

E-NEWS

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NATIONAL ECONOMY BY: ADRIAN NEVES

Economic growth rose again as expected in the first quarter of 2007, according to the Bureau of Economic Analysis. Real gross domestic product (GDP) increased at an annual rate of 1.3 percent in the first quarter after increasing 2.5 percent in the fourth quarter. GDP measures the market value of all final goods and services produced by labor and property within the United States. GDP is the sum of personal consumption expenditures, private domestic investment, net exports or goods and services, and government expenditures.

The final estimates of gross domestic product for the first quarter included positive contributions from personal consumption expenditures (PCE), weaker exports, state and local government spending, and federal government spending. The negative growth rate included a decrease in residential fixed investment, private inventory investment and federal government spending. Economists say that the first quarter "preliminary" estimates are probably due to the slowdown in spending on homebuilding. Economists had been anticipating first-quarter GDP growth of about 1.8 percent.

Real personal consumption expenditures increased 3.8 percent in the first quarter compared to a

4.2 percent increase in the fourth quarter. Nondurable goods also increased 2.9 percent, compared to an increase of 5.9 percent in the fourth quarter. Nondurable goods are non-perishable and may be used and re-used over time such as clothing. Real exports of goods and services decreased 1.0 percent in the first quarter. Real imports of goods and services increased 2.3 percent, in contrast to a decrease of 2.6 percent.

Real federal government consumption expenditures and gross investment decreased 3.0 percent in the first quarter, compared to an increase in the fourth quarter of 4.6 percent. National Defense expenditures decreased by 6.6 percent in contrast to an increase of 12.3 percent in the fourth quarter.

Current-dollar personal income increased \$245.7 billion which was 9.2 percent in the first quarter, which was up from the increase of \$126.1 billion, 4.7 percent, in the fourth quarter. Personal current taxes increased \$57.8 billion in the first quarter compared to an increase of \$24.0 billion in the fourth. Disposable personal income increased \$188.0 billion, 8.0 percent, in the first quarter, compared with an increase of \$102.0 billion, 4.3 percent, in the fourth. Real disposable personal

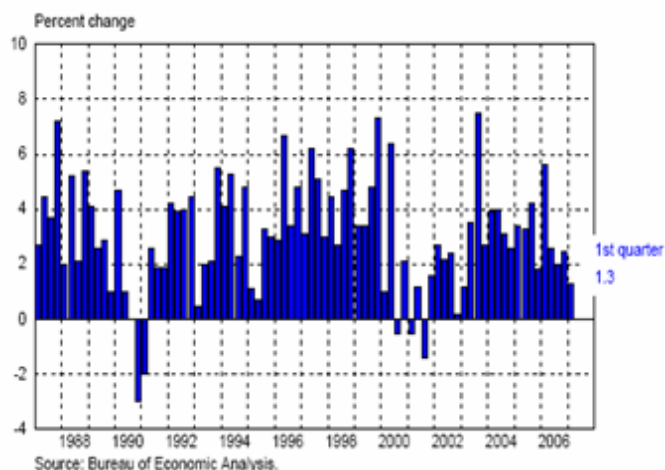
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income increased 4.5 percent, compared with an increase of 5.3 percent.

Real GDP for the first quarter of 2007 was the weakest in four years as it was stated 1.3 percent. It was just half of what the 2.5 percent fourth quarter growth, and well under the expected rate of 1.8 percent. Forecasters suggest that this was due to a slumping housing market and weakening international trade. Residential spending shrank by 17 percent in the first quarter following declines of 19.8 percent in the fourth quarter and 18.7 percent in the third quarter last year.

