

United Nations
Economic
Commission for
Latin America and
the Caribbean

ECLAC WASHINGTON
Office

LC/WAS/R.51

UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments



UNITED NATIONS

ECLAC



SIXTY YEARS WITH LATIN AMERICA AND THE CARIBBEAN

Washington, D.C. June 16, 2008

CONTENTS

I.	OVERVIEW	1
II.	CURRENT ASSESSMENT	2
	• GDP Growth	2
	• Sectoral Developments	4
	• Inflation.....	5
	• Monetary Policy.....	6
	• Labor Markets.....	8
	• Financial Markets.....	10
	• External Sector.....	11
III.	LOOKING AHEAD.....	12

U.S. ECONOMIC OUTLOOK

I. OVERVIEW

The U.S. economy grew at an annualized 0.9% in the first quarter of 2008, a small increase, but still better than the small contraction that many forecasts have expected. Since then, labor market conditions have remained soft, but not as much as anticipated, with payrolls declining less than markets expected, despite a surprising jump in the unemployment rate in May. Consumption has slowed, but it has shown resilience, while other indicators such as the April durable goods orders and the ISM May's reading have come out better than expected. Moreover, financial markets have improved, with credit spreads narrowing and systemic risks recoiling. Financial markets have rallied since early March up until recently as conditions in financial markets improved, leading many to believe that the worst of the financial pain may have already passed.

Second-quarter growth is expected to be adversely affected by the continued slump in the housing sector, the cutback in consumer spending due to falling house prices and rising gas and foods prices, the weakness in business investment, and concerns about financial and credit markets. However, the release of the preliminary first-quarter real GDP growth also brought some good news from the perspective of future growth, and many forecasts have been revised slightly upwards as a result. Although the economy's expansion was weak, it was slightly better than in the fourth quarter. Moreover, inventories fell in the first quarter, although at a slower pace than in the fourth quarter, thus growth in the next couple of quarters should not be hindered by large business stockpiles.

On average, growth is expected to remain positive in the second quarter although weak, expanding at an annual pace of about 0.6% according to market forecasts. The economic outlook is expected to improve in the second half of the year, however, as the tax rebates that are part of the government's stimulus plan boost spending, businesses investment increases, and improvement in the trade deficit continues to spur growth. Still, there is no consensus on how long and how deep the slowdown in economic growth will be, and there is a lot of uncertainty on how the U.S. economy will fare in the coming months.

Forecasts for U.S. Economic Growth

	Q2 2008(qoq)
<i>What Markets Say</i>	
National Association of Realtors	1.1%
Merrill Lynch	-0.4%
Moody's Economy.com	0.3%
Morgan Stanley	0.5%
J.P. Morgan	1.0%
Wachovia	0.6%
Mortgage Bankers Association**	0.3%
Forecasts average	0.6%

* All Forecasts as of June 2008, except for the MBA's.

** Forecast as of May 2008.

The Federal Reserve has already cut the key federal funds rate seven times since September of last year, to the current 2%, down from 5.25% before the easing began. The Fed Chairman Ben Bernanke says housing continues to hold down the overall economic outlook but suggests that the Fed will soon stop cutting rates. According to him, "for now, policy seems well positioned to promote moderate growth and price stability overtime." He believes that "we may see somewhat better economic conditions during the second half of 2008, reflecting the effects of monetary and fiscal stimulus." "However, until the housing market, and particularly house prices, shows clearer signs of stabilizations, growth risks will remain to the downside."

Recent increases in energy prices have also been creating additional downside risks to growth. Inflation has remained high, although it has not translated into higher labor costs and the prices of most other products in the economy have remained contained. Despite the limited pass-through, investors have started to bet that inflation pressures could prompt the Federal Reserve to raise interest rates later in the year, although most expect the Fed to remain on hold at its next meeting in June.

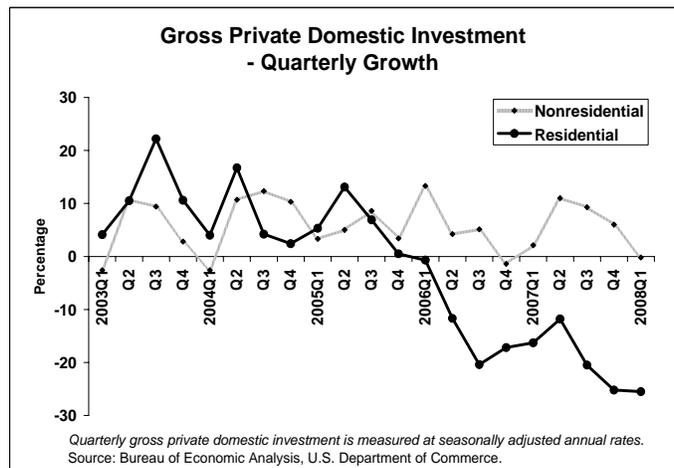
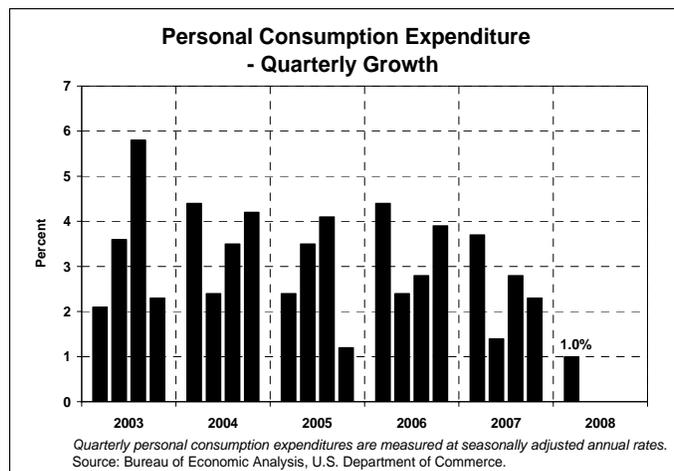
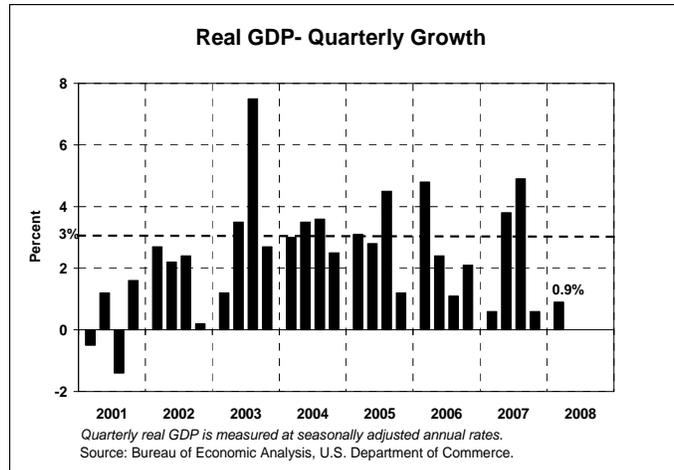
II. CURRENT ASSESSMENT

- **GDP Growth**

According to the preliminary estimates released by the U.S. Department of Commerce on May 29, the U.S. economy expanded at an annual rate of 0.9% in the first quarter of 2008, a slightly faster pace than in the fourth quarter of 2007, when the economy grew at 0.6%. The small acceleration relative to the fourth quarter can be explained by private inventories, which fell at a slower pace than in the fourth quarter, although that was somewhat offset by a slower growth in consumer spending.

