ECONOMIC UPDATE

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CHALLENGING TIMES FOR MONETARY, FISCAL POLICY

Overview

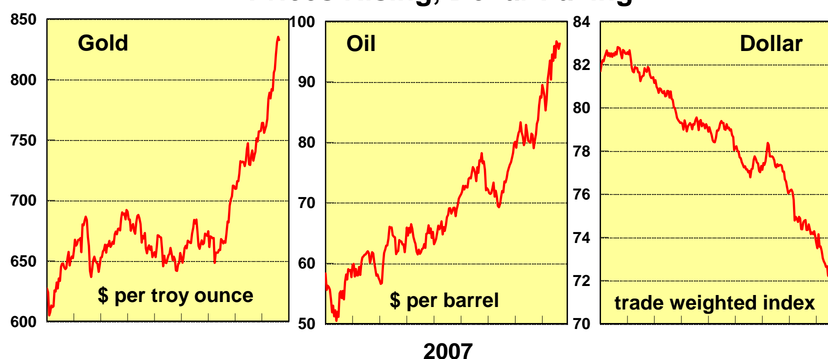
The mix of recent and projected economic conditions is posing a challenge for the Federal Reserve. The Fed has lowered interest rates to guard against potentially serious economic fallout from the subprime mortgage crisis. But the benefits of this preventive measure have been partly counteracted by the fall in the dollar and the increased likelihood of higher inflation. Meanwhile, other factors also threaten the economic outlook, including rising energy prices, sluggish consumer spending, and continued financial market turbulence.

The latest statement by the Fed's policy-making board – the Federal Open Market Committee [FOMC] – signaled further interest rate reductions were unlikely in the near future. The FOMC noted that risks to the economy were equally balanced between slower growth and higher inflation. Nevertheless, recent news of major Wall Street banks facing write-downs on billions of dollars worth of mortgage-related securities has set off speculation that the Fed could lower interest rates further at its next meeting in December. The prospect of even lower short-term U.S. interest rates has caused the dollar to decline further, posing two significant risks: 1) a lower dollar can stoke inflation by raising prices on imported goods; and 2) a declining dollar undermines U.S. competitiveness in the international marketplace, as foreigners choose to invest elsewhere.

One lesson of history is that loose monetary policy coupled with tight fiscal policy – specifically higher taxes – can lead to stagflation, as it did under similar conditions in the late 1970s. Demand may be stimulated, but there is no supply to meet it because investment has been curbed, and prices start to rise. Therefore, as the Fed works through its strategy over the next several months, Congress will need to recognize its own crucial role in setting fiscal policy, especially at this critical time of rising inflation and economic doubts. A policy of tax certainty with low rates on capital and income could restore faith in the economy, and would boost the dollar by attracting investment back to the U.S. Such an approach would provide for real growth, rather than the artificial growth deriving from monetary inflation.

Higher Inflation, Slumping Dollar

The value of the dollar has fallen by roughly 12 percent so far this year against a basket of currencies of major trading partners; and it recently hit an all-time low versus the Euro (one Euro now equals $1.45). Such a drop can stoke inflation pressures – which the Fed has long sought to restrain – by raising the costs of imported goods. The import



price index, for instance, rose nearly 10 percent in October from its level of a year earlier, one of the sharpest jumps of the past decade.

In terms of fundamentals, the dollar's decline is linked to recent actions of the Fed, and its expected decisions in the near future. Reacting to the late-summer U.S. credit crunch, the Fed lowered its interest rate target by 50 basis points in mid-September, and another 25 basis points in October – bringing the federal funds rate down to 4.5 percent. These actions contrasted with those of other major central banks around the world, such as the European Central Bank in Frankfurt, which have held interest rate targets steady. Consequently, more funds have tended to flow into currencies other than the dollar. (Interest rate differentials between countries are one of the main drivers of exchange rate movements.)

