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RECENT ECONOMIC DEVELOPMENTS

APRIL 8, 2008

UNPRECEDENTED FED ACTIONS, RECESSION SIGNS, STAGFLATION FEARS

The Federal Reserve (Fed) took unprecedented action to put private sector assets, and therefore risk, onto its, and hence the taxpayers, balance sheet. That action was part of the Fed's backstop for the acquisition by JPMorgan Chase & Co. of Bear Stearns Companies Inc (Bear), following a run on Bear by its creditors. The Fed has also continued to supply more liquidity to financial markets in the face of incoming data that increasingly suggest that the economy may be in a recession. Included in those signs are the significant slowdown in growth in the inflation-adjusted (real) gross domestic product (GDP) to a sluggish 0.6% annualized rate in the 4th quarter of last year, three consecutive months of payroll employment declines, and a rising unemployment rate. While inflation and inflation expectations remain low by historical standards, if significant recent increases in energy, food, and commodity prices get passed on to consumer prices more generally, the fear is of rising inflation just as growth in the economy slows and unemployment rises—a situation characterizing "stagflation." While the Fed is lowering short-term interest rates significantly and is currently supplying ample liquidity to financial markets to combat slow growth and significant financial market pressures, those low rates and liquidity infusions could lead to higher future inflation.

Highlights

- The *Fed* agreed to take $29 billion of assets onto its balance sheet, retaining private asset management firm BlackRock Inc. to manage the portfolio which is, effectively, owned by U.S. taxpayers. This raises many public policy issues (discussion, next page).
- The *unemployment rate* rose to 5.1% in March, from 4.8% in February (Fig. 1).
- Non-farm *payroll employment* declined by 80,000 in March, the 3rd consecutive monthly decline (Fig. 2, next page). Higher unemployment and declining payrolls suggest that we may be in a recession.
- *GDP* growth was an anemic 0.6% in the 4th quarter (Fig. 3, next page). Fears of "stagflation" have arisen given: slowing growth; rising unemployment; employment declines; rapid increases in energy and food prices (Fig. 4, next page).

Unemployment Rises to 5.1%; Three Consecutive Months of Payroll Job Declines

The *unemployment rate* rose to 5.1% in March from 4.8% in February and a near-term low of 4.4% in March 2007 (Fig. 1). *Payroll employment* fell by 80,000 jobs in March (Fig. 2, next page). There has been a decline of 232,000 payroll jobs over the past 3 consecutive months with payroll job declines. Reflecting adjustments in the housing sector, employment in the construction industry declined by 51,000 in March and has declined by 394,000 jobs since peaking in September 2006.

GDP Grew at a 0.6% Annualized Rate in the 4th Quarter

GDP growth was 0.6% in the 4th quarter of 2007, down sharply from the rapid 4.9% growth in the 3rd quarter (Fig. 3, next page). Growth in the 4th quarter primarily reflected consumer spending (up an annualized 2.3%), business investment (up 6.0%), state and local government spending (up 4.0%), and exports (up 6.5%). Partly offsetting those positive contributions to growth was a decline in residential investment (down 25.2%) and reduced inventories (which subtracted 1.79 percentage points from the 4th-quarter real GDP change). Residential investment has declined for eight straight quarters, reducing growth over that period by an average 0.88 percentage point. Over the same period, export growth has added an average 0.97 percentage point to GDP growth. Real GDP has grown for 25 straight quarters, with growth averaging 2.7%.

Fed Lends To JPMorgan To Acquire Bear in Fire Sale

The *Fed* agreed to a nonrecourse loan of $29 billion to JPMorgan Chase & Co., secured by difficult-to-value assets inherited from Bear Stearns over the weekend of March 14-16. Lenders speculated that Bear had demand liabilities (e.g., callable margin loans) in excess of the not-altogether-clear market value of its assets. So, those holding Bear's demand liabilities (e.g., margin lenders to Bear) effectively staged a speculative run by making margin calls and refusing to engage in further dealings with Bear. JPMorgan agreed to acquire Bear at a fire sale price of $2 per share on March 16, revised to $10 per share a week later.

The Fed's Actions Were Unprecedented

The unprecedented action of taking private-sector risky assets onto the balance sheet of the Fed, and therefore the balance sheet of U.S. taxpayers, was done to prevent a global financial meltdown. The Fed's action represents a government backstop to private-sector bets that were made which, should they have been liquidated at fire-sale prices during the weekend of March 14-16, threatened the stability of the world's financial system given that Bear had large exposures to many counterparties. Should those exposures have turned sour precipitously, solvency of other major financial institutions was threatened.