REAL GDP

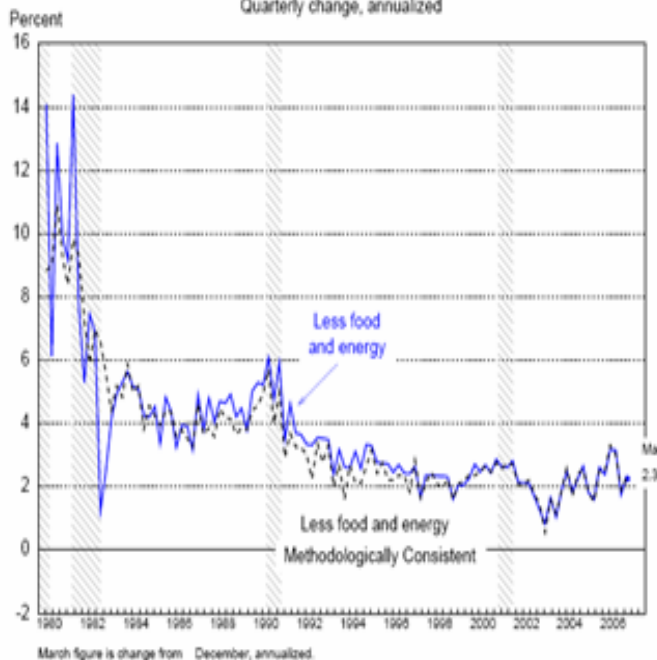


U.S. consumer prices increased during the first quarter of 2007 climbing 0.9 percent in March. This month was 2.8 percent higher than in March 2006. On a seasonally adjusted basis, the CPI increased 0.6 percent. The reason for this is the hike in gasoline prices that helped drive US consumer prices. The price of gasoline jumped 10.6 percent and was the largest increase in 1-1/2 years since September 2005. The housing market also staggered and was a leading factor for the slower economic growth. Inflation is a rise in the average price level of all goods and services within an economy. The Consumer Price Index (CPI) is a measure of the average change in prices over time of goods and services purchased by households. The CPIs are based on prices of food, clothing, shelter, and fuels, transportation fares, charges for doctors' and dentists' services, drugs, and other goods and services people buy for day-to-day liv-

ing. Increases in the CPI have held quite constant over the past year. This shows our economy growing slowly with a steady growth in the overall inflation rate.

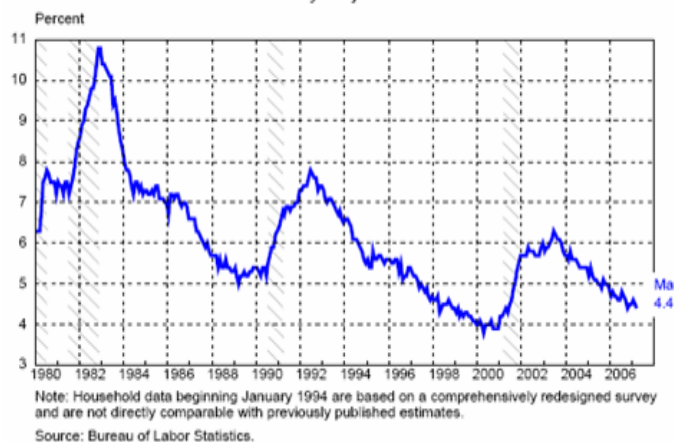
CORE CPI INFLATION

Quarterly change, annualized



Unemployment rate decreased as job growth increased in the first quarter of 2007. The unemployment rate fell to 4.4 percent while economists feared that it would rise back up to 4.6 percent. October 2006 and this March were the only two times that the unemployment rate has been this low. By sectors, manufacturing lost 16,000 jobs and business services lost 7,000 jobs. Although the housing market is still trying to pick back up construction jobs added 56,000 jobs. Economists believe that there exists a natural rate of unemployment that cannot be avoided. This is due to frictional unemployment and seasonal unemployment. Natural unemployment is estimated to be around 4 percent so the remaining 0.4 percent would be the unemployment rate holding that natural rate true. Average hourly wages rose 0.3 percent to \$17.22, in line with forecasts and down from the 0.4 percent increase posted in February. Wages were up 4.0 percent within the last year, which implies average hourly employees are starting to see their paychecks grow faster than prices.

CIVILIAN UNEMPLOYMENT RATE Seasonally Adjusted



Sources:

www.bls.gov

www.bea.gov

AGGREGATE SAVINGS IN THE U.S. BY: JUSTIN CLINTON

Consider for a moment your level of personal savings. Perhaps you are one of the relatively elite few who might respond with something like “My level of savings is excellent, no worries.” Maybe you fall into a larger group of middle-class Americans and would therefore respond “My savings level is ok, but it could be better.” Possibly, you are among the group of Americans who do not (or cannot) save. Whichever the case may be, you would still comprise part of what is commonly known as *aggregate personal savings*, or the total amount of personal savings for the country as a whole. As is to be expected, aggregate personal savings generally takes on a positive value. However, it has been suggested that, in recent times, the level of aggregate personal savings has actually taken on a negative value. In a February 2007 Survey of Current Business article by Marshall B. Reinsdorf, the author states that “In 2005, annual personal saving (as a percent of disposable personal income—DPI) in the national income and product accounts (NIPAs) was negative for the first time since 1933, dipping to -0.4 percent of disposable personal income (DPI).” This is a national low that has not been attained since the height

of the Great Depression.

