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Economic Outlook

False Dawn

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> *I see nothing in the present situation that is either menacing or warrants pessimism. . . . I have every confidence that there will be a revival of activity in the spring and that during the coming year this country could make steady progress.*
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> —Andrew W. Mellon, U.S. Secretary of the Treasury, December 31, 1929

The bursting of every bubble is followed by statements suggesting that the worst is over and that the real economy will be unharmed. The weeks since mid-March have been such a period in the United States. The underlying problem—a bust in the residential real-estate market—has, however, grown worse, with peak-to-trough estimates of the drop in home prices having gone from 20 to 30 percent in the span of just two months. Meanwhile, the attendant damage to the housing sector and to the balance sheets tied to it has grown worse and spread beyond the subprime subsector.

Of the 130 million U.S. housing units, 18.5 million—almost 15 percent—are empty. This bodes ill for the outlook for homebuilding; house prices; and the balance sheets of commercial banks, investment banks, and American households. In June, Congress will pass the Foreclosure Prevention Act of 2008. This is a symbolic measure that will not become effective until October 1 and, given its cumbersome structure, will provide virtually no relief to the households facing foreclosure that it is designed to help.

At the same time that U.S. house prices are continuing to collapse, the Federal Reserve's interest-rate cuts to cushion the U.S. credit crisis, coupled with a continued surge of funds into emerging-market nations and a stubborn refusal by those nations to allow their currencies to appreciate and to stop holding domestic energy prices at far below market levels, have pushed the price of oil up by nearly 30 percent since mid-March alone. The rise is sufficient by itself to absorb virtually all of the $115 billion in rebate checks being distributed to Americans in the second quarter. If the jump in food and energy prices leaks into core U.S. inflation (which thankfully has not yet happened), then, as Federal Reserve vice chairman Donald Kohn said with classic understatement on May 20, "We would be facing a more serious situation" concerning inflation. Needless to say, with shaky financial markets and a shaky real economy, the need for the Federal Reserve to respond to an elevated threat of inflation would constitute a "serious situation" indeed.

Relief from Panic

Relief from the acute, panicky phase of the credit crisis, following the Federal Reserve's March 16 acknowledgement that even Bear Stearns, the smallest of the investment banks, was too big to fail, has been palpable. When someone stops hitting you over the head with a two-by-four, you feel better for a while, even though you may have sustained a concussion.

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We have moved on to the potentially more dangerous, chronic phase of the crisis resulting from the end of the U.S. housing bubble. The relief in the financial sector arising from avoidance of a financial meltdown has also translated—at least until the mid-May spike in oil prices—into a modest rally in the financial markets and a lessening of U.S. recession fears. Headline macroeconomic data have, in general, been weak to stable instead of showing acceleration to the downside, with the important exception of housing data, where the fall in prices and sales has quickened. Also, the U.S. stimulus package has already added $40 billion to household disposable income and will add another $75 billion in coming weeks.

> The growth rate in the second half of 2008, contrary to the consensus forecast and that of the Federal Reserve, will likely be substantially slower than in the first half.

The "weak-to-stable" characterization of macroeconomic statistics was perhaps best captured by the April employment report. The headline payroll number, at –20,000, was less bad than the anticipated –75,000. Much like the economy at large, however, the underlying details of the report were weak. The year-over-year growth rate of employment continued to fall—from 0.36 percent to 0.28 percent in April. Employment in construction and manufacturing also continued to fall rapidly. A drop in the length of the average workweek and weak hourly earnings growth caused weekly earnings to fall by 0.2 percent. Although the household survey indicated a drop in the unemployment rate from 5.2 to 5 percent, the increase in household employment masked the drop of 375,000 in the full-time workforce that was offset by 550,000 additional part-time workers. The Bureau of Labor Statistics' net birth/death adjustment, an assumption about jobs created by small businesses, added 267,000 workers to the overall payroll statistics. Revisions downward of payroll data for the third quarter of last year, correcting overly generous assumptions about uncounted additional workers, will likely be repeated for the subsequent quarter. Any such assumptions strain credulity in view of tightening credit conditions, falling consumer and business confidence, and a drop in overall investment.

Financial markets also took heart from an apparent stabilization of retail sales in April, although overall retail sales dropped at a 2 percent annual rate during the three months ending in April, with a 0.2 drop in April alone. Excluding motor vehicles, where sales are swooning, the annual growth rate of current-dollar retail sales was 2.5 percent over the three months ending in April. That translates into a negative real growth rate of 1 percent, however, allowing for inflation at about a 3.5 percent annual rate over that period.

Overall, optimists concerning the stock market and the economy have taken heart from the relief attendant upon the Fed's willingness to guarantee the balance sheets of commercial and investment banks and from selected economic data in April that were not as bad as expected.