Consumer spending grew at 1.0%, down from a 2.3% pace in the fourth quarter. Despite some improvement in the stock market recently, household net worth plunged US\$ 1.7 trillion in the first quarter as house prices continued to decline, while slowing labor demand and the steep increase in oil and food prices have damped real income gains. Underlying problems in the economy, particularly in the housing market, have made consumers more hesitant to spend, especially on large-scale purchases like cars and kitchen appliances. There was a large drop in spending on durable goods (-6.2%), and a small decline in spending on nondurable goods (-0.3%). Real consumer expenditure, which accounts for more than two-thirds of GDP, added 0.7% to first-quarter GDP growth.

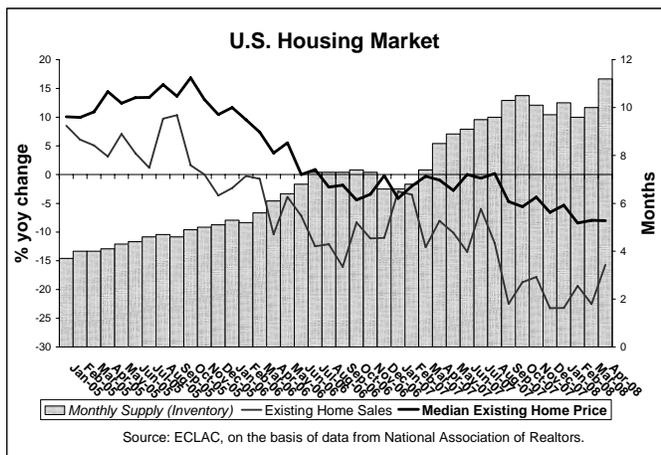
More difficult financing conditions seem to have affected nonresidential construction, which started to soften in the first quarter following a couple of years of sharp gains. Real nonresidential fixed investment, which represents overall business spending, fell in total, with a small decline in investment in equipment and software and a small increase in investment in nonresidential structures. Real nonresidential fixed investment dropped 0.2%, compared to an increase of 6.0% in the fourth quarter, with investment in equipment and software falling 0.9% and investment in nonresidential structures increasing 1.1%.



Investment spending in the second half of the year could receive some help from the accelerated depreciation provisions in the recently approved fiscal stimulus bill. However, the magnitude and timing of this help is very uncertain. Business spending subtracted 0.03% from the economy's growth rate.

The housing market continued to weigh on the economy in the first quarter. Real investment in residential structures fell an annualized 25.5% in the first quarter, its ninth consecutive quarterly decline, subtracting 1.17% from growth. Total fixed investment (residential and nonresidential) subtracted 1.2% from overall GDP growth in the first quarter.

Credit problems have made it harder for future buyers to finance a home, deepening the house slump. In the first quarter of 2008, the inventory of unsold homes continued to pile up and builders continue to cut back. Sales of existing single-family homes reached a low point in January 2008, falling to more than 30% below their peak in September 2005, and showed an increasing trend after that. The monthly supply of new homes for sales jumped to 11.2 months in April, the highest monthly supply since the peak reached in October 2007. However, on some of the more optimistic assessments, market analysts believe that April 2008 may mark the bottom of the U.S. housing, meaning that the trend will no longer get worse from there.



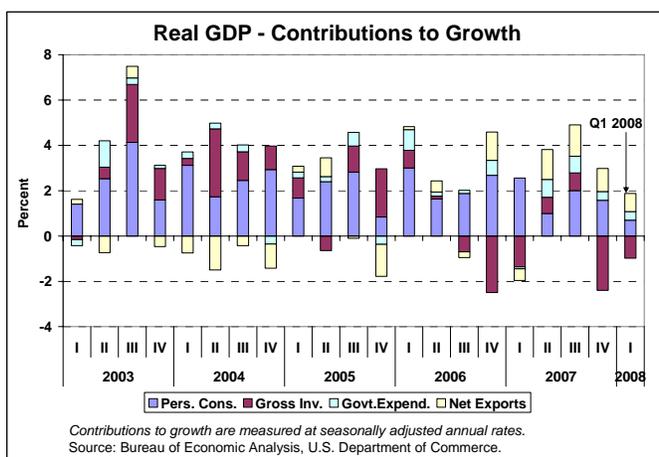
The reason for that is that while house prices have fallen 10%-15%, incomes have continued to grow (although more slowly recently) and mortgages rates have come down 70 basis points from their highs, thus housing may start to become affordable again. Moreover, while an inventory of unsold homes equivalent to 11 months of supply is at a 25-year high, it is also similar to 1974, 1982 and 1991 levels, which saw a slowing in home-price declines within the following six months. The more pessimistic assessments, on the other hand, believe the housing sector has yet to hit bottom, and will see further price declines before reaching it.

Investment in inventories fell in the first quarter of 2008, albeit at a slower pace than in the fourth quarter, thus adding 0.2% to GDP growth. The decline in inventories may be a positive for growth in the coming quarters, suggesting that if demand accelerates, businesses will need to quickly increase production to meet it. Private businesses decreased inventories by US\$ 14.4 billion in the first quarter, following a decrease of US\$ 18.3 billion in the fourth quarter, and an increase of US\$ 30.6 billion in the third quarter. Overall, gross private domestic investment subtracted 0.98% from GDP growth in the first quarter (-1.20% due to fixed investment, plus 0.21% due to inventories).

Federal spending increased 4.4% in the first quarter, following an increase of only 0.5% in the fourth quarter. State and local spending increased 0.6%, following an increase of 2.8% in the previous quarter. Overall, government spending added 0.38% to growth in the first quarter.

