

ECONOMIC NEWS UPDATE

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Will We Need the 1% Solution?

Both barrels of the heavy policy guns -- fiscal and monetary policy -- are now aimed at the slowdown. The president and the congress have worked out a stimulus package that will pump some \$150 billion into the US economy. Bureaucracies being what they are, it will take the Treasury more time than it should to get the checks into the mail. But by early or mid-summer Americans families and single persons will have some more money, either to spend (as the sponsors of the program hope), or with which to pay down some of their credit card balances.

Meanwhile, back at the Federal Reserve Board's offices, officials are watching to see whether their recent interest rate cuts totaling 1.25%, when combined with the stimulus, will put the economy back on a growth path. Now at 3%, the Fed funds rate was a much higher 5.25% only a few months ago. Chairman Ben Bernanke, who on Friday reached the half-way point in his four-year term, is surely hoping that by the time he is up for reappointment, his rate

cuts will have had their intended effect, and the new president will follow tradition and reappoint him.

Otherwise, it's back to university life. Of which Bernanke was reminded when a particularly obtuse congresswoman, confusing him with Treasury Secretary Hank Paulson, asked him what it had been like to be CEO of Goldman Sachs. Bernanke, known for his gentle sense of humor, replied that the lady was mistaken, and that he had been CEO of the Princeton University economics department before going into government. He might have pointed out that his had been a somewhat less lucrative position than Paulson's, even though more demanding of managerial talents than the Goldman Sachs post.

That was perhaps the only light moment in the Chairman's recent weeks. He still believes that "downside risks to growth remain", although he seems to think that the economy will avoid a recession. But after a period of more rapid growth, slow growth will feel

as bad as a recession, especially in an election year in which politicians compete to persuade voters that only they can change the bleak outlook they describe to a sunnier one. Besides, some economists -- confirming that theirs is the dismal science (if a science at all) -- are computing that the new 3% Fed funds rate is consistent with an annual growth rate of a mere 1%, hardly something to cheer about.

Fortunately, the Fed has not exhausted its weapons: it can always deploy Alan Greenspan's 1% solution -- the level to which he reduced rates in a crisis. And nothing is to stop the President and congress from increasing the stimulus package. But, for now, it is probably best to suffer through a few bad months and wait for the rate cuts and stimulus to take effect. Doug Elmendorf, an economist at the Brookings Institution, says that both moves "are going to look smart". Just not tomorrow.

The economy did grow at an acceptable 2.2% in 2007, but managed only feeble growth in the fourth quarter, if the initial unrevised GDP report is to be believed. Good news came from the consumer sector (spending increased by 2%), business investment (up 7.5%), and exports (up 3.9%). But declines in residential investment (down 23.9%) and a drop in inventory investment almost wiped out those gains, and produced the first drop in jobs in years -- unless the famously unreliable jobs report, published last Friday is revised.

Attention remains focused on the housing market, where sales continue to fall. As do prices, and at an accelerating rate. They are now almost 8% lower than a year ago, and are down in 17 of the 20 cities for which decent data are available.

Well informed Washington sources tell me that it is unrealistic to expect a comeback in the housing market before 2010, so little relief is in sight for homebuilders trying to seduce buyers with "free" swimming pools, finished basements, and a Mercedes in the garage. The last man to promise a car in every garage was Herbert Hoover, in 1928; he also promised a chicken in every pot, but builders offering upgraded kitchens have not gone that far.

Fortunately, mortgage rates seem to be headed down, which might, just might, put a bit of a spring into the steps of potential home-buyers as they savor the bargains available. Combined with an increase in the level of qualifying mortgages that Fannie Mae and Freddie Mac can finance, these rate drops mean that mortgage money is more readily available than in recent months. And lower rates mean that the much-feared resets of some so-called teaser rates in adjustable rate mortgages won't bite as deeply into the pockets of subprime borrowers.

Not that foreclosures are not a problem. They are. But it turns out that they are not quite as numerous as forecast, as sensible banks give troubled borrowers a bit of breathing space. And somewhere between 25% and 33% of foreclosures in the hardest-hit states are of homes that are not occupied by their owners: it is speculative buyers of for-rent properties who are taking some of the hit.

Fortunately, there is more to the US economy than the much-reported housing market. According to Brian Westbury, chief economist of First Trust Portfolios, housing accounts for only 4.5% of GDP. And if the losses from subprime mortgages come to \$100

billion, as Bernanke is guessing will be the case, they will account for only 0.1% of the assets of U.S. households and non-farm financial corporations.

Perhaps even more important is the restoration of some semblance of normality to credit markets. Commercial paper issuance is rising from its credit crunch levels. Yes, there are still worries about the condition of some bond insurers, but Warren Buffett and others seem ready to pump capital into that market, and several banks are trying to arrange a capital infusion for players in that market. Yes, some banks need capital to shore up write-off-ridden balance sheets, but the sovereign wealth funds are ready and eager to take advantage of bargain prices and pump billions into troubled banks. All in all, economists at Goldman Sachs are telling clients that “money markets [are] back to a more normal situation.”

None of this should be taken to mean that Goldilocks has returned to center stage. But some economists are saying that she is putting on a new coat of make-up in anticipation of a re- entry onto center stage sometime later this year.

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