JOINT ECONOMIC COMMITTEE REPUBLICANS

Representative Jim Saxton, Ranking Republican Member | Senator Sam Brownback, Senior Republican Senator

RECENT ECONOMIC DEVELOPMENTS

SEPTEMBER 11, 2007

MORTGAGE WOES WEIGH ON FINANCIAL MARKETS

Housing market adjustments have included reductions in home sales and builder activities along with increased delinquencies and foreclosures on mortgages. Those delinquencies, and related losses on some mortgage-backed securities, led to a systemic liquidity event in early August, with borrowers facing increased difficulties obtaining funds. In response, the Federal Reserve (Fed) injected funds into the banking system and lowered the rate it charges banks on discount loans to assure borrowers about the availability and cost of funds. As a sign of moderation in the economy, payroll employment edged down in August, following 47 consecutive months with job gains. The unemployment rate remained low, however, at 4.6% in August and has ranged between 4.4% and 4.6% since last September. Annualized growth in the inflation-adjusted (real) gross domestic product (GDP) in the 2nd quarter was revised up to 4.0%, a significant acceleration from the modest 0.6% 1st-quarter growth rate and the 23rd consecutive quarter of expansion of real GDP.

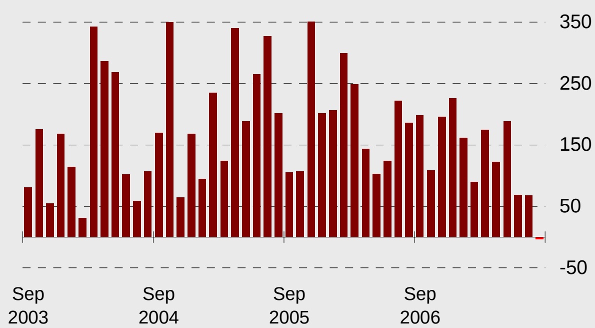
Highlights

- For the first time in four years, *payroll employment* fell in August, by 4,000. Payroll job growth has averaged 109,000 since January, compared with 189,000 in 2006 (Fig. 1).
- The *unemployment rate* remained at 4.6% in August and has ranged between 4.4% and 4.6% since last September (Fig. 2, next page).
- Real *GDP growth* was revised up to an annualized 4.0% rate in the 2nd quarter, up from an earlier estimate of 3.4% and up significantly from 0.6% 1st-quarter growth.
- The Fed, facing a *liquidity event*, lowered its discount-lending rate by ½ of a percent and has been injecting relatively large amounts of funds into the banking system (Figs. 3 and 4, next page).

Over 8.2 Million Jobs in Past 48 Months

(Change in employment, in thousands)

Fig. 1



Source: Bureau of Labor Statistics

Over 8.2 Million New Jobs in 48 Months; Unemployment Rate at 4.6%

Payroll employment fell by 4,000 in August, following 47 consecutive months with job gains (Fig. 1). More than 8.2 million new jobs have been added to payrolls in the past four years. Since January of this year, payroll job growth has averaged 109,000, a moderation from an average of 189,000 in 2006. The *unemployment rate* held steady at 4.6% in August and has ranged between 4.4% and 4.6% since last September, well below the near-term peak of 6.3% in June 2003 (Fig. 2, next page).

GDP Grew at a 4.0% Annualized Rate in the 2nd Quarter

GDP growth was revised up to 4.0% in the 2nd quarter, from an earlier estimate of 3.4%, a solid acceleration from the modest 0.6% 1st-quarter growth. The acceleration primarily reflected international trade, faster growth in federal government spending, an upturn in inventory investment, a rapid acceleration in investment in non-residential structures, and a smaller decline in residential investment. Consumer spending was notably slower in the 2nd quarter, growing 1.4% compared with 3.7% in the 1st quarter. Reflecting ongoing weakness in housing markets, residential investment fell, for the 6th consecutive quarter, by 11.6% in the 2nd quarter. That decline was, however, well below the average 16.4% in the previous four quarters. Real GDP has grown for 23 straight quarters, with growth averaging 2.7% over that period. The *Blue Chip* consensus of private forecasters sees a return to more trend-like growth of around 3.0% by the end of next year.

Mortgage Delinquencies & Foreclosures on the Rise

Mortgage delinquency and foreclosure rates have risen markedly since the start of last year, with large increases for subprime, adjustable-rate, mortgages, which account for about 9% of mortgages outstanding (Fig. 3).

