

The economy: calming the markets

The third quarter of 2007 began on an upbeat note, as the Dow Jones Industrial Average and S&P 500-stock index marked new highs in early July. By late July the Commerce Department reported that gross domestic product rose at a buoyant 3.4% annual rate in the April-June quarter. Continued strong employment numbers seemed to be powering an economy-wide surge.

Then the August employment numbers marked a reversal of fortune. For the first time in four years, the economy lost nonfarm jobs. Although a loss of 4,000 positions may not seem like much, economists had been expecting another gain of 100,000. What's more, the June and July employment figures were revised downward. Problems that began in the subprime mortgage market spread to home building and housing generally. Home prices have fallen in many parts of the country, in some cases severely. Thousands more jobs are expected to be eliminated in the mortgage industry, and no one is certain when the housing sector will recover.

These were among the forces to which the Federal Reserve Board was responding when it cut the federal funds rate by 50 basis points on September 18. The move calmed the markets, but at the cost of a lower dollar, higher oil prices and an increased risk of inflation.

Could there be a recession?

Will the problems in the housing industry spill over into the rest of economy, triggering a recession? The last recession began in March 2001 and ended in November of that year. When *The Wall Street Journal* polled 55 respected economists in September, the consensus on the chance of a recession emerging over the next 12 months was an uncomfortable 36%. Eleven of the economists believed that the probability of a recession was more than 50%, with one pegging it at 95%. On the other hand, 13 respondents forecast a 30% chance or less of a recession.

Optimists pointed to historically low unemployment rates, growth in overall personal income and the strength of the world economy to justify their confidence. However, even they expect that growth will slow to something in the 2% range over the next six months. Pessimists expect the economy to contract, citing the employment drop and ongoing housing problems, historically closely associated with recessions. Falling home prices will make it harder for many to borrow, which in turn could hamper consumer spending—some 70% of economic activity.

Could the global economy come to the rescue?

But should the inquiry be limited to U.S. economic data? The fact is that the global economy has been growing at close to 5% for the past three years. This year, nearly 120 countries expect growth of 4% or more. Globalization has led to rapid growth in international trade—global imports were \$3.5 trillion in 1990, but now have reached \$11.6 trillion. This increased economic activity has increased competition and put a damper on inflation. It also may make the U.S. economy less vulnerable to shocks in individual economic sectors.

Falling federal deficit

Another bright spot in the economic picture concerns federal tax receipts. The Congressional Budget Office has forecast that the federal deficit for the year ending September 30, 2007, will be down a whopping 36.2% from the prior year. The deficit is projected to be \$158 billion.

The reason for this happy development is that the stream of tax payments has held up despite the shakiness in the economy. Through the first 11 months, when federal outlays were up 5.3% over the prior year, tax receipts rose an impressive 7.5%.

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