

ECONOMIC NEWS UPDATE

IRWIN M. STELZER

13 July 2008

Discontented Americans are Worriers, not Whiners

This is the summer of our discontent. Only 14% of us are satisfied with the way things are going in the United States, the lowest figure recorded by Gallup's pollsters since they began asking that question almost fifteen years ago. Consumer confidence is at its lowest level in 28 years, according to the respected Reuters/University of Michigan survey. And not many Americans are expecting things to improve soon. "Consumers' economic outlook is so bleak that the Expectations Index has reached a new all-time low," reports the Conference Board.

In part this pervasive gloom is due to gasoline prices that have passed the \$4 per gallon level. In part it is due to the squeeze

soaring food prices are putting on consumers' pocketbooks. In part it is due to falling house prices, and to a deteriorating job market, with long-term unemployment up 37 percent from last year.

And there is no escape from the gloom. Try to get away from it all, hop in your car, and soon you are pumping \$4+ gasoline into the tank of a vehicle designed more for safety and comfort than for fuel efficiency. Try to get on a plane, and you find that most flights are full, fares are up, and your air miles are virtually useless as the number of seats allocated to freebies shrinks. Which might explain why sales of flat-screen television sets at Wal-Mart increased by double digits in June:

staying home is an increasingly attractive alternative.

But only if you live in a neighborhood where for-sale signs aren't festooning the lawns. Not only are home sales and house prices down and still declining in most parts of the country, and inventories of unsold houses and mortgage foreclosures up, but the few families willing to buy houses are finding that their once-friendly lender is not delighted to see them. I am told that even pricey Manhattan properties are languishing on the market as Wall Street layoffs mount -- driving some from the buyers' queue to the unemployment benefits queue. Indeed, even those bankers still at work find that mortgage lenders are so nervous about the career and bonus prospects of Wall Streeters that financing is not available.

The proud new owners of those flat-screen TVs will have to stay away from the 24-hour financial news channels if they are to find solace in their new acquisition. Share prices are falling, earnings expectations are being lowered, financial-sector firms continue to scramble for new capital to offset write-downs of loans gone sour, and it took government intervention over the weekend to restore calm after shares in Freddie Mac and Fannie

Mae plunged something like 90 percent.

The softer jobs market affects more than those who have lost their jobs. Even though the unemployment rate (5.5%) is nowhere near the levels characteristic of serious recessions, many people who have jobs quite reasonably feel there is reason to worry about their futures. That's why it was unhelpful to the McCain campaign for his top economic advisor, Phil Gramm, to label these folks "whiners". "Worriers" might have been a better choice of words.

In this atmosphere it is difficult for the shreds of good news to penetrate the gloom. The International Council of Shopping Centers reported that sales at stores open at least a year ("same-store sales" in the jargon of the trade) rose by 4.3% last month, with Wal-Mart recording a 5.8% jump, its largest in four years. Since June is the second most important month for retailers -- summer stock is cleared to make room for back-to-school items -- this should be unalloyed good news.

It isn't. Pessimists argue that the sales increase results from a combination of the \$86 billion tax-rebate checks from a program due to end this week, higher prices of food and gasoline, discounts on clothing and electronic goods, and

that old favorite of retail analysts, the weather --warmer than usual and therefore good for getting summer clothes off the racks and into consumers' closets. Besides, much of the stuff that consumers buy in the flourishing discount stores comes from overseas, and so directly provides no jobs for American workers.

The two most powerful forces underlying almost all of the economy's problems are the price of oil, and the condition of the financial sector. Bring oil prices down, and share prices will rise; revive the financial sector so that credit is again available to businesses and homebuyers, and the economy will revive. Unfortunately, it is not easy to forecast either of those important drivers of the economy.

The best we can say about the outlook for the price of oil is that in the short run it will continue to be affected by geopolitical events. An Israeli decision not to live under the threat of a nuclear attack by Iran, or Mahmoud Ahmadinejad's test-firing of a few missiles by the Iranians, can cause a temporary spurt in prices. In the longer run we are reduced to guessing about the balance of supply and demand. In a free market higher prices would cause an increase in exploration and, eventually, available supply, and "demand destruction" as high

prices induce Americans and others to drive less, heat less and cool less will ease demand. But the OPEC cartel is capable of curtailing the amount of crude it allows on the market, which might offset the beneficent effect of increased non-OPEC supplies and an easing of demand in developed countries.

The eventual outlook for the financial services sector is somewhat easier to predict. Despite the weekend announcement that in essence confirmed that two of the biggest players in that sector, mortgage lenders Fannie Mae and Freddie Mac, are too big to fail, investors continue to worry that shares of these government-chartered, shareholder-owned entities will be hit harder by defaults, and that Fannie and Freddie will be forced to raise new capital on unfavorable terms. Both have ample reserves according to both Treasury Secretary Hank Paulson and their regulator, but when fear stalks the markets, reassurances from government carry little weight.

Meanwhile, banks need to deleverage -- raise more equity capital relative to their debt -- to make up for write-offs of bad debts. Paulson told congress, "Much has been accomplished. Our financial institutions are

repricing risk, deleveraging, recognizing losses, raising capital and improving their financial position.” But he won’t attempt to guess when the recovery will be completed, and the credit spigots turned on. Market analysts are guessing that share prices of banks will fall further, before an eventual recovery at the end of 2009.

That means that the credit squeeze will persist at least until then, making it unlikely that at this time next year we will be experiencing the “glorious summer” celebrated by Richard III, with all the gloom-producing clouds by then “in the deep bosom of the ocean buried.” But we might just have a merry Christmas. Or at least a less gloomy one.

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