PopularEconomics.com

Popular Economics Weekly

WEEK OF OCTOBER 31, 2005—INFLATION ANGST

Inflation Angst is beginning to hit consumers, says the latest University of Michigan consumer sentiment survey, a twice-monthly telephone survey of consumer attitudes. Studies have shown that inflation is fed as much by consumers' fears about inflation as rising costs. I.e., consumers will pay a higher price when they believe inflation is rising, and bargain harder (buy less) when prices are perceived to be stagnant or declining.

That may be one reason for soaring real estate prices, whether or not bubble related (i.e., speculative). We cited in last week's column a NBER study that put the blame on a shortage of new housing over the last decade, which in turn was caused by more restrictive zoning and approval processes. This means that buyers who want into the most desirable real estate markets have little choice but to outbid each other.

Something has to give sooner or later, of course, and it is usually some form of declining income, and/or the loss of a job. There are few savers in our society these days, outside of those with substantial 401(k) or pension plans. But even that part of our safety net can no longer be counted on as the likes of GM, United Airlines and others find ways to cut their pension obligations.

"The current outlook for higher costs of home heating, higher interest rates, and falling real incomes will cause cutbacks in consumer spending in the coming months," noted consumer survey director Richard Curtin. Based on the survey, Curtin expected spending growth to me no more than about 1 percent above inflation in both of the next two quarters.

This is one more piece of evidence that higher prices combined with rising interest rates have devastated consumers' financial situation. "When consumers were asked to explain their situation, more consumers cited higher prices than any time since 1982, and just as importantly, the fewest consumers cited income gains in more than a decade," said Curtin.

The Commerce Dept confirmed Curtin's survey. Adjusted for inflation, real spending fell 0.4% in September after dropping 1percent in August, reported Commerce last Monday. It was the first back-to-back decline in spending in 15 years.

This is not a good sign for Christmas shoppers, needless to say, for several reasons. Firstly, inflation is beginning to filter through to core prices—other than food and energy, that is. Secondly, incomes continue to fall behind inflation. 'Real' personal incomes in Sept. fell 0.4 percent after inflation is figured in, and the personal savings rate has now been negative for 4 months in a row. Inflation-adjusted incomes have been falling since the last recession (2001), which means that consumers have to continue to borrow in order to continue to spend. The result has been record debt levels.

The Commerce Department's (Sept.) press release said it best: "Negative personal saving reflects personal outlays that exceed disposable personal income. Saving from current income may be near zero or negative when outlays are financed by

borrowing (including borrowing financed through credit cards or home equity loans), by selling investments or other assets, or by using savings from previous periods."

Another sign of rising inflation was the jump in the Personal Consumption Expenditure (PCE) Index of 0.9 percent for Sept. It is the Federal Reserve's favored inflation indicator as it measures a broader range of consumer prices than the Consumer Price Index. This was the biggest single monthly jump in prices since 1981, though its core rate remained at 2 percent, which is still the high end of the Fed's desired inflation range.

The Federal Reserve's Open Market Committee raised their overnight rate for the 12th consecutive time to 4 percent. The Prime Rate is now 7 percent. Its press release was enough to cause more inflation jitters among consumers (and the bond market), even with the usual obfuscations:

"Elevated energy prices and hurricane-related disruptions in economic activity have temporarily depressed output and employment…The cumulative rise in energy and other costs have the potential to add to inflation pressures; however, core inflation has been relatively low in recent months and longer-term inflation expectations remain contained."

MANUFACTURING ACTIVITY—The Purchasing Manager's Sept. ISM survey held steady at 59.1 percent vs. August's 59.4 percent showing growth in manufacturing activity. Only employment and prices increased, but producers showed concern over the price of oil and its effect on the future prices of commodities. "Existing inventories are being depleted and we are seeing some significant price increases in some commodities," said the report.

SERVICE SECTOR ACTIVITY—The ISM non-manufacturing index soared to 60 percent from 53.3 in August on signs that overall business remains robust going into the year-end. Eleven of the seventeen sectors increased, with most concerned about energy prices. "Rising energy costs, as a result of the recent storms along the Lower Gulf Coast, are having an impact on budgets and may delay planned capital spending unless supply and prices improve.," said the report.

CONSTRUCTION—The construction industry was booming even before Gulf Coast reconstruction has begun, reported the Commerce Dept., of which 58 percent is residential construction. And we mentioned in last week's column that existing-home sales in the South grew 8 percent, mainly in areas outside of the hurricane damage. This is when construction material costs for the likes of wood and cement are already soaring. Hence fears that the hurricanes will boost inflation.

The Fed could be wrong about inflation, of course, and continue to boost interest rates into next year. Inflation could be a temporary phenomenon tied to the hurricanes and a temporary energy shortage. The Fed has been tightening credit since last June, and it takes 6 months to a year before any results are seen. This last happened in 1999, when the Prime rate soared to 9.5 percent, before the stock market bubble burst. Many economists believe that had the Fed ceased tightening sooner, much of the damage to stocks in 2001-03 might have been mitigated.

The real danger to consumers (and the real estate market) is that all this talk by the Fed about inflation will hurt, rather than help control prices. Squeezing buyers with higher interest rates when they already see incomes growing at less than the inflation rate can only cause more inflation angst.

© Copyright 2005

Please address questions & comments to: Editor@PopularEconomics.com