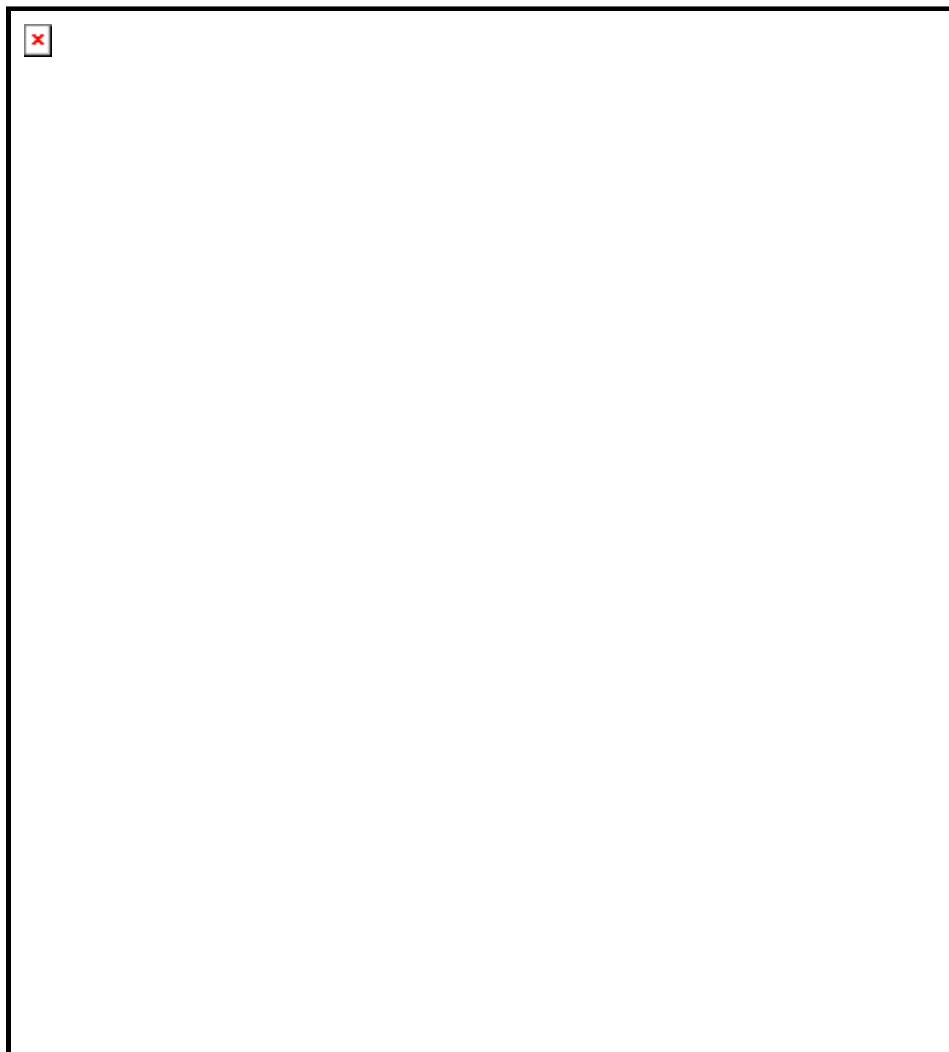


## WEEKLY ECONOMIC COMMENTARY -- WEEK OF MAY 9, 2008



Economists, policy makers and politicians are strongly influenced by economic data, making forecasts, policy decisions and legislation based on their perceptions gleaned from the numbers. The problem is, the numbers don't always reflect reality. Even worse, they frequently distort reality, particularly when initial estimates of some economic event get substantially revised later on when more complete information becomes available. Meanwhile, decisions have to be made in real time, which means that bad choices are often formulated on the basis of spurious information.

We note this unfortunate happenstance because it is during transition points in a business cycle that economic data are especially vulnerable to error. The employment figures are a glaring case in point. During any given month, the Labor Department surveys a small fraction of companies - primarily larger ones - to ascertain changes in payrolls. It then blows up this sample, using a "birth/death model" into a national figure that gets widely reported in the press. The birth/death model essentially estimates how many companies and, hence, jobs were created and destroyed (went out of business) during the month based on historical experience. But historical experience is less relevant when the economy is transitioning from expansion to recession (or vice versa), resulting in gross overestimates of the payroll count during the early recession phase and underestimates during the early expansion phase.