A Liquidity Event (a.k.a. "Credit Crunch")

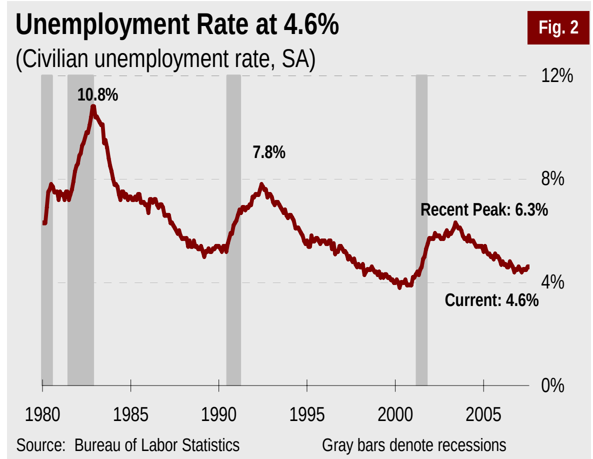
Losses suffered by mortgage lenders and holders of mortgage-backed securities, and uncertainty about exposures to risks, led to a systemic *liquidity event* that began around August 9. Heightened risk aversion of lenders and security purchasers led to a *flight to quality* (or *flight to safety)* in which lenders cut off lending to many counterparties and sought safe havens for funds in the form of things like U.S. Treasury securities. As investors fled to Treasury securities, yields on those securities fell precipitously (e.g., 3-month T-bill rate in red in Fig. 4). Yields on assets that are riskier than Treasuries, though normally not viewed as very risky, correspondingly rose precipitously (e.g., 90-day AA asset-backed commercial paper rate in orange in Fig. 4).

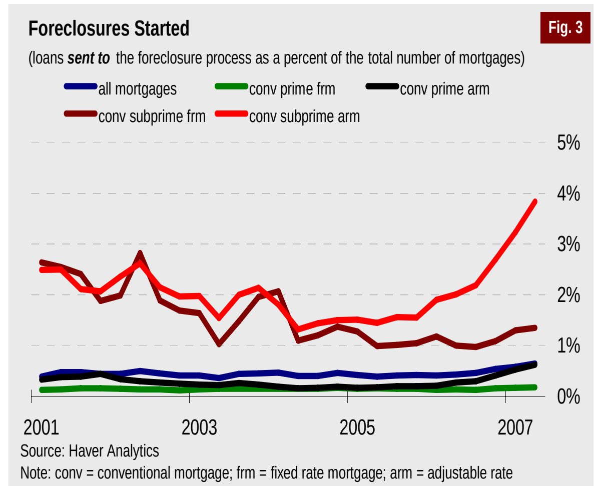
The Fed Responded

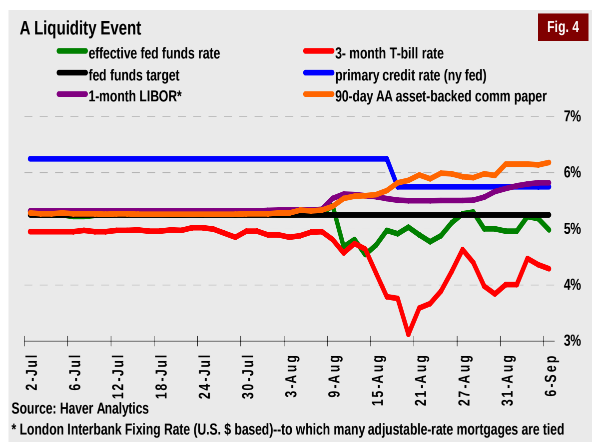
Sensing that banks were having difficulties obtaining short-term financing, the Fed began injecting relatively large amounts of funds into the banking system beginning around Aug. 9. There was, as a partial consequence, a precipitous decline in the effective *federal funds rate* (green in Fig. 4)—the rate on overnight inter-bank borrowing and lending—below the Fed's target of 5.25% for that rate (black in Fig. 4). Following Aug. 9 and the Fed's injections of funds, financial markets did not immediately seem to have weathered the liquidity event. In response, sensing that banks and other investors were still having difficulties obtaining financing, the Fed acted, on Aug. 17, by cutting the *discount rate* it charges on fully secured loans to commercial banks and other depository institutions by ½ of a percent and made adjustments to ease its usual discount window practices. The Aug. 17 actions were taken because, according to the Fed at that time: "Financial market conditions have deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward." As Fig. 4 suggests, financial markets have moved toward more stability since the Fed actions, but heightened risk aversion seems to remain.

Markets Expect Fed to Cut Rates

Recent financial-market turbulence and signals of moderation in economic activity have led to increases in the odds markets assign to the Fed cutting its target overnight interest rate at its next policy meeting on Sept. 18 from the current 5.25% to either 5.00% or 4.75%.







Upcoming Indicators

Federal Reserve – The Fed's next policy meeting is scheduled for *September 18.*

Inflation – The Consumer Price Index for August is scheduled for released on *September 19*.

GDP – A final estimate of GDP for the 2nd quarter is scheduled for release on *September 27.*

Employment – The Bureau of Labor Statistics reports the September employment situation on *October 5.*