



The **Economy** ■ David Malpass

Surviving rate hikes will be easier than you think

FINANCIAL MARKETS HOLD THEIR BREATH WHENEVER Alan Greenspan speaks, parsing his words to guess when interest rates might start rising. They certainly won't stay at 1% for much longer, and probably this year, certainly next, they'll rise substantially. But don't panic: It won't be the end of the world. Higher rates will hurt bonds, but they aren't likely to cause another recession or even do much damage to the economy's crown jewels, the equity and housing markets. Here's why.

When bond yields rise, a large chunk of the bond price losses fall on foreigners, while another portion is widely dispersed across the economy through pension funds, bond funds, and 401(k)s. The economy passed a stress test with flying colors in mid-2003 when bond yields rose 1.5% without causing much damage. In fact, GDP expanded at a whopping 6% average rate in the second half of 2003. True, when interest rates go up, mortgage rates will rise, and mortgage refinancings will slow to a trickle. But it probably won't depress consumption growth much, for several reasons.

First, personal income reached a record \$9.2 trillion in 2003, thanks to a relatively high level of employment, the tax cut, strong productivity growth, and even some increase in wages. Add in even lower unemployment this year and personal income will be substantially higher, providing a solid base for consumption.

Second, the actual savings rate is much higher than the government's low "personal savings rate" statistic cited in many bearish analyses of the U.S. economy. It severely understates the actual growth in consumer savings in the 1990s by excluding gains on equities, houses, and mortgage refinancings. It captures only the consumption from those gains but not the additions to savings. When properly adjusted, the savings rate has been stable at relatively high levels over the past decade. Third, the household sector is a net saver. Overall, higher interest rates will benefit households more than they will hurt. Their savings tend to be in short-term vehicles like money-market funds, while much of their debt is long term, such as mortgages or auto loans. Thus, I don't think consumers will be the weak link in the economy.

Which brings us to real estate. As interest rates rise, house prices may stall. However, the general support for house prices—expanding population, the low inventory of homes, the level of

mortgage rates, and big tax incentives—should still provide support for house prices, even after several rate hikes. In 2003 roughly 19% of homebuyers chose more volatile floating-rate mortgages. They will feel financial pressure if interest rates rise sharply. So far, though, they have been saving a bundle on their monthly payments, leaving them room to get ready for higher payments.

The government is in the same boat as homeowners with floating-rate mortgages. It has borrowed up a storm, mostly in short-term Treasury debt. That saves money for now but will be costly when rates move up. However,

despite concerns about the ballooning fiscal deficit, government debt is still at 37% of GDP, compared with an average 48% during the previous Bush administration. As rates rise, it will put upward pressure on the deficit but still leave the U.S. a AAA-rated credit risk entitled to one of the world's lowest borrowing rates.

Corporate debt will come under market scrutiny when interest rates rise. Corporations have borrowed to invest in their businesses, meaning many companies will see profits squeezed when rates rise. The good news here is that corporate profits have been hitting new records in recent quarters. With the economy growing strongly, it's likely that the negative impact from higher interest rates will be overwhelmed by the positive impact from healthy leverage. In short, profit growth looks as if it will outweigh the added interest costs.

Until rates actually rise, we won't know exactly how much the economy depends on low rates. I think problems from higher rates will be localized, however, to certain companies, households, and cities. I would even suggest that contrary to fears, the first few rate hikes could accelerate rather than crimp economic growth. Rate hikes may encourage a get-it-while-you-can reaction, pushing firms and individuals to borrow, build inventories, perhaps even buy more real estate to lock in rates.

In this environment, I think it would be prudent for consumers, businesses, and government to get out of short-term and floating-rate debt, and think long-term and fixed-rate. That wouldn't be the right choice if the economy were heading for another recession, but all the signs are pointing to continued strength. I think that strength will hold up even as rates rise, providing another positive discovery about U.S. economic flexibility. ■

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Rising interest rates will hurt bonds—but not the economy.

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Story ECO08 Page 1 of 1 Time of Resend XXX