

ECONOMIC NEWS UPDATE

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The Fed's Dilemma

The housing market remains weighed down with unsold inventory, oil prices flirt with \$100 per barrel, the dollar spirals downward, food prices spiral upward, and interest rates on millions of mortgages are about to be reset at levels that owners might not be able to pay.

That's the semi-bad news. The really bad news comes from the financial markets, where estimates of losses due to subprime and similar mortgages have been raised from \$200 billion to \$300 billion in only a few days. Beset by such losses, a credit crunch, and a threat that last year's Christmas bonus pool of \$37 billion might, just might, be off a billion or two, bankers and brokers are urging the Fed to lower interest rates lest the financial system implode.

So you can imagine the upset when the newly released minutes of the last meeting of the Federal Reserve Board's monetary policy committee showed that the committee's enthusiasm for more rate cuts might be

muted. Indeed, some on the committee were uncertain that the most recent cut was really, really necessary.

Not that the Fed doesn't believe the economy is slowing. American consumers, who account for about 70% of the economy, can no longer borrow easily against the equity in their homes, face gasoline prices that are likely to remain at or about \$3 per gallon, and are telling pollsters that they are losing confidence in the economy's ability to continue growing.

Still, Bernanke & Co believe that the economy is likely to grow at somewhere between 1.8% and 2.5% next year. Private forecasts are coalescing around the high end of that range, which is what the Fed guesses is the best the economy can do without triggering inflation. A slowdown, yes, but not necessarily one calling for the drastic rate cuts the panicked bankers say are needed if there is not to be a meltdown of the entire financial system. After all, some of the losses being tallied by investment banks are due to bad

guesses. Goldman Sachs, which got out of the subprime market before it tanked, will distribute bonuses of perhaps \$20 billion, enough to buy Bear Stearns and leave sufficient cash to give each of its 30,000 employees a Porsche for Christmas.

Fed uncertainty about the need for drastic and repeated action is reinforced by its conclusion that the risks of a serious slowdown are not all it has to contend with: it sees inflation as an equal threat. Oil prices are not the only ones flashing warning signs. Food prices are also moving up at an annual rate of something like 6%. This combination of higher food and energy prices has raised inflationary expectations -- up from 1.9% in September to 2.4%. That always worries central bankers, as consumers build these expectations into their wage demands, and manufacturers into their pricing plans.

All of which tempts the Fed to be cautious about lowering interest rates. Then, there is the dollar. Foreign countries hold an estimated \$3.7 trillion of their reserves in America's currency. China alone holds well over \$900 billion in greenbacks -- and rising. The global purchasing power of these dollar reserves is shrinking, posing a dilemma for foreigners holding US assets. Hold onto the dollars and face further losses, or start selling dollars and accelerate the pace of the greenbacks' decline. Their solution, if it can be called that, is to reduce the portion of dollars in the currency reserves being *newly* acquired, which provides a bit of diversification, but puts less pressure on the dollar than all-out dumping would.

Bernanke & Co. know that a rate cut would increase the pressure on the dollar, which would please US exporters

but further upset holders of dollar assets. Chinese premier Wen Jiabao has already expressed concern about the shrinking value of his country's vaults full of dollars, and Middle East oil producers are wondering whether to follow the lead of Kuwait -- ever grateful for the fact that the US saved it from becoming a province of Saddam's Iraq! - - and abandon the dollar as their benchmark currency. If confidence in the greenback deteriorates further, dollar dumping might replace the acceptable downward drift of recent years, and start the protectionist warfare with which Nicolas Sarkozy threatened the US congress.

But doom and gloom is only part of the story. The gyrating stock market has indeed plunged -- but only to the level it was when we took time off from work in 2006 to give Thanksgiving for our myriad blessings. And the value of their homes remains well above the wildest dreams of avarice of all save the newest buyers.

Which may be why businessmen on the economy's front line seem more optimistic about 2008 than do their bankers. One British banker, fresh from a visit to his US clients, reports himself astonished by their bullish outlook. A leading globe-trotting British businessman/entrepreneur reports that his private equity clients around the world are gloomy -- because they are unlikely to earn the 45 percent return on equity to which they have grown accustomed. And I found that 46 of the 50 CEOs of major companies who attended a closed-door meeting expect profits at their companies to increase by double digits in 2008.

And this was before consumers descended on the nation's shopping malls last Friday -- the day after

Thanksgiving that has become known as Black Friday because it is the day retailers' red ink is replaced with the black ink that signifies profits. ShopperTrak, which tracks sales at more than 50,000 stores, reports that storekeepers were all smiles after a long hard day swiping credit cards: sales were up 8.3% over last year. That's about double what even the optimists were predicting. The interesting fact buried in these numbers is that almost all of the increase occurred in stores that cater to low- and middle-income consumers -- those customers supposed to be under greatest strain from high gasoline prices and mortgage rate re-sets. The truly affluent, not interested in the bargains on offer, will show up later in the shopping season.

So the Fed is caught between the Scylla of threatened inflation and the Charybdis of an impending downturn. Lower rates and risk inflation in an economy that might not be slowing as much as the bankers think; hold steady and risk bringing credit markets to a screeching halt, triggering a recession. The Fed has decided that by adopting "appropriate monetary policy" it can avoid both dangers and pilot the economy to the safety of a soft landing. We will know when the Fed meets on December 11 just what it means by "appropriate monetary policy".

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