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## ECONOMIC NEWS UPDATE

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### **Bad Might Not Come To Worse**

With all of the bad economic news coming out these days, I wouldn't be surprised if many readers are wondering if I am not being overly optimistic in my reports on the US economic outlook. So, to provide a balanced view of the turbulent economic scene, let me sketch the more widely believed worst-case scenario. Then, I can honestly say, "I report, you decide."

The economy is not merely slowing, it is heading towards recession. New home sales are 34% below year-earlier levels, as homes move from builder to buyer at the slowest pace in thirteen years. The market for existing homes is no better: sales are down 23%, and the inventory of unsold homes has resumed its rise after a brief fall. House prices are down about 10%, and are headed lower at an accelerating pace. Worse still, non-residential construction, until now holding its own, "is likely to decelerate sharply," says Fed chairman Ben Bernanke.

Nor is any relief in sight. "Downside risks to growth remain,"

warns Federal Reserve Board chairman Ben Bernanke, frustrated by the inability of the Fed to bring the housing market's decline to an end. The Fed has cut its short-term rate by 2.25 percentage points since September to 3%. But rates on the standard 30-year fixed rate mortgage are stuck at around 6.8%, almost exactly where they were at the height of the credit crunch last autumn. And any hope that the government would intervene directly was dashed when Treasury Secretary Hank Paulson announced that he sees no reason for "the American taxpayer to be stepping in with more taxpayer dollars," and congress refused to give bankruptcy judges power to re-set mortgage terms.

Given that houses are most Americans' largest asset, it is little wonder that consumer confidence is at its lowest level in five years, and that consumer spending, which held up in the first half of 2007, "appears to have slowed significantly," as Bernanke put it to the House Committee on Financial Services. That's not news to car

companies, which are watching sales shrink to 10-year lows.

More important, falling house prices, rising mortgage (and credit card) defaults, and other negative developments in the credit markets are shriveling bank balance sheets, making it more difficult for them to lend to even credit-worthy customers. There is no question that such credit as is being made available to both consumers and businesses is offered on tougher terms - more collateral, higher interest rates, more proof of credit-worthiness. Tighter credit, especially when combined with plummeting consumer confidence, causes the blood to run cold in the nation's boardrooms. Projects are put on hold, investment spending declines and with it the new jobs needed to keep the unemployment rate down. Unemployment rises, consumer confidence and spending drop even more, foreclosures increase, credit tightens even more, and America settles into a long period of substandard growth, or actual decline.

Meanwhile, the number of people waiting for the next shoe to drop in credit markets is rising. When Credit Suisse can go from an "all's well" to discovery of a \$2.85 billion loss in a few days, investors can be forgiven for wondering what's out there. There's an old saying that you can't make chicken salad out of chicken droppings, and investors have discovered that applies to the complicated debt packages that were supposed to elevate the quality of dicey loans by bundling them with other dicey loans. You can't make a triple-A credit instrument out of lots of loans that are unlikely to be repaid.

If that's not enough bad news, add this. Bernanke believes the current problems are far worse than those

arising from the bursting of the dot.com bubble in 2001. A fall in house prices affects more consumers than that fall in share prices did, and inflationary pressures now are greater than they were in 2001, limiting the Fed's freedom of maneuver. Indeed, some small banks will fail -- and failing banks, even small ones that don't threaten the stability of the banking system, are likely to prove unsettling, to put it mildly.

All of this leads most observers to expect the Fed to cut rates even more, which Bernanke is hinting he will indeed do. But further loosening, especially when the fiscal stimulus is about to hit the economy, threatens to increase the already substantial inflationary pressures that Bernanke concedes exist. They have driven the consumer price index up by more than 4% in each of the past three months, forcing the Fed repeatedly to raise its inflation forecast. Oil prices have passed \$100-per-barrel, and food prices are soaring, in part because of demand from increasingly better-off consumers in developing countries, in part because misbegotten energy policies are diverting land from growing food to growing fuel.

Adding fuel to the inflationary fire is the falling dollar. Every drop in the value of the US currency makes imports more expensive. And now there is a new problem: prices of once-cheap Chinese goods are rising as China copes with rising wage levels. The price-restraining effect of Chinese imports is, therefore, diminishing.

Faced with the risk of a recession, Bernanke has decided that inflation is the lesser evil. Which has brought a furious response from Carnegie Mellon professor Allan Meltzer, America's leading student of

the Fed and its history. Writing in The Wall Street Journal, Meltzer excoriates the Fed for its “unseemly and dangerous response to pressures from Wall Street”, where bankers are hoping that lower interest rates will drive up the prices of shares and bonds -- not to mention houses.

Meltzer points out that even the Fed is predicting that the economy will grow more rapidly in the second half of this year, bringing the overall 2008 rate to between 1.3% and 2.0%. It expects unemployment to rise to 5.3%, up from current levels, but still below the postwar average. He might have added that billions continue to flow into private equity firms, indicating that someone out there sees the emergence of opportunities to make some money.

So, nervous readers, hold off on the Prozac, at least until this summer, when we might just find out that lower interest rates and the stimulus package provide that bridge over troubled economic waters that will ease your mind.

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