

Suite 502 • 1150 17th Street NW • Washington, DC 20036

Telephone (202) 777-3000 • Facsimile: (202) 777-3010

ECONOMIC NEWS UPDATE

Irwin Stelzer

17 June 2008

The Focus Shifts to Inflation

It's one thing when consumers grumble about inflation -- gasoline prices that are at previously unheard-of levels, food prices that have homemakers spiking their hamburgers with bread crumb. It's quite another when a troika of central bankers says it worries that inflation might be getting out of hand, that the genie they thought they had permanently bottled up is pressing hard on the cork in the bottle that entraps him.

European Central Bank boss Claude Trichet is dropping broad hints that he will finally act on his concerns and raise interest rates next month "to anchor inflation expectations". Bank of England Governor Mervyn King says "we are now facing a period of rising inflation". And the biggest gorilla in the international banking community, the chairman of our Federal Reserve Board, tells an audience in Massachusetts that "the latest round of increases in energy prices has added to the upside risks to inflation and inflation expectations".

If you think that the statements of the central bankers mean that peace prevails in international finance, think again. Bernanke hoped that his statement would shore up the dollar, which would ease oil prices because each dollar the producers received would be worth more. But Trichet's statement strengthened the euro against the dollar, causing more than a little consternation at the Fed and in the halls of the US Treasury, both of which institutions are trying to talk up the dollar after a long period of hands-off-currency-markets.

Bernanke wanted to make certain that everyone got his message, so he pointedly added that the Fed "will strongly resist an erosion of longer-term inflation expectations", which for consumers means, "Don't count on cuts in mortgage rates or credit card charges", and for investors it means, "I will raise interest rates if prices continue to rise."

And well they might. Although core inflation (excludes food and

energy) has been relatively tame, rising at an annual rate of 2.3%, inflationary expectations are formed by people who both eat and drive. They see inflation rising at a rate of 4.2%, making eating into their purchasing power. And developing countries, which have been providing Wal-Mart with low-priced imports to keep consumers' costs down, are now finding that inflationary pressures are forcing them to raise prices. The Wall Street Journal reports that all 24 of the developing nations tracked by the Bank of America are failing to contain inflation within the bounds they have set for price increases. So when back-to-school time rolls around, consumers might find that the long decline in apparel prices has come to a screeching halt.

Unfortunately, the central bankers' inflation worries do not stem from a fear that the economies of Europe, the UK and the US are booming -- indeed, over-heating. In fact, Europe's economy is slowing, the UK is about to reclaim the title of the sick man of Europe, and the US.....

Here the story is more complicated, which is why Bernanke devoted the bulk of his speech to telling the followers of his every word what he doesn't know. He isn't really sure of the effect of commodity prices and rising wages on inflation, and "there is much we do not understand about inflation expectations, their determination, and their implications." Not much reassurance there for those who think the Fed chairman's hand is firmly on the tiller, steering the economy between the twin shoals of inflation and recession.

But despair not. His knowledge might be imperfect, but his judgment seems fine. He has so far used all of the tools available, and invented new ones,

to prevent the credit crunch from morphing into a major recession. And he believes that because of his aggressive interest rate cuts "the risk that the economy has entered a substantial downturn appears to have diminished over the past month or so."

The latest retail sales figures, released after Bernanke's speech, support the Fed chairman's views. They came in at twice the increase analysts had been expecting, and earlier months' data were revised upward. It seems that more of the \$56 billion in tax rebates distributed so far is ending in the tills of electronics and department stores than anyone anticipated -- except perhaps the Bush team. "It's just amazing the American consumer's resilience in the face of everything negative", Stuart Hoffman, chief economist at PNC Financial told Bloomberg Television.

That doesn't mean that we can safely ignore the word "substantial" in Bernanke's statement that the risk of a substantial downturn seems to have diminished. That still leaves room for a downturn. The Fed's monthly "Beige Book", reporting on business conditions around the country, is dotted with "softer, weaker, ... slower, sluggish" from seven of the twelve Federal Reserve districts; the five others report "stable" activity. Whether the slowdown will become a recession is the question that is puzzling analysts.

The dominant worries are gasoline, houses, and banks. Although on average gasoline claims only about 4.5% of consumers' budgets, these prices are posted on huge signs that consumers see daily -- perhaps several times per day -- which accounts in part for the plunge in consumer confidence. And the 4.5% is only a nationwide average: even a tall person can drown

in a lake with an average depth of three feet. Low-income consumers in rural areas, often driving their pick-up trucks long distances to get to work or the supermarket, are especially hard hit. This might explain why Neil Offen, President of the Direct Selling Association, tells me that in the South and Southwest sales of products that are sold door-to-door, or at parties, are sinking. "Families with relatives in Iraq don't feel like partying, and part-time sales staff can't afford the gasoline to cover their districts." Offen is too careful to mention specific products, but we have to believe that manufacturers of Tupperware are nervous, and that the Avon Lady has been calling less frequently.

Housing remains a problem. Large inventories of unsold houses overhang the market, and mortgages are not as easy to get as they were in the glory days of easy credit. Worse still, foreclosures are no longer confined to the subprime market. Borrowers with prime adjustable rate mortgages (ARMs) are finding it increasingly difficult to keep up payments, and foreclosures in that part of the market are now rising faster than subprime foreclosures.

But all is not gloom. There are signs that bargain-hunting buyers think prices have bottomed out. In April the number of signed sales contracts rose to its highest level in six months. One month does not make a trend, some of those contracts might get canceled, and signings were still 13% below last year's at this time, but drowning realtors grasp at whatever straws they can. One such is the decision of Eddie Lampert, the billionaire hedge-fund operator, to invest part of his \$11 billion capital pile in home builders and mortgage lenders.

Another encouraging sign is the willingness of the regional and community banks to return to the mortgage market, doing business in a quaint, old-fashioned way: the loan-origination staffs are on fixed salaries, rather than commissions, and each loan application is reviewed by a committee to make certain that the borrower can keep up his mortgage payments.

The banks are in better shape than they were at the height of the credit crunch. They are selling off their worst paper, albeit at deep discounts, and raising capital, albeit by paying a handsome price for it. As new capital flows in, and investors are convinced that the last shoe has dropped -- that the banks have finally confessed to and booked all of their losses -- the banks should be able to begin lending at a more normal pace.

All this add up to an economy that is treading water but not sinking, which is more than anyone thought it capable of doing just a few months ago. The stimulus checks have given the swimmer added strength, but when that boost wears off, the economy's ability to stay afloat will depend on an easing of gasoline prices, a recovery of house prices and sales, and consumers' willingness to continue shopping while telling pollsters just how gloomy they are.

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