The dollar's tumble also is partly linked to the subprime mortgage crisis. At the margin, foreigners likely have grown wary of buying and holding U.S. dollar-denominated assets (bonds, asset-backed securities, derivatives, and so on) that may be connected, directly or indirectly, to subprime mortgage loans. These assets decline in value when the loans go bad.

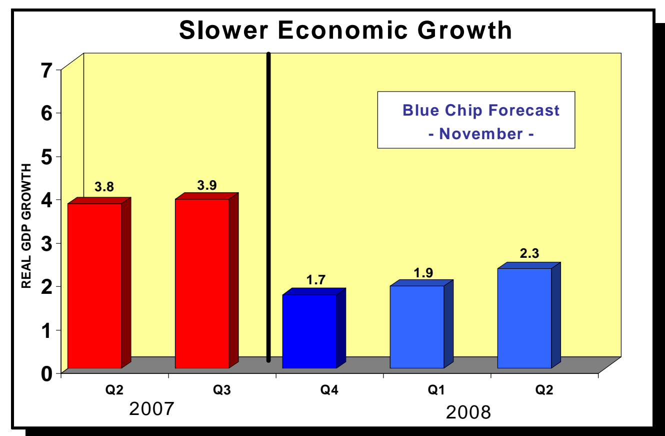
Other factors are adding to inflation concerns as well. The price of oil, for instance, has nearly doubled, from just over $50 per barrel at the start of the year to nearly $100 in recent weeks. That will put sharp upward pressure on a range of consumer goods. The Blue Chip forecast expects the consumer price index [CPI] to post an increase of more than 3.5 percent this year, up from 2.0 percent last year.

Ominously, the main bellweather for inflation, gold, has been soaring. Gold – a physical commodity that traditionally retains its value over time – represents a good hedge against inflation and is a solid alternative to paper currency that is losing its value. The price of gold recently breached $830 per troy ounce, the highest level in 27 years. The last time the price of gold reached this level was in the late 1970s and early 1980s, when annual inflation in the U.S. was running at approximately 12 percent.

Slower Projected Growth

The Fed's efforts to maintain economic growth are understandable in light of the Blue Chip forecasters' projections. Real gross domestic product [GDP] grew by nearly 4.0 percent in the second and third quarters of 2007, but the Blue Chip expects the pace of growth to slip below 2.0 percent in this year's fourth quarter and the first quarter of 2008.

One factor behind the expected slowdown is a softening in consumer spending, largely due to sharply higher energy prices this season. Retail gasoline prices, which typically decline after the summer driving season, have risen 35 cents over the past month to a national average of $3.11 per gallon, and are likely to go higher. In addition, the Energy Department announced this month that home heating bills this winter are likely to rise by an average of about $100 (11 percent) compared to last season. Households in the northeast, which typically use heating oil, can expect bills about $375 higher than last year; those in the midwest, which mostly use natural gas, will pay about $115 more in heating costs.



An additional weight might be declining home values, which tend to make consumers feel less wealthy and therefore less inclined to spend. The latest reading from the S&P/Case-Shiller Home Price Index, for instance, shows national home prices have slipped by more than 3 percent over the past 12 months, a stark contrast from the double-digit annual home price appreciation of the past few years.

Given the headwinds, it is not surprising that the Conference Board's consumer confidence index fell to a 2-year low of 95.6 in October. In addition, retail sales (excluding gasoline, which can show artificially inflated sales due to rising energy prices) edged up just 0.1 percent in October, and data for previous months were revised down sharply.

Job Growth Continues

On the plus side, job growth has remained surprisingly robust. The Bureau of Labor Statistics reported 166,000 new jobs in October, nearly double the market expectation, and an unemployment rate holding steady at a low 4.7 percent. These figures marked the 50th consecutive month of increasing non-farm payroll employment. The sturdy labor market has kept income growth intact as well. Over the latest 12 months, real disposable (i.e. after-tax) income has increased by a healthy 4 percent. Nevertheless, weekly claims for State unemployment insurance have ticked slightly higher in recent weeks.