A shrinking trade deficit added 0.8% to overall growth. Higher exports of goods and services contributed 0.34% to overall GDP growth, while imports added 0.46%. International trade was a positive for growth thanks to the expanding global economy and the weak dollar. Although the decline in imports helped nudge the GDP estimate up in the first quarter, some analysts highlight that demand for imports fell because the bleak economic outlook is making consumers more hesitant to spend, a factor that may lead the business sector to cut back expenditures in coming months.

In summary, the major contributors to U.S. growth in the first quarter of 2008 were the narrower trade deficit, personal consumption expenditures, and state and local government spending, which were partly offset by decreases in residential and non-residential fixed investment. Housing was the most significant problem faced by the U.S. economy in the first quarter, and the decline in residential investment represented a large burden on economic growth. Growth in personal consumption expenditures slowed as a result. Given reduced access to home equity and a negative wealth effect from lower house prices, households have become more cautious with their expenditures. Businesses, uncertain about future market conditions, are also becoming more cautious, as concerns over growth and tighter credit are now weighting on investment.



- **Sectoral Developments**

Total industrial production declined at a seasonally adjusted annual rate (SAAR) of 0.2% in the first quarter, after rising at a revised rate of 0.4% in the fourth quarter of last year. This is the first quarterly decrease since the fourth quarter of 2006. The capacity utilization rate was 80.6% in the first quarter, lower than the 81.0% in the fourth quarter.

Industrial production dropped a sharp 0.7% in April, as output of motor vehicles and parts plunged 8.2%. With the significant decline in production, the capacity utilization rate shrank sharply, easing some inflationary pressures. Capacity utilization fell to 79.7% in April – the first reading below 80% since 2005 – from 80.4% in March.

Industrial Outlook

	Total Industrial Production		Capacity Utilization Rate (%)
	Index 2002=100	Percentage Change From Previous Period	Total Industry
2007 Q4	112.2	0.4	81.0
October	111.8	-0.4	80.8
November	112.3	0.4	81.1
December	112.4	0.1	81.0
2008 Q1	112.1	-0.2	80.6
January	112.6	0.1	81.0
February	111.8	-0.7	80.3
March	112.0	0.2	80.4
2008 Q2	n/a	n/a	n/a
April	111.2	-0.7	79.7

Source: Federal Reserve.

Note: Quarterly changes are at annual rates. Annual changes are calculated from annual averages.

Manufacturing output fell 1.2% at an annual rate in the first quarter, led by a 14.3% decline in auto output (motor vehicles and parts). Pressures on the manufacturing sector are expected to remain in coming months. Consumer spending is expected to slow, as well as business spending, and downward pressure on inventories may further aggravate weakness in industrial production.

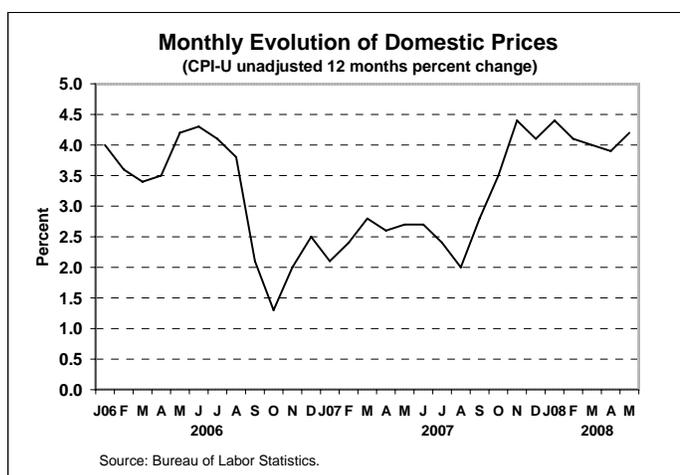
However, orders for big-ticket manufactured goods excluding transportation rose unexpectedly in April, suggesting that manufacturers are displaying resilience despite adverse conditions. Durable goods order minus transportation, a less volatile measure of business expenditure, rose by 2.5% in April according to the Commerce Department, the biggest increase in nine months. Overall durable goods orders fell by 0.5% in April, but the result was still better than the 1.5% drop being forecast by economists.

In addition, manufacturing activity seems to have leveled off in May, suggesting that the economic downturn is not getting worse. The Institute of Supply Management's manufacturing index came in at 49.6 in May, and although it remained in contraction territory, the ISM May's reading was higher than markets have expected. The index was below 50 for the fourth consecutive month, but it was up from April's 48.6. The improvement brings the index close to its expansionary threshold of 50, in another sign that manufacturing sector is displaying resilience despite more restrictive credit conditions and weaker demand.

In the ISM report, production expanded and exports continued to increase, continuing a five-and-a-half-year trend that is contributing to offset the slowing U.S. domestic demand. New orders rose, and imports grew only slightly. However, high commodity costs pushed prices to a four-year high, with the index of prices paid jumping to 87 – the highest since April 2004 – from 84.5 in April, and employment and inventories contracted.

- **Inflation**

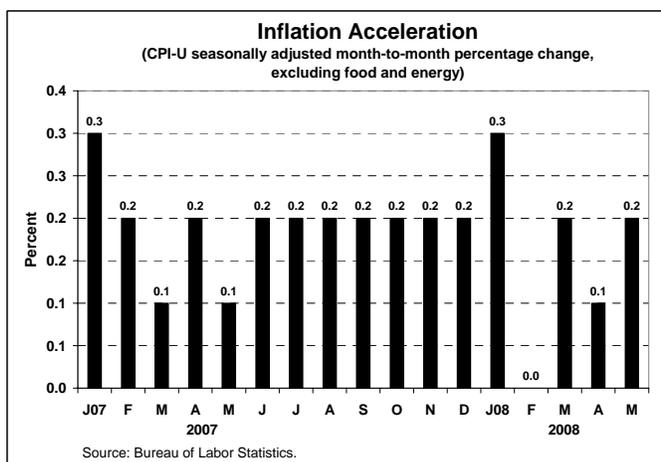
The Consumer Price Index for All Urban Consumers (CPI-U) increased at a seasonally adjusted annual rate (SAAR) of 3.1% in the first quarter of 2008, following an increase of 5.6% in the fourth quarter. The energy price index, after rising at a 17.4% SAAR in 2007, advanced at an 8.6% annual rate in the first quarter and at a 16.5% annual rate in the first five months of 2008. The food index advanced at a 5.4% SAAR in the first quarter and at 6.3% in the first five months of 2008, following a 4.9% increase in all of 2007.