In response to this finding, a statistical analysis was conducted using linear regression. The purpose of this study was to estimate the determinants of consumption in the United States for the years 1971 to 2006. It was hypothesized in the analysis that consumption is a function of both DPI and interest rates. Obviously, disposable personal income is the largest contributor to the determination of an individual’s level of consumption. In this analysis, the coefficient of the DPI variable represented the estimated MPC, or *marginal propensity to consume*. This value (which must be between 0 and 1) represents the additional amount of consumption for one additional unit of income. For example, an MPC of 0.90 indicates that for every extra dollar an individual earns (after taxes), he or she will spend 90 cents of that dollar. The important duality of the MPC is that (1-MPC) must equal the MPS, or *marginal propensity to save*, since every dollar earned must be either spent or saved. Similar to the definition of MPC, MPS is the additional amount saved for every one dollar taken home. Given the definitions of MPC and MPS, as well as the aforementioned estimates of negative savings, it was expected that the study would find an MPC of close to 1 and an MPS of close to 0.

The study found that when interest rates go up, consumption goes down, and vice versa. This observation is logical—higher interest rates generally make saving more attractive and purchase financing less attractive. The study also estimated an MPC of 0.975, meaning that 97.5 cents of every dollar earned is spent (and 2.5 cents is saved). While this savings rate of 2.5% of DPI is very low, it is not negative. In order to elaborate on this model, so-called “dummy variables” were added. The dummy variable(s) could be referred to as “post-September 11th consumption”, and they could be described as “economic intangibles”, or simply a public attitude toward consumption that is rooted more in human emotion than in other quantifiable economic variables. Stated plainly, the hypothesis is that individuals in the U.S. have taken more of a *carpe diem* attitude towards consumption and spending since the tragedy, and are “living for today” instead of saving for tomorrow. The updated study (with dummy variables added) estimated that since 2001 the MPC has, in fact, increased. Specifically, MPC moved from a newly estimated 0.95 (for years 1971 to 2000) to 0.967 for years 2001 to 2006. Once again, these numbers imply a savings rate of 3.3% for the years 2001 to 2006.

In summary it can be said that, according to these methods of calculation, the aggregate personal savings rate has been very low (or possibly even negative) during the first years of the 21st century. Factors at work behind this phenomenon may include: increased post-September 11th consumption, low interest rates, the facilitated and readily available market for consumer credit, and others. These findings, moreover, should not be cause for too much alarm; the MPS method is only one method of determining the level of personal savings, as was outlined in the aforementioned article. Other methods may involve factoring investment in consumer durable goods, as well as defined benefit pension plans into the equation. In doing so, these methods usually paint a different --and more optimistic-- picture of personal savings in the U.S.

Sources: www.bea.gov

PERSONAL SAVING BY: ANDREW GALLAGHER

Annual personal saving as a percentage of disposable income fell below zero for the first time since 1933. Although the U.S. economy hardly resembles the dark times of 1933, the current state of personal saving raises much concern and debate. To criticize personal savings strictly in terms of disposable income may be considered naïve because there is a variety of ways to evaluate personal saving and ultimately find the best solution to stimulate more saving.

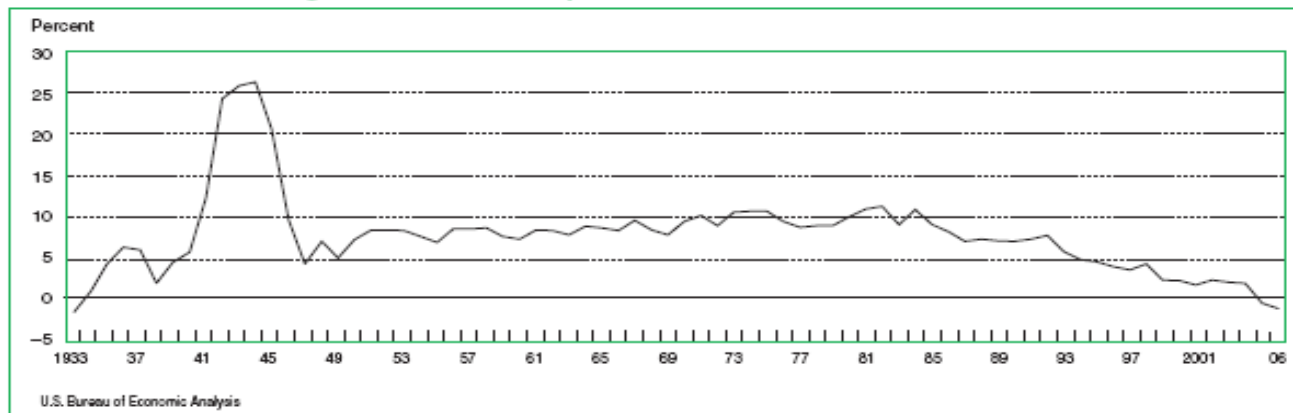
The first alternative method of measuring personal sav-

