

**Economic Research – Scott J. Brown, Ph.D.**

**Thursday, March 13, 2008**

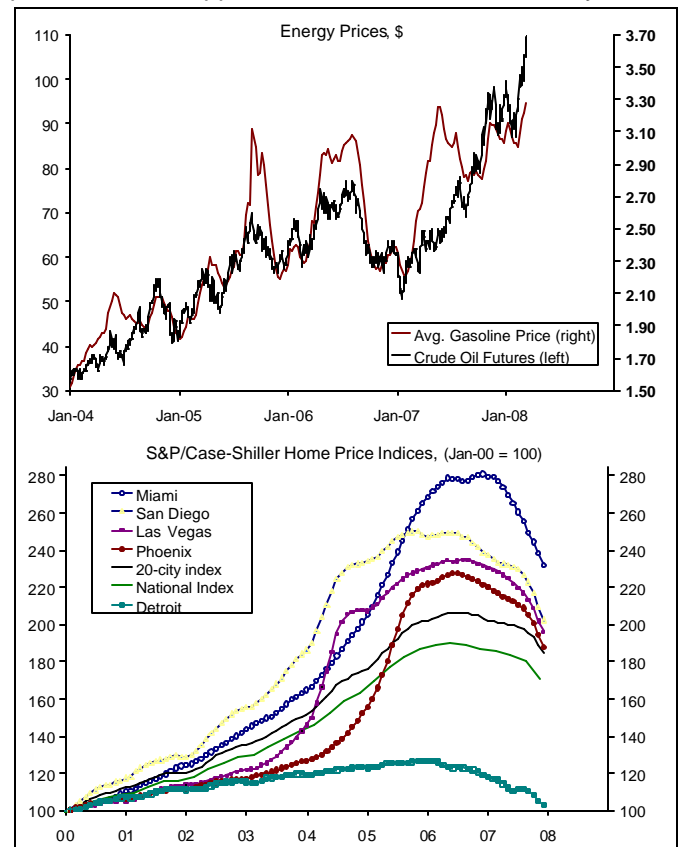
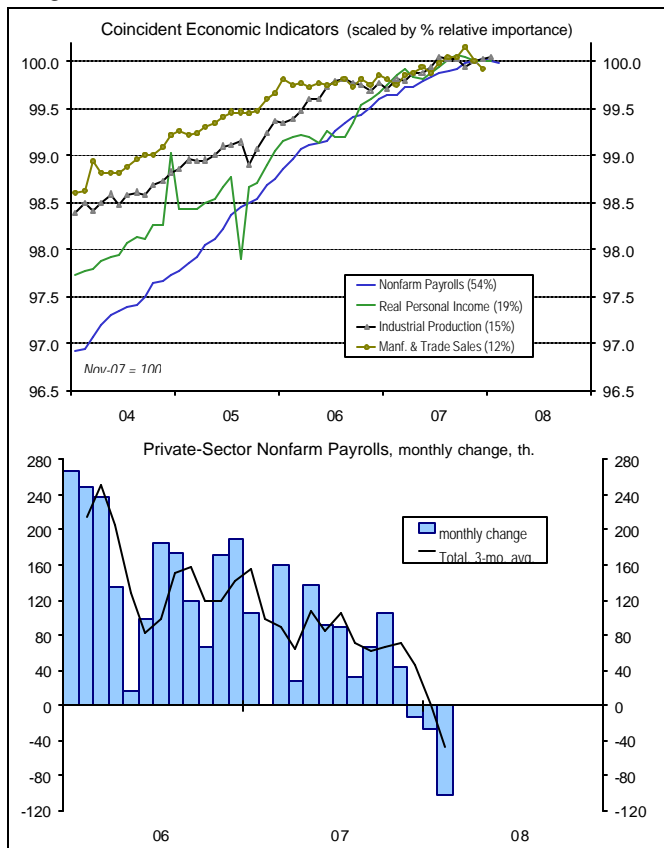
## An Economy On The Edge

- *The U.S. economy appears to be growing at a sluggish pace, on the edge of a recession. Monetary and fiscal stimulus will provide some support in 2H08.*
- *Downside risks to growth remain. Further declines in home prices could amplify and extend the housing correction. Higher energy prices and a soft job market could dampen consumer spending growth more than anticipated. Credit market conditions remain strained.*
- *The Fed has extended efforts to provide liquidity to the troubled credit markets and is poised to cut short-term interest rates further. However, inflation fears should limit the Fed's ability to move more aggressively.*

Real GDP rose at a 0.6% annual rate in the revised estimate for 4Q07 (the same as the advance estimate). The behavior of the key monthly indicators of recession have been flat to slightly lower in the last few months, suggesting an increased chance that the economy has entered a recession. An official declaration of recession, which would come many months after the fact, will depend on the depth and duration of any decline in overall economic activity. Yet, it's clear that the overall economy has slowed further and that downside risks to the growth outlook have moved closer.