For the 12-month period ended in April, the CPI rose 3.9%, following an increase at an annual rate of 4.0% in March. In May, inflation worsened for the first time in three months, reversing a downward trend. Inflation ran at an annual rate of 4.2% in May. This compares with an increase of 4.1% in all of 2007.

Higher-than-expected oil and food price increases should continue to be the main upside risk for inflation in coming months. Oil prices continued to hit record highs in the first quarter and have recently touched US\$ 139 a barrel on the New York Mercantile Exchange. Food prices rose at a 0.9% annual rate in April – the largest jump since 1990 – and 5.1% compared with the same month a year ago.

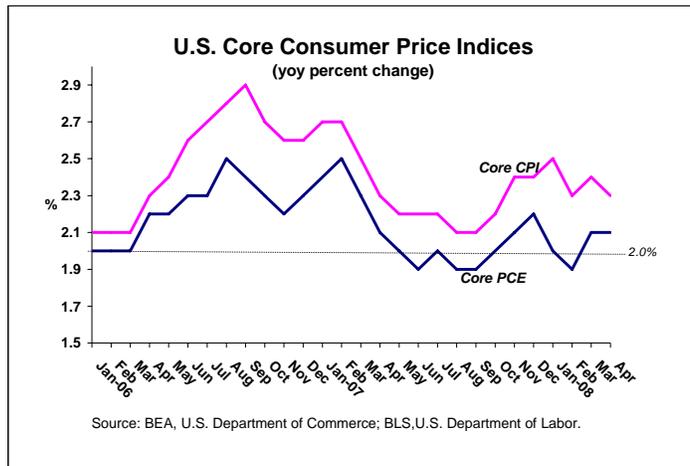
Excluding food and energy, the CPI-U advanced at a 2% seasonally adjusted annual rate in the first five months of 2008, following a 2.4% increase in all of 2007. The deceleration in 2008 so far reflects a slower advance in the indexes for shelter and medical



care, coupled with a larger decline in the apparel index. Recent data on consumer prices has left the Fed in a quandary, with headline inflation going up while core inflation looks reasonably contained. Soaring energy prices and a big jump in airline fares caused consumer prices to rise sharply in May, a reminder that the economy remains vulnerable to an undesirable mix of rising inflation and weak economic growth. However, prices in other sectors were well contained, suggesting that higher oil and food prices haven't yet spilled over into the broader economy.

The Personal Consumption Expenditure (PCE) price index excluding food and energy, the most closely watched measure by the Federal Reserve, increased at an annualized 2.0% in the first quarter, falling from a 2.1% rate in the fourth quarter. In March and April of 2008, however, the core PCE readings were above 2%, considered to be the top threshold for the Federal Reserve (consistent gains above 2% are considered a concern for policymakers and investors).

Despite the readings just above the threshold, recent inflation readings have not put additional pressure on the Fed to hike interest rates. The benign readings of core inflation both in April and May boosted the view that a slowing economy is helping to contain inflation. April was the third consecutive month of a smaller-than-expected increase in the core number (in May it met expectations), and some market analysts are taking this as a sign that the Fed may not need to raise rates in coming months to reduce inflation. The Fed, markets believe, will probably stay on hold at the June 24-25 FOMC meeting. Still, if inflation expectations continue to trend higher, the Fed may be forced to act.

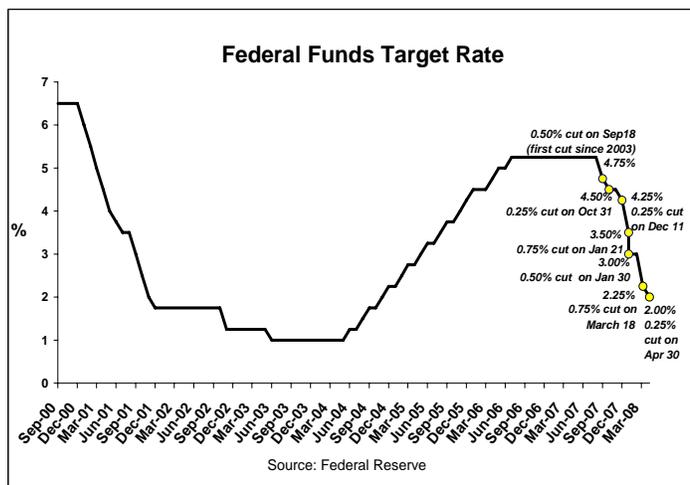


According to the University of Michigan Consumer Sentiment Survey in May, near-term inflationary expectations have continued to rise. Year-ahead headline inflation expectations are running at 5.2%, their highest level since 1982, from 4.8% in April. Five-year expectations rose more modestly to 3.4% in May, from 3.2% in April, the highest since 1996. The data suggest that inflation expectations may be losing anchor, a fact that should come to focus at the next FOMC meeting, as policymakers balance weak economic growth with a rising inflation outlook.

• **Monetary Policy**

Since September of 2007, the U.S. Federal Reserve has cut the federal funds rate seven times, for a total of 325 basis points, to the current level of 2%. The FOMC met six times since the beginning of 2008, and reflecting the volatile conditions in financial markets, three of those meetings were unscheduled.

On January 21, in a rare inter-meeting decision, the FOMC cut the federal



fund target rate by 75 basis points to 3.5%, moving quickly and decisively, in contrast with its actions in previous months. A week later, at its scheduled meeting on January 30, the Committee lowered its target for the federal funds rate again by 50 basis points to 3%. On March 18, the FOMC cut rates once again by 75 basis points to 2.25%, as the economic outlook weakened further. Finally, on April 30, the target for the federal funds rate was cut by 25 basis points to 2%. Federal Reserve Chairman Ben Bernanke has recently hinted that the Fed is done cutting rates, saying “policy seems well positioned to promote growth and price stability over time.”

March was a busy month for the policymakers at the Federal Reserve. On March 7, the Federal Reserve announced that it was making US\$ 200 billion available to lenders through two channels. It raised the size of its Term Auction Facility (TAF) auctions to fight back against heightened liquidity pressures in financial markets, and it also unveiled another US\$ 100 billion in new one-month repurchases operations primarily for investment banks, accepting pledge mortgage-backed bonds and even riskier assets as collateral. The intention of the Fed was to absorb some of the liquidity risk facing the markets by offering cash in return for relatively illiquid assets. The announcement was meant to reassure investors that they would be able to cash in securities if they want, and thus prevent a panic selling that could push asset values down and cause further economic damage.