ing involves defining the personal sector of the domestic economy. The personal sector includes households as well as the nonprofit sector that serves households. Households are the biggest element of the personal sector and if isolated gives a better understanding of the personal saving predicament. From 1995 to 2002 household savings fell a considerable amount in comparison to the personal saving rate. This was said to be partly caused by the potential savings tied up in more profitable areas of the late 90's booming economy, such as the stock market or real estate. Although the percentage of household saving returned much closer to annual personal saving by 2003, the downward trend of saving continued.

Another way to change the way personal saving is analyzed is through realized capital gains. Capital gains are not included in personal income, but once realized are taxed by the government. Those tax dollars will come out of personal income to find disposable income, which is the key component in determining overall personal saving. If capital gains and personal income are taxed separately it can provide a better understanding of saving patterns. This assumption raises disposable income and saving. Personal saving increases nearly one percent higher than when capital gains taxes are not treated as separate transfers to the government.

These first two examples of changing the way national personal savings are viewed, may on paper seem to increase or decrease saving, but are simply allocating different amounts to different sectors. This final hypothetical view may do more for national saving than re-

Chart 1. Personal Saving as a Percent of Disposable Personal Income



allocation.

This final measure of personal saving takes an interesting yet logical approach to how consumers spend money. When consumers purchase durable goods, such as a car or a refrigerator, they are treated as expenditures. This is the case because these goods do not gain value with time nor even sustain the original purchasing price in the event of a resale. Although they are not viewed as an investment, they can have the power to save money in the future due to the longevity of the life of these products. In addition, exceptional care for these products can add to the life of these products making the original purchase that much more valuable. Given this evidence it is apparent that these durable goods could be viewed as investments rather than expenditures. When durable goods are viewed as investments, it accounts for about one percent of personal income in years of recession, and about three percent in years of a more fruitful economy. Most importantly, if disposable income is analyzed under these circumstances the savings rate would not fall below zero in recent years. The decline of savings in recent years can still be seen, but the inclusion of durable goods softens the blow and slows the process.

Personal saving plays an important role in the economy for a few reasons. Despite the obvious worry of individuals' financial security another reason is that of a source of loanable funds. Besides the idea viewing durable goods as investments and reallocating certain entities to other sectors of the economy, other aspects of saving may also ease a potential saving crisis. The business sector, for example, may be a source of reliable saving. Businesses are not included in the personal aspect of saving, but many individuals hold equity assets from small businesses to large corporations. Furthermore, the saving done by these businesses can increase the value of assets held by individuals. Both the business and government sectors have much sturdier trends in saving throughout time.

In summing up, the decline in personal saving is a relevant issue. There is more than one way to evaluate how that trend has come to be. Using alternative methods helps us to further determine the sources and nature of saving. Utilizing approaches such as separating household and nonprofit sectors, excluding capital gains taxes, and viewing durable goods as investments help to gain a better understanding national personal

income as a percent of disposable income.

Sources: www.federalreserve.gov.

