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# Storm clouds ahead

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**The economy seems a bright spot for the president. But higher interest rates could make his second term much harder**

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GEORGE BUSH'S second term has already had its hiccups. Barely had the president delivered his soaring, Kennedyesque inauguration speech, proclaiming “the ultimate goal of ending tyranny in our world”, than the White House was furiously clarifying that this did not actually imply any change in foreign policy. And long before Mr Bush's state-of-the-union address on February 2nd, his main priority at home, reforming the Social Security pensions system, is in trouble. Democrats seem united against change, and some leading Republicans are publicly pouring cold water on the idea.

Meanwhile, the budget picture seems to be getting worse. On January 25th, the Congressional Budget Office, Washington's independent bean-counter, projected that this year's deficit would reach $368 billion. That excludes the cost of the Iraq war, which the CBO thinks will be $30 billion this year. On the same day, the White House announced that it needed $80 billion more for Iraq and Afghanistan (bringing the total cost of both wars to almost $300 billion), and offered its own estimate for the 2005 budget—a new record deficit of $427 billion. That may be pitched deliberately high, to force Congress to control spending, but Mr Bush's pledge to halve the deficit in his second term looks increasingly empty.

All in all, not a great start. So what a relief that one thing looks good for Mr Bush: the economy. America is currently doing rather well, with relatively healthy growth in jobs and extraordinarily low interest rates. Alas, it is a combination that is unlikely to last—and if the economy gets bleaker, that could start to affect Mr Bush's other plans.

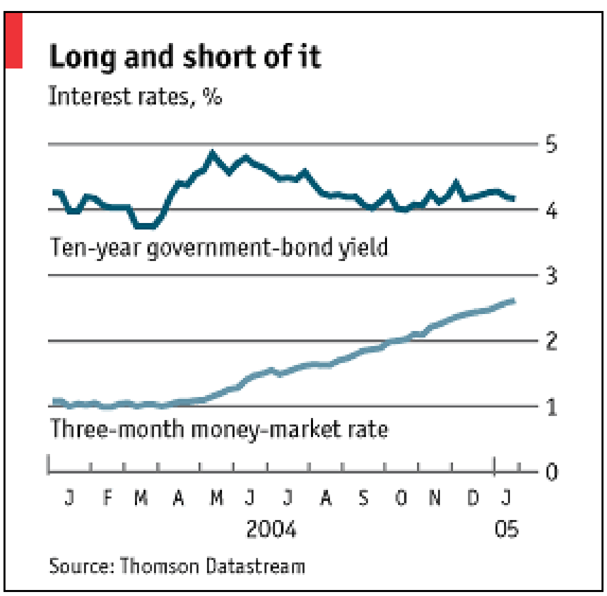
Consider the good news first. From industrial production and retail sales to housing starts, the latest statistics have been stronger than expected. Consumer confidence rose in January for the second month in a row. Although most analysts reckon that GDP growth slowed from its 4% pace to closer to 3.5% during the last three months of 2004 (the first official estimates are released on January 28th), that hardly looks weak.

While the economy is clearly working off its slack, inflation is still low enough to cause few palpitations. Headline consumer-price inflation has slowed slightly, to 3.3% in the year to December, thanks to falling oil prices. Core inflation, which excludes the volatile categories of food and energy, has doubled over the past year, but from a rock-bottom level: it climbed from 1.1% in 2003 to 2.2% in 2004.

As a result, America's central bankers have been able to inch up short-term interest rates at what they call a "measured" pace—a phrase now synonymous with regular rises of 0.25% in the central bank's federal-funds rate. At its next meeting, on February 2nd, the Federal Reserve seems likely to raise short-term interest rates to 2.5%. That will be double the level of only seven months ago, but it is still extremely low. Depending on what measure of inflation you use, real short-term interest rates are around zero or still negative.

If America's economy continues to grow robustly, monetary policy will shift from "loose" to "neutral"—and rates will go up. Although there is plenty of controversy about what a neutral fed-funds rate might be, estimates tend to be 3.5-5.5%. Oddly, financial markets are pitching it lower. Futures contracts imply that the central bank will raise short-term rates at each of its next three meetings to 3%, but will then stop, so there will be virtually no more Fed tightening in the second half of 2005 or in 2006.

If that is puzzling, the behaviour of long-term interest rates is even odder. At around 4.2%, yields on ten-year Treasury bonds, America's benchmark long-term interest rate, are virtually identical to where they were a year ago (see chart). Adjusted for some measures of inflation, real long-term interest rates are lower. Stephen Roach of Morgan Stanley reckons inflation-adjusted long-term rates are now more than 2.5 percentage points below their average level of the past 20 years.




This long-term rate has a big impact on how much American companies and consumers borrow, and thus on the American economy and Mr Bush's second term. Its level reflects all sorts of things, including demand from investors for bonds, expectations of future inflation and a risk premium for holding longer-term assets. But if you look at what has happened to America's economy over the past year, you would expect long-term rates to be heading much higher. After all, short-term interest rates and inflation are both rising, the current-account deficit is huge and widening, the dollar has fallen and the fiscal outlook has worsened. Surely investors looking over the next ten years will want a better return than 4.2%?

Economists are genuinely puzzled by all this. There are several explanations, each of which has a different implication for Mr Bush's second term. None of them are terribly good.

• The most gloomy theory is that America's economy is, in fact, rather more fragile than the current statistics suggest (and most forecasters presume). Debt-laden American consumers, so the argument goes, will not be able to sustain their current spending patterns, particularly if the housing bubble bursts. Low long-term interest rates, far from being out of kilter, are actually an accurate sign of incipient economic weakness. Mr Bush's second term, in other words, may see another sharp slowdown—not a good backdrop to his domestic revolution.

• A more hopeful argument for Mr Bush is that there has been a deeper “structural” change in the investment markets in favour of bonds. A new theory on Wall Street is that domestic pension funds are shifting more of their cash into long-term bonds in advance of possible regulatory changes from Washington. Asia's central banks have also been buying Treasury bonds to stop their currencies appreciating against the dollar; that demand has certainly pushed down the yields on American bonds, but nobody really knows by how much or how much longer the Asians will continue to be such unchoosy investors. If the Asians were to moderate their appetite, interest rates would shoot up.

• A third theory is that investors are so convinced by the Fed's record as an inflation-slayer that they don't need higher rates on long-term bonds. Overall inflation is indeed much lower than it was a generation ago. But plenty of aspects of America's economy should spook even the most trusting admirer of Alan Greenspan (not to mention the Fed chairman himself). These include that worsening budget outlook and America's rising reliance on foreign capital.

• Which leaves the last possibility: that the financial markets have temporarily mispriced the risks involved. Investors are too complacent about inflation and about America's enormous budget and current-account imbalances. If that theory is correct, long-term interest rates could rise sharply and suddenly.

### And if rates went up?

Higher interest rates would obviously hurt America's debt-laden economy. But they could also play havoc with Mr Bush's political goals. The “ownership society” would lose allure if the housing market and the stockmarket tumbled. Halving the budget deficit would be both more difficult and more necessary. Convincing lawmakers to support pension privatisation that required issuing an extra $1 trillion-2 trillion of debt would be even harder.

Just how the interest-rate puzzle will be resolved is unclear. But the chances are that either America's economy will do worse than many now expect or interest rates will head much higher. For the White House, neither prospect is appealing. These past few weeks have hardly been a political honeymoon, but the going could get much, much tougher.