On March 11, in a second big intervention in three days, the Fed announced that it was pumping more cash into a tight credit market. The Fed revealed its boldest step yet to ease the credit crunch, saying that it would lend primary dealers in the bond market up to US\$ 200 billion in Treasury securities for a term of 28 days and accept AAA-rated mortgage-backed securities as collateral in return. The initiative, called the Term Securities Lending Facility (TSLF), provides to a new set of financial institutions a chance to temporarily replace mortgage-backed assets – provided that they are AAA-rated securities – with Treasuries for periods of 28 days at a time. The dealers continue to bear the market risk of the assets provided as collateral, but this latest initiative took the U.S. central bank a step closer to the possibility of directly buying mortgage-backed securities. The FOMC also authorized increases in its existing temporary exchange-rate swap arrangements with the European Central Bank and the Swiss National Bank. The Bank of Canada and the Bank of England also extended their liquidity support operations. The total boost provided by the Fed with this announcement amounted to US\$ 236 billion, and combined with the earlier announcement, the Fed provided a total of US\$ 436 billion of new short-term funds.

Since the credit crisis began last August, the Fed has expanded the volume and types of loans it is willing to make to banks and security dealers, loans that are backed by a variety of collateral from subprime mortgages to student loans. So far it has not directly purchased such debt, although it did make an unprecedented loan of US\$ 29 billion to facilitate the sale of Bear Stearns to JPMorgan in March, which extended the agency’s safety net beyond the banking system. The understanding is that the Fed made the decision by balancing the risk of creating the precedent of such lending, with the risk of other failures that could be triggered if Bear, the country’s fifth-largest investment bank, defaulted on its obligations. In the wake of the Bear Stearns rescue, pressure has been building in Congress for tighter regulation to be imposed on investment banks, since they are benefiting from access to the Fed discount window. Warnings have also been raised about the Fed’s moves, which could lead to moral-hazard and greater risk taking. Former Federal Reserve Chairman Paul Volcker, testifying on the response to the credit crisis in Congress, said he worries about the Fed’s balance sheet and that the Fed’s independence could be hurt by the wide variety of assets it has taken onto its balance sheet to fight the credit crunch.

During most of the first quarter, the Federal Reserve was criticized for not doing enough to contain the credit crisis. Recently, however, as financial markets seem to be increasingly stabilizing, the Fed has been assailed for going too far and contributing to a spike in inflation and a decline in the value of the dollar. The criticisms highlight the difficulty the FOMC will face at its coming meetings in trying to balance risks to both growth and inflation.

The Fed's projections for both growth and inflation have deteriorated since January. The Fed's "central tendency," which excludes the three highest and three lowest figures, predicts growth of 0.3% to 1.2% this year, with unemployment rate averaging 5.5% to 5.7% in the fourth quarter. That is a substantial weakening of the January forecast, when growth was projected at 1.3% to 2% this year, with unemployment averaging 5.2% to 5.3%.

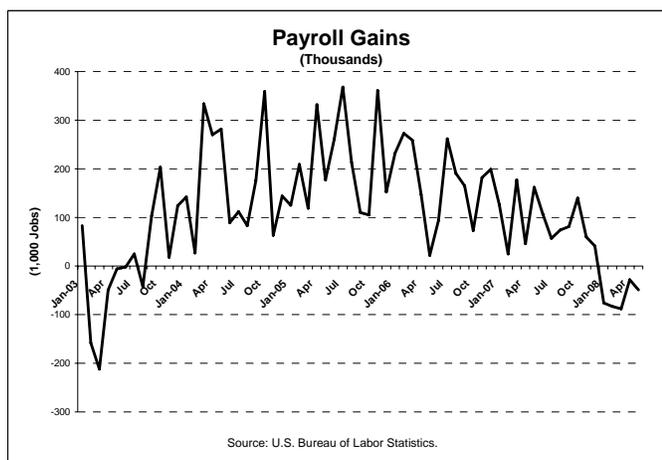
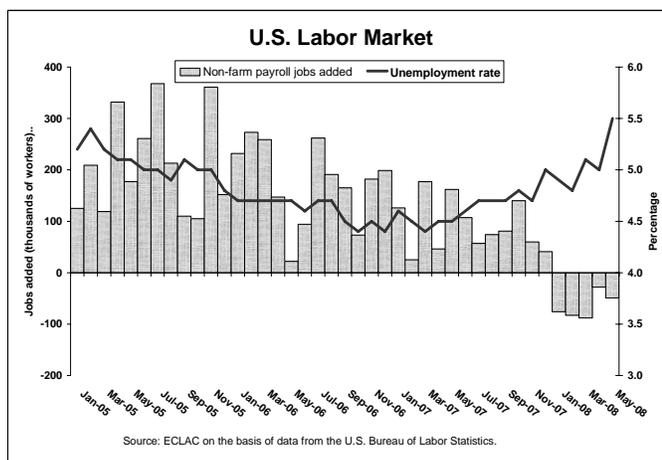
The outlook for inflation has also deteriorated. The central tendency of the forecasts put overall inflation at 3.1% to 3.4% this year, up a full percentage point from January, based on the PCE price index. At the end of May, U.S. mortgage rates soared amid a sharp increase in Treasury market yields, as investors started to bet that inflation pressures could prompt the Fed to raise interest rates later this year, although most expect the Fed to remain on hold at its next meeting in June.

In a departure from the Fed's traditional position, which is to leave currency issues to the Treasury Secretary, Mr. Bernanke recently made a rare public declaration on the dollar's steep fall, saying that it has led to worrisome increases in import prices and consumer price inflation. He focused on the links between the dollar, oil prices and inflation, and stressed that the Fed will be vigilant regarding this issue and the effects on medium and long-term inflation expectations. According to him, there is a risk that sustained high headline inflation – including food and energy costs – could push up inflation expectations and ultimately inflation itself. His comment surprised the markets, triggering an increase in the dollar and considerable declines in oil and gold prices. On June 6, however, the combination of the release of the May Labor Department report, showing the unemployment rate jumping to 5.5%, and the biggest one-day advance in the price of oil, led Mr. Bernanke to use even more forceful language about inflation, making it clear that higher energy costs, and not the economic outlook, were the bigger concern.