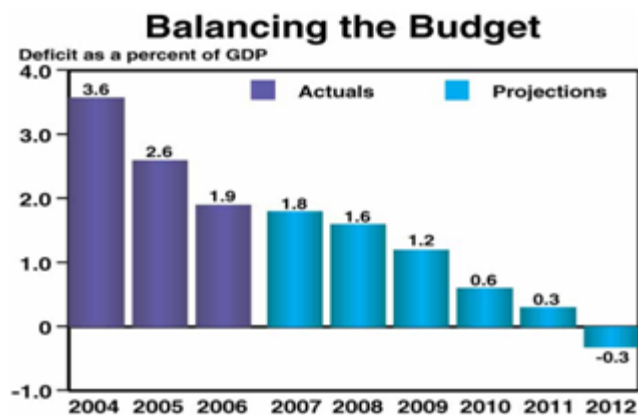
BUDGET REVIEW AND BALANCING BY: MATTHEW COLLADO

The federal budget deficit was cut in half in 2006 due to a strong economy and significant revenue growth, combined with spending restraint. The reduction in deficit has occurred earlier than anticipated. As result a new goal has been set by the President and that is to achieve a balanced budget by 2012. Deficit reduction achievements are due greatly to a strong economy, and to reach a balanced budget, steady economic growth is important. It is also important to couple growth with spending discipline. Increased innovation and investment have continued to respond to the President's tax relief efforts. This has ultimately led to an increase in employment and created more than 7 million new jobs, and a boost in wages. Pro-growth policies hope to sustain prosperity and economic growth for future generations by focusing on providing quality education, affordable health care and energy security. The President plans on spending taxpayer dollars wisely, holding the growth in non-security discretionary spending to 1% well below the rate of inflation; and also plans to slow the unsustainable growth of entitlement spending with sensible reforms. The Budget supports our troops fighting terrorism, strengthens our military for the future, supports our efforts on the diplomatic front and protects our homeland from attack.

For the first six months of fiscal year 2007, the federal government recorded a deficit of \$257 billion. The CBO estimates that this is \$46 billion less than the shortfall incurred during this same period in 2006. For the first half of the year revenues have risen by 8% and outlays have grown by about 3%. A monthly budget review has been made by the CBO based on, the *Monthly Treasury Statement* for February and the *Daily Treasury Statements* for March. A deficit of \$120 billion was reported by the Treasury for the month of February. That is about \$3 billion less than estimated by the CBO on the basis of the *Daily Treasury Statements*. The main reason for this is because in February spending was lower than expected.

The deficit in March was \$95 billion, CBO estimates this is \$10 billion more than the deficit in the same month last year. Receipts totaled about \$166 billion in March this is about \$2 billion (or 1 percent) higher than receipts in March 2006. Outlays were \$11 billion (or 4 percent) higher this March than in the same month last year. The reason for this increase was said to be, a number of unusual circumstances. These circumstances include; about a \$3 billion increase that was due to the annual payments of military aid for Egypt and Israel—in fiscal year 2006, those payments were made in December. Last year, such adjustments (as for the Export-Import Bank, the Department of Veterans Affairs, and the Small Business Administration) lowered outlays by almost \$4 billion. There was an increase of \$2 billion in both spending for Social Security and net interest on the public debt compared to their levels last March. Medicaid outlays also grew by about \$1.5 billion.

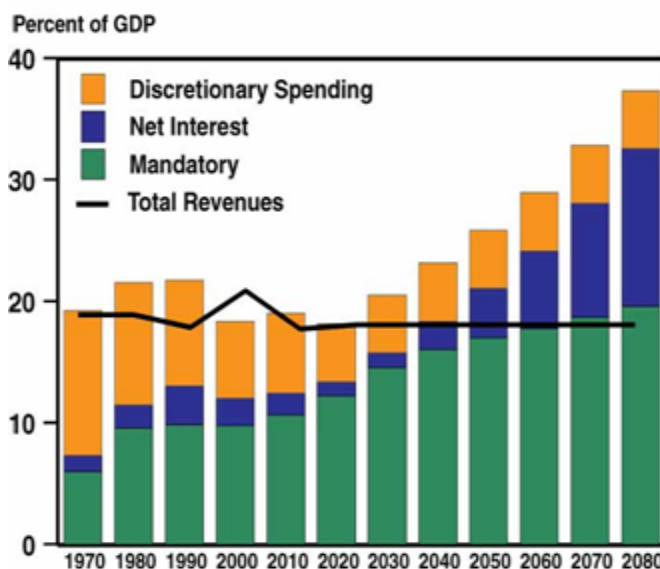
During the Budget review, each program was closely scrutinized to determine if it is among the Nation's top priorities and if the program is effective and producing the desired results. Programs that failed to meet these requirements are eliminated. Thus 141 programs have been eliminated and that led to savings of \$12.0 billion. This step helps channel resources to more effective programs. This improves program integrity and reduces waste—including improper payments to ineligible recipients.



