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"The Looming Threat of Stagflation in the United States"

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Dr. Ngoan, Mr. Lin, Mr. Subramanian, distinguished guests, ladies and gentlemen, good morning.

It gives me great pleasure to speak to such a distinguished audience today on the subject of macroeconomic challenges.

On his recent trip to Asia, the new US Treasury Secretary Hank Paulson expressed optimism about the US economic outlook. He was not being at all controversial. His comments reflect the general mood in the US. The September reading of US consumer confidence rose to 104.5, a level comfortably above a neutral reading of 100.

There are good reasons for US consumers to feel good: They have been able to defy gravity for more than a decade. Although the US current

account deficit is rising, reaching as much as 6% of GDP in the first half of 2006, the US dollar remains strong and consumers continue to buy. If you speak to an economist, he will say this is unsustainable. But the party continues. Asia and Gulf state oil exporters continue to channel their accumulated current account surplus back to the US financial markets, mostly to US treasuries.

It's the old adage: You scratch my back and I'll scratch yours. By investing in US treasuries, Asia effectively pumps money into the US at very low interest rates, allowing US consumers to sustain their spendthrift ways and maintain demand for Asian imports. The mounting US current account deficit seems a harmless side-effect.

A similar balancing act is repeated on the domestic front. American consumers have adapted a lavish living style in recent years, spending more than they earn. As a very traditional banker, I cannot but fear the consequences. If more is going out than is coming in, there will be trouble down the road.

However, my American friends assure me that there is little to worry about. Housing and equity prices have risen by an average of 7% and 10% annually between 2003 and 2005. The positive wealth effect gives consumers a safety cushion. And after all, wages are rising.

I believe this optimism is based on faith; faith that the US economy will continue to grow. Growth is essential for the US to remain attractive to capital inflows, which in turn serve as the fuel for rising asset markets and rising wages.

However, the US consumers' faith is now facing its most daunting challenge in recent memory. The deceleration of the housing market since the start of this year has many worried. Housing prices dropped 1.7% in August, the first time they registered a drop from year-ago levels since 1995. Inventory has climbed from 2.5 million units in 2003-04 to close to 4 million level currently. Rising interest rates are squeezing many households.

This has not only put an end to the positive wealth effect from the rising house prices, but also reduced the collateral protection of homeowners. The slowdown in housing-related business and consumer spending will adversely affect company earnings, and will no doubt affect employment and wages in the months ahead. Yet, as I mentioned at the beginning of my speech, optimism is still firmly in place.

How can we explain this?

I believe it is partly due to plain inertia. When consumers are bullish, it will take time or a shocking event to force them to reverse course.

Furthermore, even if a slowdown does occur, the consumer expects the Federal Reserve to come to the rescue by cutting interest rates, just as Mr. Alan Greenspan did after the dot.com crash in 2001. As a matter of fact, with the recent weak economic figures, the bond market is now projecting a 40% chance of an interest rate reduction early next year.

But this is a different Fed chairman and a different time. Do not be mistaken. It is not that I think Mr. Ben Bernanke is less competent than his predecessor. But there is a beast lurking in the shadows, one that was nowhere to be seen when Mr. Greenspan last cut rates – inflation.

US economic growth has hovered at a solid 3-4% in the past two years. Unemployment is at a low 4.7%, while average hourly earnings for private non-farm payrolls has accelerated to 4%, approaching the previous high reached in 2000.

The surge of oil and commodity prices is another concern. Despite recent corrections, comparing the year-to-date average to the 2005 level, oil prices are 20% higher. Gold and copper are 35% and 82% more expensive, respectively. As China is likely to maintain a 10% growth

rate in the foreseeable future, demand for oil and commodities should continue strong. It would not surprise me if prices rise again in the coming months. With the labour market operating near full capacity and oil and commodity prices still high, inflationary pressures remain in the pipeline. Already, the headline inflation rate has risen to 4%.

To keep inflationary pressure from spilling over to the core inflation number, the Fed raised the Fed Funds Rate 17 consecutive times beginning in mid-2004 reaching 5.25%, before pausing at the August meeting of the Federal Open Market Committee. The Fed believes it has some breathing room in the fight against inflation. But the battle is far from over. The core inflation rate stood at 2.8% in August, which is higher than the Fed's comfort zone of 2%. If the economy continues to slow next year, will it be safe to lower interest rates? I believe it is naïve to assume that inflation is contained.

Hence, the Fed is now facing a dilemma. The correction in the housing market will continue. The cry for interest rate cuts to generate a soft landing will grow in coming months. Mr. Greenspan reduced interest rates by 5.5 percentage points during the last downturn to achieve a soft landing. Mr. Bernanke probably has only two shots, of just 25 basis points each, at his disposal to jump-start the economy. If he reaches for more ammunition, which I fully expect him to do, inflation will return.

The Fed will then be fighting on two fronts – inflation and economic slowdown. After a quarter of a century, the beast of stagflation will return.

This should come as no surprise. The "Asia produces – American consumes" cycle is not without penalties. It has strained global markets, causing oil and commodity prices to take off. The natural result is inflation.

And as I said earlier, no one should think they can spend more than they earn for long.

If you jump off a cliff, you actually can fly – for a while. But gravity still works, and the landing will be hard.