- **Labor Markets**

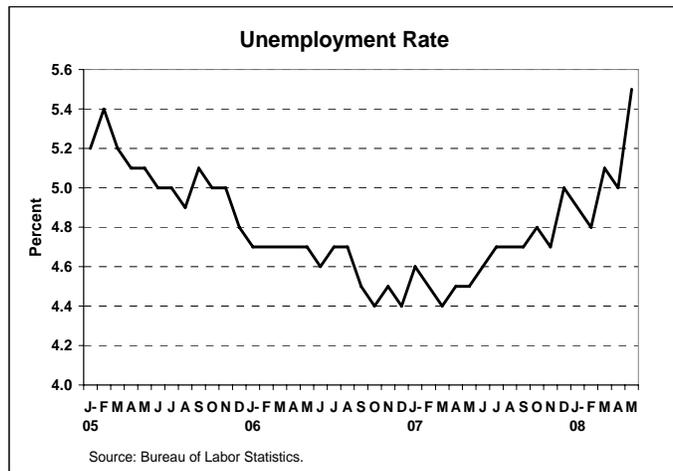
Conditions in the job market have continued to soften since the beginning of the year. In April, the Labor Department report was not as weak as anticipated with monthly job losses of 28,000, compared to an average of 82,000 during the first three months of 2008, and with unemployment declining only a tenth of a percentage point, to 5%. In May, however, the unemployment rate jumped by a half percentage point to 5.5%, the biggest monthly increase in 22 years, bringing back fears of a recession. Job losses also accelerated to 49,000 in May, albeit slightly less than the consensus forecast of about 60,000.

Although employers have cut jobs for five consecutive months, by the standards of previous recessions the number of job losses has so far been mild. Employers have shed 324,000 positions year-to-date at an average rate of 65,000 a month, whereas at the start of the 2001 recession, 110,000 jobs were being cut monthly and almost 130,000 when the 1990 recession began. According to



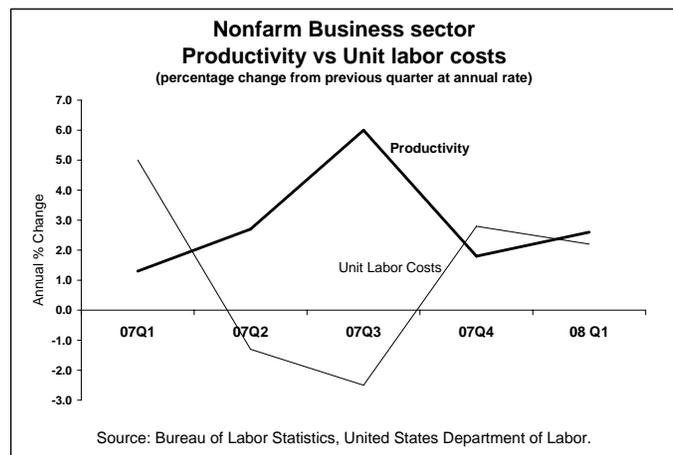
Moody's Economy, the pace of monthly layoffs this time around is expected to be less than the historical average, given that businesses were more cautious and slow in their hiring decisions in the boom years. One of the features of this recent period of growth was the slow growth in the labor market, so now that the economy is slowing, it is expected that layoffs will also be more measured. Despite the low pace of job losses, the April and May reports portrayed the picture of an economy that is shedding jobs. There were severe job losses in housing and consumer-related industries, and given the state of the housing sector, further job losses are still likely. The reports confirm the view that the economy is in for an extended period of weak growth.

The unemployment rate declined slightly in January and February 2008, from 5% in December 2007 to 4.9% in January and 4.8% in February. It was at 5.1% in March and 5% in April, but it jumped to 5.5% in May, the highest level since October 2004, and the biggest monthly increase since 1986. According to experts, much of the spike in unemployment was a result of a large surge of teenagers and people in their 20s into the labor force, who had little success in finding jobs. The jobless rate among 16- to 19-year-olds increased to 18.7% from 15.4% in April. Retailers, who usually employ a large number of unskilled teenagers over the summer, shed 27,000 positions in May. The increase in unemployment, however, spread well beyond young people, with the jobless rate rising for almost every other group in the report. Despite the magnitude of the May increase in the unemployment rate, other indicators, including payroll jobs excluding agriculture suggest a more mild erosion of labor-market conditions. Fed officials expect the unemployment rate to stand in the range of 5.5% to 5.7% by the end of the year, according to their latest quarterly forecast, and were surprised the rate had been so slow to rise before May.



The U.S. productivity accelerated in the first quarter of 2008, a trend that could help companies offset the inflationary burden of increasing oil prices and energy costs and should help minimize the need for substantial layoffs. First quarter productivity growth for the nonfarm business sector, a measure of business efficiency, was 2.6% (SAAR), following 1.8% in the fourth quarter 2007. From the first quarter of 2007 to the first quarter of 2008 productivity increased by 3.3%, the biggest increase since mid-2004. Some economists fear that the record commodity and oil prices will reduce company profit margins, but that are many, on the other hand, who are confident that productivity gains will help counteract some of these problems. Companies have been adjusting quickly to the economic slowdown by shedding workers and cutting back on the number of hours worked. According to Wachovia Economics Group, this cutback was the primary driver for the stronger-than-expected productivity gain in the first quarter. Hours worked declined at a 1.8% annual rate in the first quarter, but output continued to rise, although modestly, at a 0.7% annual rate.

Nonfarm unit labor costs increased an annualized 2.2%, following an increase of 2.8% in the fourth quarter. From the first



quarter of 2007 to the first quarter of 2008 unit labor costs increased by only 0.2%. Companies have been successful in keeping wage demands under control, in spite of the growing cost pressures on consumers. Wages have struggled to keep pace with inflation, suggesting that maybe consumers, not companies, will bear the biggest brunt from rising commodity prices.

- **Financial Markets**

Financial markets, in the words of the Fed Chairman in a recent speech, had “improved of late but conditions remained strained.” It is possible, and markets have started to speculate about that, that the worst of the financial crisis is over. The Fed efforts of the past nine months contributed to that. The institutions in trouble weren’t traditional banks, thus the usual tools for dealing with financial trouble, designed for a system centered on traditional banks, were inadequate. The Fed, in response, found innovative ways to respond to the crisis by creating new tools (the TAF and the TSLF), offering credit lines to investment banks, and culminating with an unprecedented loan to Bear Stearns in March. The Fed is now reviewing its policies towards asset bubbles, considering the possibility of using regulation, not monetary policy. The idea is to use regulatory powers aggressively and pro-actively to limit the threat from future asset bubbles. The Fed’s very success in containing the financial crisis, however, has been contributing to slow the impetus for financial reform. Some believe that if regulatory changes are not implemented, the vulnerabilities at the heart of the crisis that started in August of last year may not be addressed, increasing the risks of even bigger crisis in the future.