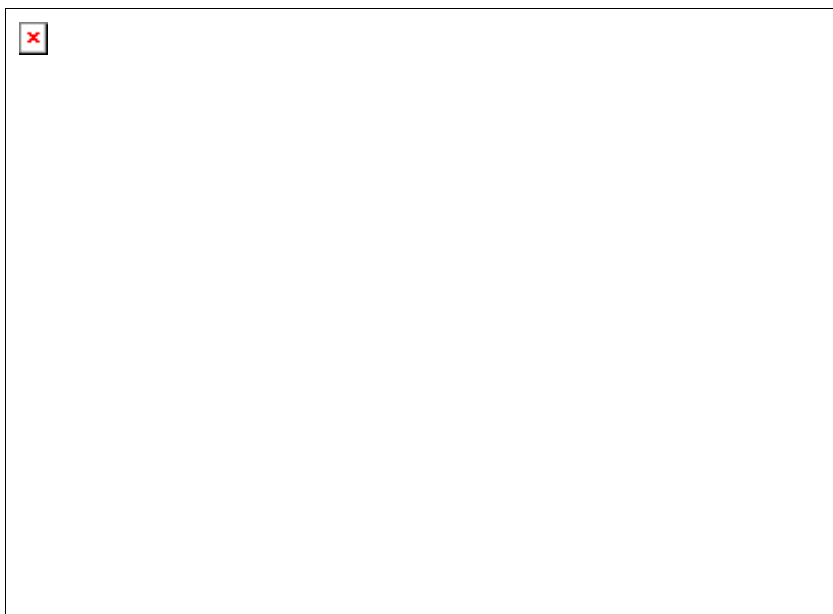
Take the April employment report. The 20 thousand loss of jobs during the month was much less than

expected and considerably smaller than the 81 and 83 thousand payroll declines posted in each of the previous two months. Some commentators were quick to conclude that the worst of the economy's troubles was behind us, suggesting that less aggressive policy stimulus was needed going forward. But the smaller drop in payrolls in April reflected a larger estimate of the number of "phantom" jobs that were created through the Labor Department's birth/death model. During the month, the statisticians assumed that 267 thousand workers found employment through the net creation of new companies, which is even larger than the 262 thousand that the model assumed was the case in April of last year. Now recall that in the second quarter of 2007, the economy was expanding at a robust annual rate of 3.8 percent and, no doubt, its growth was fueled by many more startups than company failures. However, it is not likely that in the current environment of near stagnant growth, more jobs than last year are being generated by new company start-ups.

If anything, the birth/death model should be assuming just the opposite. Not only are small and median sized companies falling prey to weakening domestic demand. They are less able to benefit from global growth than their larger multinational counterparts, who are deriving an ever-larger fraction of revenues from foreign demand. What's more, the financial environment is much more restrictive now than was the case during the easy-lending period of a year ago. True, the Federal Reserve has been on a vigorous rate-slashing campaign, having reduced its target federal funds rate from 5.25 percent last August to the current 2 percent set on April 30. But neither businesses nor households have seen their borrowing costs fall by nearly that much. One reason: lenders have become much more risk averse than they were a year ago, thanks to the sharp deterioration of credit quality that has accompanied the weakening economy as well as the huge loan losses associated with the debilitating housing-related mortgage crisis.

What's more, even if companies and households were willing and able to pay the going rate on loans, they are finding it hard to get in the proverbial door. That's because lenders are more reluctant to provide credit until balance sheets are restored to health. Nowhere is this more evident than in the Federal Reserve's latest survey of senior bank lending officers taken in April. Simply put, banks are holding back on all types of loans to both businesses and households. Their pullback from mortgage lending is well documented and has been ongoing ever since the housing crisis reached epic proportions last year. But banks are also cutting back on consumer loans, trimming limits on credit cards and home equity loans. That probably should not be too surprising, giving the rising trend in credit-card delinquencies, falling home values and a weakening job market, which undercuts the capacity of households to service their debt obligations.

But more recently, there has been a sizable jump in the number of banks that are closing their doors to business borrowers. In April, more than half of the banks responding to the survey reported tightening their lending standards to companies, both large and small. That's up from about 30 percent in the previous survey taken in January and the highest percentage since the first quarter of 2001, the onset of the last recession. Admittedly, the survey reveals that banks are making it harder for both small as well as larger companies to obtain loans. But the percentage of banks restricting credit for small firms shot up to the highest level since the second quarter of 1990, whereas large companies faced more restrictive conditions in 2001.



