For the Federal Reserve chief, even good news turns out to be bad

JITTERY investors and anxious politicians have often relied on Federal Reserve chairmen to conjure up something to steady their nerves. But when Ben Bernanke gave his twice-yearly monetary testimony to Congress on July 15th and 16th, he had little to offer but unvarnished and uncomfortable truths. There were “significant downside risks” to the economy’s outlook, he said, and the chances that high inflation would persist had “intensified”. Mr Bernanke did not specify which was the bigger threat: recession or inflation. This lack of a clear policy bias invited the conclusion that, for the time being at least, the Fed thinks it cannot safely move interest rates in either direction.

With financial markets buffeted by renewed fears about the credit drought and a deepening housing slump, Mr Bernanke could hardly boast of the economy’s soundness. To make matters worse, figures released as the Fed chairman gave his second day of testimony showed that year-on-year inflation rose in June to 5.0% (see chart), the highest rate since 1991. Paltry pay rises, as well as job losses, mean employment income is probably growing by less than 3%, well below the inflation rate. Falling real income, slumping share and house prices and tighter credit all cast a cloud over consumer spending. Firms worried about future demand will be more cautious too about shelling out for costly capital projects, even if they could raise the finance.

Despite these unsettling prospects, the Fed’s rate-setters bumped up their forecasts for GDP growth in 2008, to 1.0-1.6%, from the 0.3-1.2% range set out in April. According to the central bank’s 48-page report to Congress, the upgrade was prompted by stronger data on consumer and business spending between April and June. Private-sector analysts are revising up their forecasts for this year too. The first estimate of second-quarter GDP, released on July 31st, is likely to show that the economy grew at an annualised rate of around 2%, twice as fast as in the first quarter.
The Fed’s trouble is that, though the economy has avoided recession so far, it may not do so for much longer. Indeed Mr Bernanke acknowledged that some of the demand that the Fed had hoped for later this year may have already come and gone. So the economy’s first-half resilience may be of more concern than comfort.

The performance of companies and consumers shows why. Businesses received some extra tax relief as part of February’s fiscal-stimulus package, which may have helped a little to stave off recession. There was also a spurt in the construction of offices, hotels and other business structures in the spring. However, this burst of activity may have been just the fag-end of the commercial-property boom. “These are projects that were planned when money was cheap,” says Kevin Logan, an economist at Dresdner Kleinwort in New York. Now conditions have deteriorated: vacancy rates for offices are rising and retail chains, such as Gap, are closing stores.

Consumer spending seems likely to flag too. A jump in retail sales in April and May owed something to the tax rebates first sent out at the end of April. By July 11th around $92 billion of the expected $110 billion of rebates had been disbursed. With household finances under so much pressure, consumers probably leant more heavily on the rebate cheques than had been expected. But a slim rise in retail sales in June is a hint that the effects of this one-off stimulus may already be fading.

Another crutch for consumers has been the home-equity loan. Borrowing from this source rose by 3.8% between March and June, despite a big fall in overall bank credit. This increase came about partly because access is blocked to other forms of borrowing, such as mortgage refinancing. It may also be a sign of distress borrowing, as consumers battle with rising living costs. That battle will become harder if, as anecdotal evidence suggests, banks are cutting pre-arranged credit lines.

The brightest hope for America’s economy is its foreign sales. Net trade added more than one percentage point to GDP growth in the year to the first quarter. The weak dollar is still helping American firms take advantage of the strong demand in other parts of the world. Export volumes rose by 10.1% in the first five months of the year, compared with the same period in 2007. But even here, the future is looking bleaker. Rising global inflation, spurred in part by countries with dollar pegs mimicking the Fed’s rate cuts, is now prompting central banks in many emerging economies to tighten monetary policy. That will curb demand for imports. America’s richer trading partners are struggling too. The euro-area economy may have shrunk in the second quarter. The outlook for Japan and for Britain has worsened too.

There is little that central banks can do to support the economy when inflation is rising dangerously high. The Fed’s hands are tied by its concern that today’s inflation may lead to higher wages. Mr Bernanke is “in a box”, 
says Michael Feroli, an economist at JPMorgan Chase. The Fed chief has to sound hawkish to show that he has not lost sight of inflation. But equally he cannot set out a plan for interest-rate increases when the financial system is so wobbly.

The good news in the first half may even make the Fed’s job harder. If consumers have already used up much of their tax rebates and credit lines, spending is likely to flag soon. A first-half recession followed by a sluggish recovery—the standard forecast until recently—could well have enabled the Fed to raise rates in the autumn. But with the worst news on the economy yet to come, Mr Bernanke can only keep his fingers crossed that inflation does not become ingrained.