Problems Ahead

The picture going forward is not as bright. The latest data from the Case-Shiller house-price survey suggest that the underlying problem, the drop in home values, has accelerated. The indicated drop in house prices accelerated to a 25.1 percent annual rate over the three months ending in March—the latest period available. The futures market indicated that the peak-to-trough drop in house prices would exceed 30 percent. That development has been associated with a sharp drop in consumer confidence to levels not seen since 1991, as well as curtailment of home-equity credit lines by banks and a rapid acceleration of housing foreclosures to a pace of about eight thousand per day in April. The Fed's April 2008 Senior Loan Officer Opinion Survey (released early in May) showed a sharp tightening of lending standards both for households and businesses. This is a direct result of the banks' need to reduce their balance sheet exposure to the housing sector and, less directly, to households and businesses suffering from the sharp contraction in that sector.

Discretionary purchases of consumer durables have taken the sharpest hit from deteriorating household finances. Domestic vehicle sales fell to a 14.4 million annual rate during April, down at a 21.3 percent annualized rate over the three months ending in April. Domestic vehicles fell even more sharply because of the high concentration of fuel-inefficient vehicles in the domestic fleet. Partly as a reflection of the sharp slowdown in auto sales, U.S. industrial production fell a sharper-than-expected 0.7 percent in April, down 4.9 percent at a seasonally adjusted annual rate over the three months ending then. Some suggested that a General Motors axle plant closure disrupted GM production of trucks and sport-utility vehicles. That seems unlikely to have been the primary cause, given the collapsing sales and rising inventories of vehicles with poor gas mileage. A drive around the outskirts of most small U.S. towns will find—sitting in fields or open lots—unsold pickup trucks and SUVs that dealers have given up trying to sell.

The stimulus package passed by Congress in January has been offered as an antidote to the gloomy picture on consumer spending. But even there, difficulties have emerged. The rise in gasoline prices alone (by more than 30 percent between mid-February and late May) has added well over $100 billion to annual fuel bills, enough to absorb the entire tax rebate being sent to households. The initial indications of the impact of rebate checks are not encouraging. By May 16, nearly $40 billion of tax rebates had been distributed. It appears that some spending in anticipation of the rebate checks may have boosted discretionary retail sales in April, but a high-frequency survey of retail sales conducted by the research firm International Strategy and Investment revealed that in the week ending May 16, the survey result was down sharply by 3.8 points to an index level of 37.8. It may be that a combination of higher energy costs, not to mention higher food costs, and some anticipatory spending will limit the future impact of the earlier-than-expected distribution of rebate checks. With the underlying growth rate of the U.S. economy for the second quarter probably around –2 percent, the net impact of the rebate checks may be to raise that rate to –1 percent. After the rebate check distribution effects wear off, the impact on the growth rate will be reversed, suggesting that the growth rate in the second half of 2008, contrary to the consensus forecast and that of the Federal Reserve, will likely be substantially slower than in the first half.

The Fed's Dilemma

There is a connection between the necessary, rapid easing of monetary policy by the Federal Reserve and the sharp increase in global food and energy prices that is feeding back onto the United States as a contractionary force by reducing real purchasing power. The currency pegs to the dollar of some large, rapidly growing countries, including China, Russia, and Brazil, in effect make the Federal Reserve the central bank of those countries. Steep cuts in interest rates by the Federal Reserve to help cushion the impact of the bursting of the housing bubble have created a huge inflow of funds in search of returns to these same emerging market countries, as well as India and Middle Eastern oil exporters. The attempt to peg their currencies to the dollar forces those countries to produce rapid increases in liquidity that, in turn, stimulate demand growth for food and energy products. So by pegging their currencies to the dollar, those countries are forcing more adjustment in the United States to higher energy prices. The more the Fed eases to accommodate credit strains in the U.S. economy, the more money floods abroad into emerging market countries and pushes up their energy prices. Beyond that, energy prices are held below market levels by governments such as that of China so that as their economies grow more rapidly, the demand for energy expands even faster without any discipline from higher prices, and so inflation in other sectors rises. The estimated effective oil price inside China is about $60 a barrel—half the full international market price. Rapidly rising inflation and accommodating central banks have resulted in negative real interest rates in most emerging countries—a further spur to more inflation. The corollary is that energy prices have to rise more in the United States in order to slow the global growth of demand for food and energy products.

Higher food and energy prices feed back negatively onto U.S. and developed economies in two ways. The higher inflation hurts the terms of trade of the developed countries and compresses real wages and profits. U.S. real wage growth has already dropped below zero, while profit compression is becoming more intense as U.S. companies, facing higher input costs, are unable to pass on the higher costs through price increases in a slowing U.S. economy.

The second negative impact of the stimulative policies to ease the credit crisis arises from the commitment of central banks in developed countries to resist inflation pressure. The Fed, after its April 30 reduction of the federal funds rate to 2 percent, with two dissenting votes in the Open Market Committee against that rate cut, has already signaled a desire to stop easing in the face of higher inflation pressures from higher food and energy prices. The determination of the European Central Bank, the Bank of England, and the Bank of Japan to resist higher energy prices has also been clearly stated.

