

Consumers to the rescue?

AS WITH most paths from mountain-top to valley, the road into recession tends to be winding and uneven, with enough flat or even rising stretches to raise the occasional hope that the traveller has reached the bottom. The past few weeks' data have been sufficiently ambiguous to convince some economists that the descent of America's economy is nearing an end, though many others fear further steep drops. Who is right may depend largely on whether consumers, who have so far carried on spending fairly freely, decide to shut their wallets.

The manufacturing sector has been a source of modest encouragement for the optimists. True, it remains in recession. But the National Association of Purchasing Managers' manufacturing index unexpectedly edged up a bit in March, suggesting that the rate of decline in activity is slowing.

The big car makers, whose sudden troubles a year ago made them the leaders of the economic retreat, reported a fall in sales in the first quarter. Even so, they claimed, sales were better than expected, things look better for the second quarter and the surge in inventories that had caused so much alarm is being brought under control.



The NAPM non-manufacturing survey was also less worrying than some economists had feared. The index fell in March, but not by much. This is a much newer indicator than the NAPM manufacturing survey, so nobody really knows how to interpret it. But plenty of economists are happy to regard a merely small fall, in today's gloomy climate, as a reason for optimism.

Some economists also take comfort from the Federal Reserve, which shows every indication that it is ready to cut interest rates as low as is necessary to get the economy back on its feet. Even after the 150 basis points of cuts so far this year, monetary policy is now merely neutral rather than tight. The markets are forecasting that it will become stimulative shortly, with interest rates falling to 4.5% or lower (from 5% now) over the next two Fed meetings, on May 15th and June 26th-27th, and maybe even sooner.

That is the rosier view of the Fed's actions. A gloomier one is that the central bank is unimpressed by the not-so-bad-after-all numbers mentioned above, and knows that it has its work cut out avoiding a recession, perhaps a severe one.

The interest-rate cuts so far this year have not calmed the nerves of corporate America, where the outlook for profits is deteriorating daily, and any spending that can be postponed has been--with technology spending, in particular, screeching to a halt. Many firms have been delaying more drastic action, such as big job cuts, in the hope that the economy will rebound quickly; but each day it does not, more will have to act. The impact of rate cuts has been limited, not least by the banks: so much so that Alan Greenspan, the Fed chairman, has warned them, again, not to deny loans to fundamentally sound credits.

The one unworried head in this storm, at least until now, has been the American consumer, who still shops as if there was no tomorrow. Consumer spending, which accounts for two-thirds of GDP, continues to rise, and is on course for real year-on-year growth in the first quarter of over 3%. Americans are still straining their credit cards, after a brief flirtation with prudence in December. Their spending exceeds after-tax income--the "negative savings rate"--by a record amount. Incredibly, this has happened despite a sharp fall in consumer confidence; it plunged to a four-year low in February, before improving somewhat in March.

So what happened to the much-cited "negative wealth effect" supposedly caused by the past year's plunge in share prices, particularly the Nasdaq? The destruction of several trillion dollars of stockmarket wealth seems to have influenced only what Americans say, not what they do. There is a strong correlation between changes in the Nasdaq and the level of consumer confidence, but not between the Nasdaq and spending.

People may be much slower to allow changes in share prices to influence their spending than has been supposed up to now, says Henry Willmore, an economist at Barclays Capital. In the past, they have been twice as likely to consume out of gains in the value of their homes as out of share appreciation. Strikingly, last year, the value of owner-occupied property went up by over 10%, the biggest increase since 1985. This raised household wealth by around \$1.1 trillion, roughly half the loss due to falling share prices--but enough, on past trends, to cancel out the negative wealth effect of the stockmarket.

Will tumbling share prices now trigger falls in house prices? There is some evidence of this at the luxury end of the market. But in the past, there has been no strong correlation between share prices and house prices. If anything, they tend to move in opposite directions.

Supporting the housing market seems to have become the focus of the Fed's activities. Its rate cuts have stimulated a boom in mortgage refinancings, which gives money straight to consumers. Most of the recent rapid increase in the money supply stems from the lending activities of two federally sponsored mortgage agencies, Fannie Mae and Freddie Mac, which as a result are facing growing political scrutiny.

If the housing market continues to boom, it should lead to an acceleration of consumption, led by increased spending on "big ticket" items, from ovens to carpets, as the year goes on, according to Carolyn Scott of McCoy Scott, a consultancy.

The main risk to this rosy scenario is the labour market, which has so far remained more resilient than economists thought likely. However, unemployment tends to follow economic activity with a lag. And in this downturn companies have been particularly reluctant to fire workers, since hiring has been hard in recent years and the economy may recover quickly. If they do start to wield the axe with zeal, consumers will have to learn restraint.