The private-sector shed 101,000 payroll jobs in February, the third consecutive monthly decline. Measures of job destruction (weekly claims for unemployment insurance benefits and announced corporate layoff intentions) have continued to indicate a relatively limited pace of job losses. However, new hiring has apparently been curtailed sharply. Estimates from Automated Data Processing, Inc. show net job losses at large firms and weaker gains at small firms.

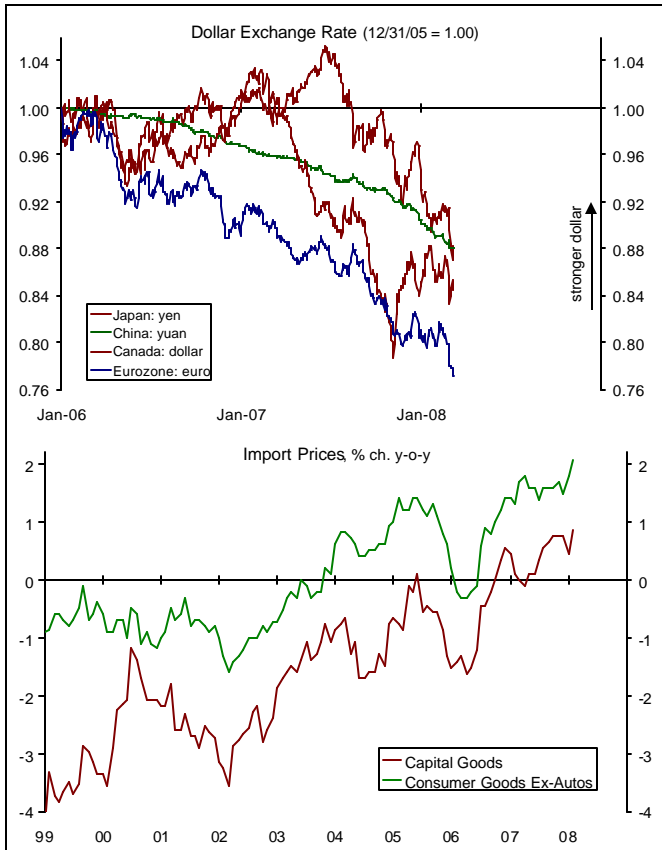
The weak job outlook is a serious worry. Combined with the impact of higher energy prices and declines in housing and stock market wealth, the near-term outlook for consumer spending growth is poor. Tax rebate checks, likely to be sent out in May and June, should provide some support into the second half of the year.



Declining home prices have become a more serious threat to the overall economic outlook (much more than adjustable-rate resets). The vast majority of homeowners have had little difficulty meeting mortgage payments. However, further declines in home prices will turn an increasing share of recent homebuyers (those who bought within the last few years) upside down (owing more than the home is worth). Increased foreclosures will then add to the volume of unsold homes and put further downward pressure on home prices.

Credit market conditions have deteriorated since the Federal Reserve lowered short-term interest rates in January. A reappraisal of risk and a deleveraging of the financial system has reduced liquidity even in high-quality assets. A seizing up in credit conditions is, in turn, a threat to overall economic growth. The Fed and other central banks have expended efforts to provide liquidity, effectively shoring up the market for higher-quality mortgage debt. For the Fed, these efforts will not turn bad debt into good, but should keep good debt from turning bad and help to prevent a panic.

The Fed has cut short-term rates significantly over the last several months, but it typically takes six to 12 months for such moves to have an impact on the economy. Fed rates cuts have contributed to a decline in the dollar, and as a result, higher inflation in imports and commodities in general. The exchange rate of the dollar is determined by supply and demand – it is the mechanism that balances current account outflows with net capital inflows. The current account deficit has declined somewhat in recent quarters, but net capital inflows are likely to have slowed more recently.



Fed Chairman Bernanke has often spoken of inflation expectations as a key factor in the inflation process. The Cleveland Fed's measure of inflation expectations, taken from the spread between inflation-adjusted and nominal Treasury securities (adjusted for the liquidity premium in nominal Treasuries and the inflation-uncertainty premium in inflation-adjusted Treasuries), has been moving higher. While there's some debate regarding the accuracy of the Cleveland Fed's measure, it doesn't bode well for the inflation outlook and (along with \$110 oil and rising import prices) may make the Fed reluctant to cut rates aggressively.

GDP growth is expected to be sluggish in the near term, with some improvement in the second half. However, there's still a high level of uncertainty.