Tim Geithner, president of the Federal Reserve Bank of New York and one of the main architects of the rescue of Bear Stearns, said in a recent speech that large financial institutions need to be required to hold more capital when times are good, to prevent them from facing a run on the banks when things are bad. “Inducing institutions to hold stronger cushions of capital and liquidity in periods of calm may be the way to reduce the amplitude of financial shocks on the way up, and to contain the damage on the way down.” Also, former Fed Chairman Alan Greenspan warns that central banks should be weary of trying to deal more aggressively with future asset price bubbles. Bubbles, he argues, were often the by-products of innovation, such as the commercialization of the Internet in the 1990s and the advances in housing finance in the 2000s. According to him, to ask regulators to suppress bubbles would be to ask them either to prevent innovation or to second-guess the value the market puts on it. He thus suggests that rather than trying to suppress bubbles, policymakers should ensure that financial institutions are well capitalized to withstand the impact from bursting bubbles as well as other shocks. He supports efforts to develop countercyclical capital rules that would require banks to hold more capital in good times than bad. The caveat, however, is that in practice it is difficult to know at which part of the cycle the economy really is.¹

Equity prices fell in the first quarter, with Dow Jones losing 9%, the S&P 11% and the NASDAQ 15%, although they showed a small recovery in April. Treasury Yields also fell compared to the levels in 2007. U.S. financial markets have rallied since early March, with stocks and yields on risky corporate and mortgage-backed bonds falling relative to safe U.S. Treasury securities. However, on June 6 stock markets sold off sharply in response to the release of the May unemployment rate combined with the unprecedented jump in oil prices of nearly US\$ 11.

There were net long-term flows in the first quarter of US\$ 202 billion according to the Treasury International Capital (TIC) report. Despite the weaker dollar, the U.S. trade deficit widened in the first quarter to US\$ 175 billion from US\$ 174 billion in the fourth quarter. Capital flows were thus more than enough to finance the trade deficit. In March, net capital flows at a positive US\$ 80.4 billion comfortably exceeded the March trade deficit in goods and services of US\$ 56.5 billion, but in January, net long-term

¹ Krishna Guha, “*Greenspan urges policymakers to focus on banks’ capitalization,*” Financial Times, May 27 2008.

flows (US\$ 56.7 billion) were not enough to cover the trade deficit (US\$ 57.9 billion), while in February, TIC flows exceeded the trade deficit just slightly (US\$ 64.9 billion compared to US\$ 60.6 billion).

U.S. Treasury Security Yields			
Constant Maturities			
Monthly Yields			
2007	3-year	10-year	30-year
January	4.79	4.76	4.85
February	4.75	4.72	4.82
March	4.51	4.56	4.72
April	4.60	4.69	4.87
May	4.69	4.75	4.90
June	5.00	5.10	5.20
July	4.82	5.00	5.11
August	4.34	4.67	4.93
September	4.06	4.52	4.79
October	4.01	4.53	4.77
November	3.35	4.15	4.52
December	3.13	4.10	4.53
2008	3-year	10-year	30-year
January	2.51	3.74	4.33
February	2.19	3.74	4.52
March	1.80	3.51	4.39
April	2.23	3.68	4.44

Source: Economic Indicators, U.S. Government Printing Office.

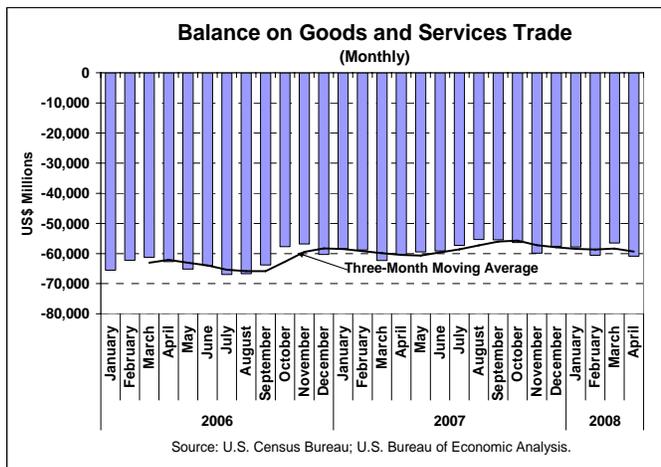
Stock Prices			
Monthly Stock prices			
	Dow Jones Industrial Average	S&P 500	Nasdaq
2007	Dow Jones Industrial Average	S&P 500	Nasdaq
January	12,512.89	1,424.16	2,453.19
February	12,631.48	1,444.79	2,479.86
March	12,268.53	1,406.95	2,401.49
April	12,754.80	1,463.65	2,499.57
May	13,407.76	1,511.14	2,562.14
June	13,480.21	1,514.49	2,595.40
July	13,677.89	1,520.70	2,655.08
August	13,239.71	1,454.62	2,539.50
September	13,557.69	1,497.12	2,634.47
October	13,901.28	1,539.66	2,780.42
November	13,200.58	1,463.39	2,662.80
December	13,406.99	1,479.23	2,661.55
2008	Dow Jones Industrial Average	S&P 500	Nasdaq
January	12,538.12	1,378.76	2,418.09
February	12,419.57	1,354.87	2,325.83
March	12,193.88	1,316.94	2,254.82
April	12,656.63	1,370.47	2,368.10

Source: Economic Indicators, U.S. Government Printing Office.

- **External Sector**

According to the Bureau of Economic Analysis and the Census Bureau, the U.S. goods and services deficit widened by US\$ 1.1 billion in the first quarter of 2008 (0.65%), from US\$ 174 billion in the fourth quarter 2007 to US\$ 175 billion. The goods deficit with China decreased to US\$16.1 billion, the lowest in two years. Crude oil prices increased in March by more than US\$ 5 a barrel, which in turn increased the total import bill for oil to US\$ 33.15 billion despite a lower volume.

Trade has turned into a boost to real GDP growth, but this boost weakened in the first quarter of 2008. In the past three quarters of 2007, net exports contributed over a full percentage point to GDP growth, but in the first quarter net exports contributed 0.8%.²



Source: U.S. Census Bureau; U.S. Bureau of Economic Analysis.