Fed's New Portfolio Raises Many Public Policy Questions

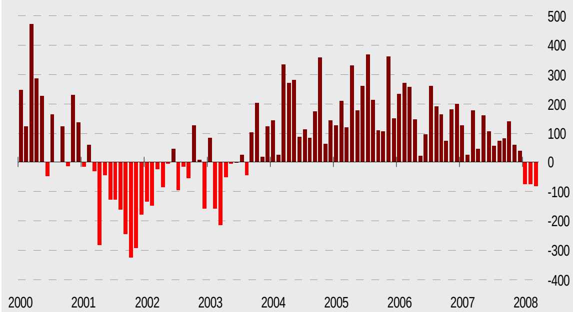
The Fed has contracted with BlackRock Inc., a private sector asset management firm, for an arrangement whereby BlackRock will manage and liquidate slowly over time the Fed's (and consequently taxpayers) newly acquired (formerly Bear) assets. It is not yet clear what the liquidation policy will be, what BlackRock's compensation from U.S. taxpayers will be, and how the Fed and BlackRock will account to Congress and the public as to the performance of the portfolio now effectively held by the Fed and managed by BlackRock on behalf of taxpayers. It is uncertain, for example, what would happen if a citizen filed a Freedom of Information Act request for information on the Fed-BlackRock-taxpayer portfolio.

The Fed Has Opened Its Balance Sheet and Discount Window to Institutions It Does Not Directly Regulate

In addition to facilitating JPMorgan's acquisition of Bear, the Fed has been battling heightened risk aversion in financial markets since early August of last year. The Fed has created new monetary policy tools to augment traditional open market operations and discount window lending. Heightened risk aversion seems to stem from uncertainty of lenders about exposures of counterparties to risks from mortgage-backed securities. The Fed set up, in December, a temporary Term Auction Facility which provides billions of dollars in term loans to depository institutions through an auction mechanism. The Fed also set up, in mid March, a Term Securities Lending Facility to lend up to $200 billion of Treasury securities (*the Fed is lending Treasury securities here, not cash)* to primary dealers (*not just Fed-member depository institutions),* thereby opening up the Fed's balance sheet to a re-shuffling on the asset side, trading off Treasury securities for securities that include *non-agency private-label residential collateral.* Of course, the Fed takes such collateral with a "haircut" (meaning that the Fed trades on a less than dollar-for-dollar value of Treasuries for the other securities as a safeguard against risk). The Fed has been taking its recent unprecedented actions using power extended to it by Congress in 1932, giving the Fed the authority to make discount-window loans to any organization or individual (not just Fed member banks) "in unusual and exigent circumstances."

Changes in Total Non-Farm Payroll Employment Since 2000 Fig. 2

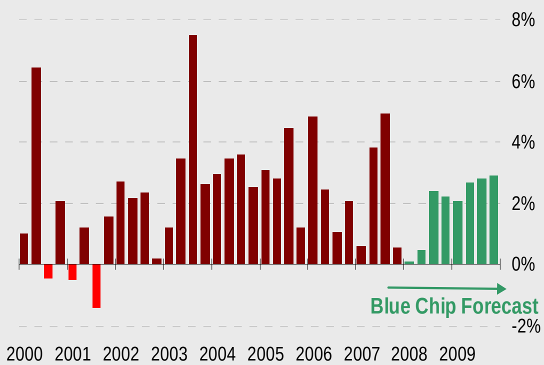
(Change in employment, in thousands)



Source: Bureau of Labor Statistics

Economic Growth Since 2000 Fig. 3

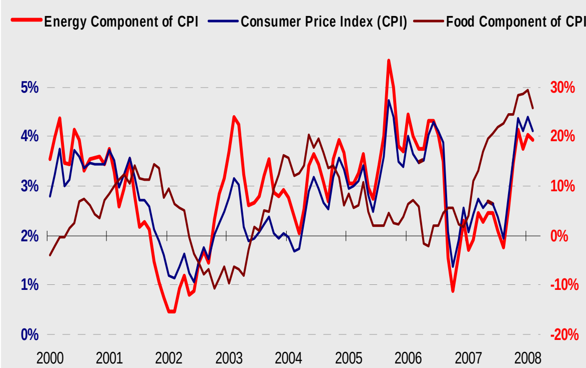
(Real annualized GDP growth)



Sources: Bureau of Economic Analysis; 03/10/08 *Blue Chip* Economic Indicators.

Energy, Consumer, and Food Price Inflation Fig. 4

(Year-Over-Year Precent Change)



Source: Haver Analytics

Upcoming Indicators

Inflation – The Consumer Price Index for March is scheduled for release on *April 16*.

GDP – The advance estimate of 1st quarter GDP growth arrives on *April 30.*

Federal Reserve – The Fed's next policy meeting is scheduled for *April 29 and 30.*

Employment – The Bureau of Labor Statistics reports April's employment situation *on May 2.*