

WEEK OF OCTOBER 10, 2005—SPECULATION

Federal Reserve officials have been talking up the virtues of economic flexibility, of late. Chairman Greenspan even gave the same speech twice to emphasize his point that Adam Smith's free market capitalism was the best model to weather recent catastrophes—whether natural or manmade, which include wars, soaring energy prices and the effects of globalization. Such 'flexibility' has diminished the strength of economic downturns and so contributed to increasing economic stability.

"Although the business cycle has not disappeared, flexibility has made the economy more resilient to shocks and more stable overall during the past couple of decades," Greenspan said.

The irony is that it has also led to the excessive speculation that has fueled the real estate housing boom. For with greater stability of financial markets, interest rates tend to fall. This is because investors require a lower so-called inflation-risk premium, all other things being equal. And California has led the housing boom.

Our own California Economic Forecast's Mark Schniepp mentioned the role of speculators in elevating real estate values. Low interest rates mean lots of money in circulation, and cheap money means there is less risk in buying a second, third, or fourth property, which drives up property values. Lending institutions are more than happy to enable the purchases, of course, since they have to put their money to work.

But Dr. Schniepp in a recent News-Press article sees signs that speculative activity is declining. In his most recent investor survey, second home purchases had declined, though overall purchases of investment properties remained the same as a percentage of sales. It is hard to know what this means, because interest rates are still at historic lows. The 30-year fixed rate is hovering slightly below 6 percent, not even up to last summer's spike.

However, the Fed's effort to tighten credit is bucking a tidal wave of its own. Globalization has created a huge pool of money in circulation—both domestic and foreign—that easily flows across borders. Top that with all the federal government spending on war and disaster relief, and we still have an economy awash in liquidity. This is beginning to show up in higher core inflation indexes, which is the Fed's greatest fear. For it means inflation could become entrenched.

The debate seems to be over whether the 'headwinds' caused by hurricanes and expensive energy will slow down next year's economic activity. The Fed says no, it will just cause more inflation. But other economists see much slower growth, since the Fed's rate hikes are hurting spending, and consumer spending accounts for 80 percent of all economic activity.

The rise in September's unemployment rate sent some tremors through financial markets, but inflation fears seem to be overriding any short-term damage to jobs. The result has been steadily rising interest rates.

UNEMPLOYMENT RATE—The economy only lost 35,000 payroll jobs in Sept., but much of the hurricane area wasn't surveyed. The number of unemployed actually rose 270,000, according to the Household survey, hence the higher unemployment rate. Hardest hit was the retail sector, with 88,000 jobs lost plus 80,000 lost in leisure and hospitality. There will be a huge pickup in construction and real estate activity, however, once the rebuilding effort gets underway. But that could also contribute to inflation, since construction materials—such as wood and cement—are already in short supply.

CONSUMER DEBT—Increased only 2.9 percent or \$4.9 billion in August, as short-term interest rates continue to climb. The Prime Rate is now at 6.75 percent, and scheduled to go higher. Most of the debt increase was installment loans, with very little increase in credit card debt. But this doesn't include a much larger increase in mortgage debt, from which most consumer spending is now financed.

What is this touted economic flexibility? Greenspan's main point is that financial markets have become more self-correcting with the greater flexibility lent by derivatives and other sophisticated trading techniques that distribute risk over a wider population. And this would not be possible if the banking industry had not been de-regulated, so that banking conglomerates such as Citibank or Chase Manhattan are now able to own brokerage and insurance entities as well as banks that are additional sources of investment capital.

So greater deregulation seems to be the future, as Adam Smith foresaw in 1776 with the publishing of his *Wealth of Nations*. World finance is no longer dominated by the major industrialized powers when China, Korea, Malaysia—the so-called Asian Tigers—have become our major bankers. The benefit to real estate is lower than normal interest rates. A recent study calculated that our interest rates would be at least 0.5 percent higher, if not for the foreign monies flowing into the U.S.

Copyright © 2005