Meanwhile, the European, Japanese, and British economies are all slowing into midyear. In the United Kingdom, house prices have begun to drop rapidly while the Bank of England has declined to provide any relief, needing instead to focus on higher inflation pressures. While European growth was firm in the first quarter, exports to Asia are beginning to slow, and negative pressure on house prices in areas such as Spain, Italy, and Ireland are exerting further downward pressure on their domestic economies. The Japanese economy, despite strong headline numbers for the first quarter, actually contracted modestly over the previous year. Year-over-year nominal growth of GDP, the most comprehensive measure of economic activity in Japan, where deflation pressures persist, was actually slightly negative at the end of the first quarter, falling 0.4 percent.

The global spillover to higher food and energy prices from the Fed's aggressive efforts to cushion the negative impact of the collapse in the U.S. housing bubble has created a dilemma for the central banks in developing countries. While real economic activity is slowing, especially in the United States, and that slowdown is exacerbated by what amounts to a tax from higher food and energy prices, central banks have to temper their rhetoric about supporting the economy with statements about elevated concerns tied to rising inflation pressures. The May 21 publication of the minutes of the Fed's policy meeting on April 29–30 underscored the rise in inflation concerns when oil was at $115 a barrel.

The transmission mechanism whereby easier Fed policies support an accelerated increase in food and energy prices in global markets is a new feature of this cycle that is tied, in turn, to the rapid development of emerging economies. As households in China, Russia, India, and Brazil—to mention the most prominent—become wealthier through the rapid growth of those economies, their demand for higher quality food and for energy accelerates, thereby boosting global prices. In China alone, nominal GDP is rising at a 17 percent rate. The rapid development of those economies makes them attractive destinations for liquidity increases tied, in turn, to easier policies pursued by central banks in developed economies. Beyond that, policies aimed at subsidizing households by capping sensitive prices of food and energy in emerging markets allow demand to grow even more rapidly for those products, thereby restricting supply in global markets and pushing prices up even faster. As one close observer of developments in the emerging markets suggested, "let the U.S. adjust to higher energy prices for a change."

Risks Rising in U.S. Economy

Taken together, these considerations suggest that the relief from the acute phase of the credit crisis and the attendant rise in optimism about U.S. financial markets and the U.S. economy are waning as we move toward midyear. Now that financial markets have decided that the U.S. recession is over, or will be shallow at worst, it is probably, in fact, just beginning. Higher energy prices, sharply tighter credit conditions, compression of real incomes and profits, and the likely slowdown in capital spending will be difficult to overcome. Meanwhile, the attendant rise in inflation pressure, with oil having reached above $130 per barrel and food prices still rising rapidly, may mean that the Fed is unable to provide the help that it provided to financial markets in the acute phase of the credit crisis.

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Still, there are signs that the Fed is not as sanguine about the outlook for the economy and financial markets as some in the private sector suggest. On May 13, Fed chairman Ben Bernanke formally requested that Congress allow the Fed to pay interest on reserves. This seemingly technical step is important. It is the necessary condition to enable the Fed to expand its balance sheet—a step it has not yet taken—while maintaining control of the fed funds rate above zero. This technical step is important because it indicates that the Fed remains concerned about the possible future need for more aggressive steps to cushion the credit crisis and protect the real economy.

The Fed has already agreed to swap five-eighths, or $500 billion, of the Treasury securities on its balance sheet for lower quality mortgage-backed securities (including those of investment banks) to cushion the impact of the credit crisis on the U.S. financial sector. The Fed has probably not failed to notice that, despite these extraordinary efforts, the fall in house prices has continued to accelerate along with foreclosures and vacancies resulting from the abandonment of homes by beleaguered borrowers. As already noted, Congress is crafting a modest effort to slow the pace of foreclosures over the balance of the year, but like past efforts, it involves a cumbersome procedure. Homes facing foreclosure must be appraised and marked down in value in a process that probably leaves many lenders with about seventy cents on the dollar on a distressed mortgage holding. Beyond that, distressed homeowners may cease making payments on existing loans to qualify for the new program. If the Foreclosure Prevention Act is actually passed in June, its modest benefits will not appear in the most distressed areas of housing markets until the end of 2008, given that the legislation will not likely go into effect until October 1. That said, house prices will continue to fall at a rapid rate, while the act, at best, will provide a template for a far more substantial bailout for the housing sector likely to come with the new administration in 2009. Meanwhile, we have to get through the rest of 2008, and that is not going to be easy.

A big question is whether the surge in food and energy prices will ultimately end up being deflationary or inflationary. If, given the likely sharp slowdown of the U.S. economy in the second half of 2008, the Federal Reserve and other central banks are forced to remain on hold or even tighten, as some have threatened because of higher food and energy prices, the negative impact on global growth could be substantial. The signal would be a drop in food and energy prices accompanied by a sharp slowdown in growth in emerging markets that accompanies a sharp slowdown in growth in developed economies. That would be what is called a global recession.