct request for a direct bail-out, but a warning that unless Bernanke saves the banks from taking an earnings and balance-sheet hit, the general economy will pay the price. I am told that officials at the Fed view some of the gloom-and-doom reports with appropriate skepticism.

Of course, the doom-mongers might be right. But fear not: a recession might be the least bad of the possible outcomes of our current troubles, according to John Makin, economist at the American Enterprise Institute. In his latest epistle he writes, "...The cost of avoiding recession after the biggest housing bubble in American history has burst is too high. It will involve rewards to those who took excessive risks that will only result in more underpricing of risk in the future, and therefore larger bubbles and, ultimately, a more unstable economy that underperforms expectations.... The positive economic aspect of the US housing bubble collapse is that it will lead to a recession."

That's why economics is called the dismal science.

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