Moreover, larger companies have better access to nonbank sources of funds - being able to tap into the securities market, for example -- than do smaller firms. The key point here is that smaller companies rely more heavily on banks to finance inventories and day-to-day operations, including paying worker salaries. If credit limits to these companies are trimmed or, worse, eliminated, inventories would have to be liquidated and new ordering would dry up. More to the point is that hiring would be seriously impaired. Since the vast majority of job creation comes from small companies (not included in the Fed's monthly payroll survey), the negative economic consequences of tighter lending standards are strikingly evident. Needless to say, the Federal Reserve's top priority in recent months has been to coax banks to reopen the lending spigot, providing them with massive doses of liquidity via its expanded discount window and term auction facilities.

If the lending survey is any indication, the Fed still has a lot of work to do to accomplish its goal. We suspect that banks will remain guarded in its lending practices for a while longer, concentrating instead on rebuilding capital that has been seriously impaired by mortgage-related writedowns as well as forced sales of distressed securities that were weighing down balance sheets with illiquid assets. And while the Fed's liquidity infusions are helping, a much bigger contribution to balance sheet repair will flow from the time-honored spread between long and short-term yields that are being anchored by the 2 percent federal funds rate. Simply put, banks can raise short-term funds, either through deposits or other money market means, and pocket the difference obtained on longer-term, higher-yielding assets, such as Treasury securities.

That was the recipe the Fed used to vanquish previous credit crunches and this time should be no different. The question is one of duration. Many critics of Fed policy believe a prolonged period of low rates will sow the seeds for an inflation flare-up that will be difficult to tame later on. Accordingly, they advocate an early rescinding of the rate-reductions put in place since last August, hoping that the Fed will move as soon as the economy shows signs of regaining its footing. At the very least, they believe that the rate-cutting campaign should now be ended, arguing that further reductions would do more to inflame inflation expectations than to reignite economic growth. We concur that the trough of the easing cycle has probably been reached at 2 percent. Even if, as expected, the economic data in coming months will deteriorate further, the Fed will likely wait to see what positive impact the stimulative measures already in the pipeline will have on economic activity, including the tax rebates now being mailed out.

But we are less confident that the Fed will start to rescind its 325 basis points of rate cuts over the past eight months anytime soon. For one, the history of easing cycles demonstrates that this one is still in its early stages. Since the late 1950s, there have been six periods prior to the present when the Fed embarked on a sustained easing cycle. Only once did the Fed shift gears right after the ninth month, in 1957-58. On average, those easing cycles lasted for more than two years, and the last two - in 2000-2004 and 1989-1994 - lasted well over three years. Incidentally, those last two prolonged easing cycles occurred in the aftermath of a credit crisis, much like the present policy-easing environment.



For another, while the Fed may well believe that the economy will respond with the usual lag to past policy moves as well as to the tax rebates, there is more than the usual degree of concern that the response this time will fall short of expectations. Studies have shown that it takes years for an economy to recover from a housing collapse and a credit crisis, and those shocks to the system have never been greater than the ones experienced over the past year. While the worst of the credit crisis may be behind us, the housing depression is far from over and its aftershocks are still unfolding. The general expectation is that the housing drag and its secondary effects will gradually fade later in the year, but a "double-dip" recession cannot be ruled out given the additional weight of spiraling gasoline and food prices.

Finally, the Fed, like many others, are concerned over the inflationary pressures associated with escalating oil and food prices as well as other commodity prices. But to date these pressures have not infiltrated the broader price measures to any great extent. As more slack in the economy and product markets appears, the odds are that companies will have an increasingly difficult time passing on higher energy and commodity costs to consumers. What's more, it is extremely difficult for a sustained inflation acceleration to gain traction without a corresponding rise in labor costs, by far the largest expense on company balance sheets. By just about any measure, labor compensation is under control and should remain so in the soft economic environment that looms ahead. Indeed, according to the Labor Department's latest quarterly reading, unit labor costs in the first quarter stood a mere 0.2 percent above the level of a year ago, the slimmest increase in four years. Don't look for the Fed to shift gears until at least early 2009.