Crude oil prices have surged to all-time highs since the beginning of the year, remaining an impediment to improving the trade balance. However, it seems that lower demand for oil in the U.S. may have started to help counter this effect. In the first quarter the decline in foreign oil dependency started to become more visible, with imports making up 57.9% of total consumption, down from 58.2% last year. That trend is set to continue according to the head of the U.S. Energy Information Administration, as people adjust to high oil prices and the impact of the Energy Independence and Security Act, which

² From 1996 to 2006 trade was a consistent drag on economic growth according to Moody's Economy, shaving from 0.1 to 1.2 percentage points from real GDP growth.

became law in December 2007, begins to be felt. Imported goods are also getting more expensive because of the weakening dollar, a trend that is putting downward pressure on imports, while helping to boost exports. The combined effect of these trends could be a lower trade deficit in coming months.

However, how much the trade deficit can improve and how much it will support economic growth, is still uncertain, and will be largely determined by how far oil, as well as food prices will continue to rise. Recent events haven't been very encouraging. On June 6, oil prices staged their biggest single-day advance ever to hit a record of more than US\$ 139 a barrel. Analysts found a number of explanations for the rise, including a falling dollar following a weak employment report and expectations of further financial losses, as well as geopolitical concerns that weighted on the market. The oil price rise was also compounded by technical factors as traders who had bet on falling oil prices through short-sales (in which they sell the commodity in the hope of buying it back later at a lower level), were forced to cover their positions, sending oil prices rocketing.

III. LOOKING AHEAD

- Current market projections for real GDP growth in 2008 now range from 0.6% to 1.5%. These forecasts were made mostly in May and in the beginning of June, thus do not include the latest market developments, including the release of May labor market data, and the unprecedented single-day increase in oil prices. The near-term outlook is turning more negative after these events, as markets come to terms with the notion that the Fed's nine-month campaign of easing interest rates is coming to an end. Policymakers worry that record oil prices are aggravating inflation expectations, and if unchecked they could result in a broader acceleration in inflation.

Forecasts for Annual U.S. Economic Growth

		Real GDP		
		2008	Date of Forecast	Previous Forecasts
A. What Government Agencies Say				
	FED*	0.3 - 1.2%	Apr-08	1.3-2.0% in Jan-08
	Council of Economic Advisors*	2.7%	Nov-07	2.7% in Jun-07
	CBO	1.9%	Feb-08	2.9% in Aug-07
B. What Markets Say				
	Goldman Sachs	1.1%	May-08	1.8% in Dec-07, 0.9% in Mar-08
	National Association of Realtors	1.7%	Jun-08	2.2% in Feb-08, 1.5% in Mar-08
	Merrill Lynch**	0.6% at current record oil prices 1.2% assuming \$100/bbl for WTI	May-08	0.8% in Mar-08
	Moody's Economy.com	1.6%	Jun-08	2.3% in Nov-07, 1.5% in Mar-08
	The Economist Intelligence Unit	0.8%	Jun-08	1.5% in Dec-07, 0.8% in Mar-08
	JPMorgan	1.6%	Jun-08	1.9% in Feb-08, 1.2% in Mar-08, 1.4% in May
	Securities Industry and Financial Markets Association (SIFMA)	2.1%	Dec-07	2.8% in Jun-07
	Wachovia	1.4%	Jun-08	2.7% in Nov-07, 1.7% in Mar-08
	Mortgage Bankers Association*	1.3%	May-08	2.4% in Nov-07, 1.6% in Feb-08
C. What International Organizations Say				
	United Nations DESA	1.0%	May-08	2.0% in Jan-08
	OECD	1.2%	Jun-08	2.0% in Dec-07
	IMF	0.5%	Apr-07	1.9% in Oct-07, 1.5% in Jan-07

* forecast on a Q4 to Q4 basis.

Note: the CBO, IMF and JPMorgan forecasts on a Q4 to Q4 basis are 1.6%, -0.7% and 0.9% respectively, while the SIFMA forecast remains the same, at 2.1%.

** ML forecast is based on two different oil assumptions. If the oil price fails to recede from the current record level, GDP growth in 2008 would come in at 0.6%.

- The market view of the risk of a recession in the U.S. has fallen sharply in the past two months. According to prices of a futures contract run by the Intrade prediction market, the chances of a U.S. recession this year are now about 30%. The Moody's Economy.com probability of recession

eased to 51% in April, compared to March's 56%. Wachovia puts the odds of a recession at 45% in May, down from 90% in April, and the latest Wall Street Journal.com survey of economists, conducted in May, puts the likelihood of a recession at 60%, down from the 90% predicted in the April survey. Blue Chip released its June survey of economic forecasts, showing that while economists have cut their U.S. growth for the second half of this year and 2009, more have come to believe that the U.S. economy will escape a recession.

- Despite showing resiliency, the U.S. economy still faces three risks: financial stability, rising oil prices, and decline in house prices, risks that are contributing to greater uncertainty regarding the future economic outlook. The recent release of the May unemployment rate combined with the unprecedented one-day increase in oil prices have rattled stock markets, bringing back fears of a protracted and deep slowdown. Plenty of economic warnings still remain. Consumer confidence has plunged and food and other commodity prices have continued to rise, prompting consumers to cut some spending and stoking concerns about inflation. The ongoing increase in oil prices has pushed the average price of a gallon up, and home prices have continued their downward trend, with many economists expecting that to depress spending in the months ahead.
- According to Fed's Chairman Ben Bernanke, the danger of a "substantial downturn" in the U.S. economy has abated over the past month, but inflation risks are increasing, and policymakers will remain vigilant regarding the links between the dollar, rising oil prices and inflation, making sure that medium and long-term inflation expectations do not become unmoored. Growth risks should remain to the downside as well, as long as the housing market does not show clearer signs of stabilization. The Fed's job has been made more difficult by the recent data's inconsistency. The weak May employment report swung sentiment sharply towards faltering economic growth. However, strong May retail sales figures brought the opposite message, while May's sharp increase in headline consumer prices swung sentiment towards rising inflation risks. Uncertainty, it seems, is not going away in the short-term.
- In the most recent Beige Book report, released on June 11, the picture that has emerged is consistent with weaker growth and greater inflation risk from rising prices for energy and other commodities. According to the report, "economic activity remained generally weak in late-April and May." Consumer spending and manufacturing slowed, while housing markets were described as weak. The report also indicated that manufacturing contacts in several Districts noted some ability to pass along higher costs to customers. The survey indicates that while rising food and energy costs are squeezing consumer spending and hurting corporate profitability, slower growth is helping the economy to keep inflation under control.