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	2007	2008	2009
GDP (↓ contributions)	0.6	3.8	4.9	0.6	<b>0.0</b>	<b>0.4</b>	<b>2.3</b>	<b>2.7</b>	<b>2.8</b>	<b>2.9</b>	2.2	<b>1.5</b>	<b>2.6</b>
consumer durables	0.7	0.1	0.4	0.2	-0.6	0.1	0.2	0.2	0.2	0.2	0.4	0.0	0.2
nondurables & services	1.9	0.9	1.7	1.1	1.1	1.0	1.5	1.6	1.6	1.7	1.6	1.2	1.6
bus. fixed investment	0.2	1.1	1.0	0.7	0.2	0.1	0.2	0.3	0.4	0.4	0.5	0.4	0.3
residential investment	-0.9	-0.6	-1.1	-1.3	-1.0	-0.7	-0.4	-0.1	0.0	0.0	-1.0	-0.8	-0.1
government	-0.1	0.8	0.7	0.4	0.1	0.2	0.3	0.3	0.2	0.2	0.4	0.3	0.2
Domestic Final Sales	1.7	2.2	2.5	1.2	<b>-0.2</b>	<b>0.6</b>	<b>1.9</b>	<b>2.2</b>	<b>2.4</b>	<b>2.5</b>	1.9	<b>1.1</b>	<b>2.2</b>
exports	0.1	0.9	2.1	0.6	0.6	0.4	0.4	0.5	0.6	0.7	0.9	0.7	0.6
imports	-0.6	0.6	-0.7	0.3	0.1	0.1	-0.2	-0.4	-0.5	-0.5	-0.3	0.0	-0.4
Final Sales	1.3	3.6	4.0	2.1	<b>0.6</b>	<b>1.0</b>	<b>2.1</b>	<b>2.4</b>	<b>2.5</b>	<b>2.6</b>	2.5	<b>1.9</b>	<b>2.4</b>
ch. in bus. inventories	-0.7	0.2	0.9	-1.5	-0.5	-0.6	0.2	0.3	0.3	0.2	-0.3	-0.4	0.2
Unemployment, %	4.5	4.5	4.7	4.8	<b>4.9</b>	<b>5.3</b>	<b>5.5</b>	<b>5.6</b>	<b>5.6</b>	<b>5.7</b>	4.6	<b>5.3</b>	<b>5.7</b>
NF Payrolls, monthly, th.	109	105	71	94	<b>-50</b>	<b>-30</b>	<b>50</b>	<b>85</b>	<b>100</b>	<b>112</b>	95	<b>14</b>	<b>113</b>
Consumer Price Index	3.6	4.3	2.5	6.2	<b>4.1</b>	<b>2.2</b>	<b>2.3</b>	<b>2.3</b>	<b>2.3</b>	<b>2.3</b>	4.1	<b>2.7</b>	<b>2.3</b>
excl. food & energy	2.2	2.3	2.5	2.6	<b>2.8</b>	<b>2.1</b>	<b>2.1</b>	<b>2.1</b>	<b>2.0</b>	<b>2.0</b>	2.4	<b>2.3</b>	<b>2.0</b>
PCE Price Index (q/q)	3.5	4.3	1.8	4.1	<b>4.3</b>	<b>2.4</b>	<b>2.2</b>	<b>2.1</b>	<b>2.1</b>	<b>2.1</b>	2.6	<b>3.2</b>	<b>2.1</b>
excl. food & energy	2.4	1.4	2.0	2.7	<b>2.8</b>	<b>2.0</b>	<b>2.0</b>	<b>1.9</b>	<b>1.9</b>	<b>1.9</b>	2.1	<b>2.3</b>	<b>1.9</b>
Fed Funds Rate, %	5.25	5.25	5.09	4.49	<b>3.28</b>	<b>2.36</b>	<b>2.25</b>	<b>2.25</b>	<b>2.45</b>	<b>2.90</b>	5.02	<b>2.54</b>	<b>3.19</b>
3-month T-Bill, (bnd-eq.)	5.1	4.9	4.4	3.5	<b>2.0</b>	<b>2.0</b>	<b>2.1</b>	<b>2.3</b>	<b>2.5</b>	<b>3.0</b>	4.5	<b>2.1</b>	<b>3.3</b>
2-year Treasury Note	4.8	4.8	4.4	3.5	<b>2.0</b>	<b>2.7</b>	<b>3.4</b>	<b>3.9</b>	<b>4.1</b>	<b>4.6</b>	4.4	<b>3.0</b>	<b>4.5</b>
10-year Treasury Note	4.7	4.8	4.7	4.3	<b>3.7</b>	<b>4.2</b>	<b>4.6</b>	<b>4.8</b>	<b>5.0</b>	<b>5.1</b>	4.6	<b>4.3</b>	<b>5.1</b>