

ECONOMIC NEWS UPDATE

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The Good News Is That Not All Of The News Is Bad

Just when things couldn't get any worse, they did. The Federal Reserve Board's economists revised their growth estimate down, and their inflation forecast up. The dreaded word "stagflation" has begun to make its appearance, reminding those Wall Street analysts old enough to remember that in the 1970s the economy experienced 15% inflation, 9% unemployment and three recessions.

Those who want to update their financial vocabularies further should also take note of the new buzz word, "contagion", used to describe the fact that problems in the subprime market are spreading to other parts of the closely interlinked credit market, such as credit cards and non-subprime mortgages.

Add "decoupling" to your lexicon and you will be au courant: analysts who confidently predicted that America's problems would not spread, are now less certain that the US economy is "decoupled" from the rest of the world. That's why BNP Paribas economist Ken

Wattret says that "All of the reliable leading indicators of euro-zone economic growth point to even worse news ahead."

And why Mario Draghi, governor of the Bank of Italy and head of the Financial Stability Forum, says of write-downs by Europe's banks, "It's not over yet". After all, led by London's bankers, Europe's industry probably put as much into the subprime market as did US banks, and have yet to write off most of the bad loans. Credit Suisse, which first proudly announced that it had suffered only minor damage from turmoil in the credit markets, was forced a few days later to confess that it had not noticed a \$2.85 billion loss from trading in the debt markets. This added to the pervasive feeling of uncertainty: if Credit Suisse didn't know its true exposure when reporting its earnings, there must be others that have merely shaved the tip off the iceberg of bad debts lurking below the surface of their published figures.

Now for the bad news.

- Consumer confidence is at its lowest level since the early 1990s.
- “There is not much doubt in my mind that the US economy is now in recession,” well-regarded Goldman Sachs economist Jan Hatzius is telling the firm’s clients.
- The jobs market is weakening, and may even be contracting. Which is bad news indeed since “Payrolls don’t just edge lower in a recession.... They drop like a stone,” reports Business Week economist James Cooper.
- There is a possibility of “blowups” in the \$6 trillion market for securities tied to the credit of the world’s largest corporations has traders fretting, says The Wall Street Journal.
- The Fed’s minutes report that “recent data ... indicated that consumer spending had decelerated considerably.”

Now for the really bad news: last week oil prices pierced the psychologically significant \$100-per-barrel level for the first time, not counting one trade on January 2 by a trader eager to become a footnote to history. This caught a lot of speculators short, because they expected prices to move in the other direction, and settle in the high \$80s. After all, several indicators suggest a weakening in demand for oil. The international Energy Agency recently cut its forecast of 2008 demand to reflect predictions of economic slowdown in America, and

petrol demand is falling in the US. Meanwhile, inventories of crude oil are on the rise. The much-followed Schork Report says it expects “crude oil supply to outpace demand through the next couple of weeks.”

Yet prices are rising. On the demand side, despite the lowering of its forecast, the IEA still expects China, India and other emerging economies to drive worldwide demand up by something like 2%. And many observers expect the checks to be issued as part of the Bush stimulus package to reach consumers by early summer, just in time to offset any pressure we might feel to stay home rather than fill our tanks and take to the road during the coming driving season.

Even more important are developments on the supply side. Markets were temporarily rattled when Venezuelan president Hugo Chávez, threatened to cut off oil supplies to the US, despite the facts that we have about the only refineries capable of using his country’s very low-grade crude oil, and that he is desperate for funds. But production in Venezuela continues to decline, as much-needed investment is diverted to Chávez’s welfare projects, and the political appointees who have replaced the oil-field technicians struggle to keep the oil flowing. Also, some 10% of Nigeria’s oil production has been cut off by rebels.

Most important of all, OPEC, which accounts for about 40% of world output, refuses to lift its production ceiling, despite personal pleas to the Saudis from President Bush. The Saudis seem to have adopted the attitude attributed to a former American wrestler, “A friend in need is a pest.” OPEC fears that an economic slowdown will cut into demand, and that the dollar

will fall further, reducing the purchasing power its cartel members receive in return for their oil.

The longer term problem stems from the refusal of many nations to open their oil fields to exploration and development by Western firms. With high prices producing as much money as even the producing countries can reasonably spend and invest, they have no compelling need to bring new supplies to market. Besides, if they want to increase the flow of cash, they can always insist on renegotiating the deals signed with Western countries, giving credence to the observation that a contract with an oil producing country is the first round in a negotiation.

At last, the good news. Last week, a leading investment banker told me that his firm's clients are making money, have good cash flows, and are earning about 20% returns on their businesses. Businessmen I talk with, although concerned about what might lurk just around the corner, report healthy sales and satisfactory profits. I can't help feeling that the health of the firms on the sharp edge of the economy tells us more about our future than the problems of accident-prone bankers and investors who forgot how to price risk.

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