The President's 2008 Budget reflects a series of budget reforms that will improve transparency and accountability in Government spending. The President has also called on the Congress to enact a legislative line-item veto. This would help the Executive and Legislative Branches work together to strike unwarranted earmarks

and other wasteful and unnecessary spending from the budget. Our Budget shows how the President can work with the Congress to achieve a balanced budget by 2012. This accomplishment will be brief and short lived unless we address the long term budgetary problems such as the unsustainable growth in Medicare, Medicaid, and Social Security. By 2040, spending on these and other mandatory programs will crowd out all discretionary spending—for defense, homeland security, or education—unless we take steps to reform these programs. The 2008 Budget takes an important step toward sensible reform of mandatory spending—saving \$96 billion over five years.

Current Trends are not Sustainable



Source: www.bea.gov

INDEX OF INDUSTRIAL PRODUCTION BY: MASENGU MULEBA

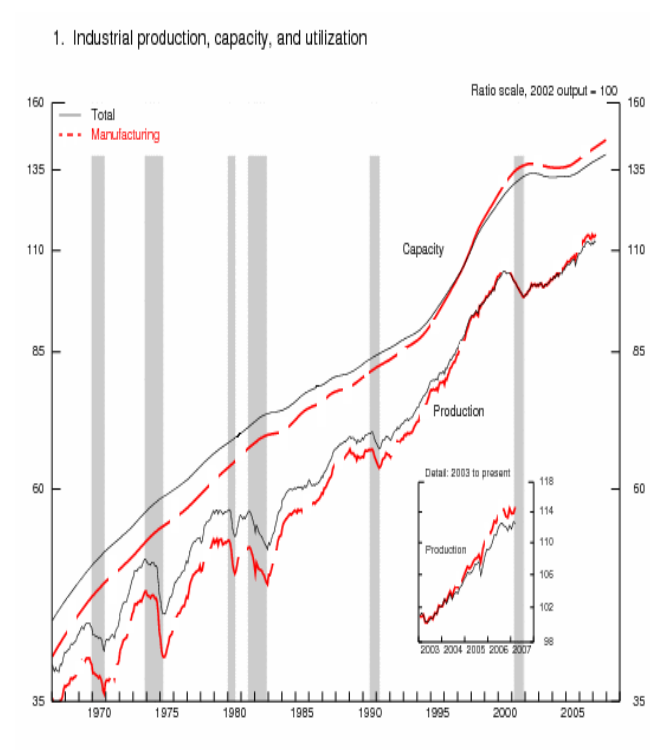
The Index of Industrial Production (IIP) is a short-term business indicator of industrial growth, where overall magnitude represents the status of production in the industrial sector for a given period with reference to a comparable base year. It is a statistical device, which enables us to measure (at a monthly frequency) the growth in the general level of industrial activity in the economy over a long period. The IIP is one of the most

important measures of economic activity that allow us to identify the turning points in economic development at an early stage.

The industrial production index measures the real output of the manufacturing, mining, and electric and gas utilities with the current base year being 2002. It is expressed as a percentage of real output in the base year. The index measures the average change in value of production between two periods of time, not the actual production level. It reflects variations in type and quality of the commodities and of the input materials; changes in stocks of finished goods and work in progress; and related services such as assembling of production units, mounting, installation, repairs, planning, and engineering.

IIP is based on a monthly survey on sales and stocks of finished products of industrial enterprises. The two main types of data source are output measured in physical units and data on inputs to the production process, from which output is inferred. Data on physical products, such as tons of steel, are obtained from private trade associations and from government agencies. When data on physical products are not available, estimates of output are based on either production-worker hours or electric power use by industry. The factors used to convert inputs into estimates of production are based on historical relationships between the inputs and the comprehensive annual data used to benchmark the industrial production indexes.

The first estimate of industrial production for a month is released around the 15th of the following month, and is subsequently revised in the next three months as new source data become available. The index is available in the Federal Reserve website at www.federalreserve.com. The overall industrial production for March 2007 is 112.5 percent of its 2002 average, meaning that industrial production has increased by 12.5 percent in five years, which decreased 0.2 percent from February. Included is a graph showing the yearly evolution of the industrial production index from 1966 to 2007, with 2002 as the base year. The shaded areas are periods of business recessions as defined by the National Bureau of Economic Research (NBER).



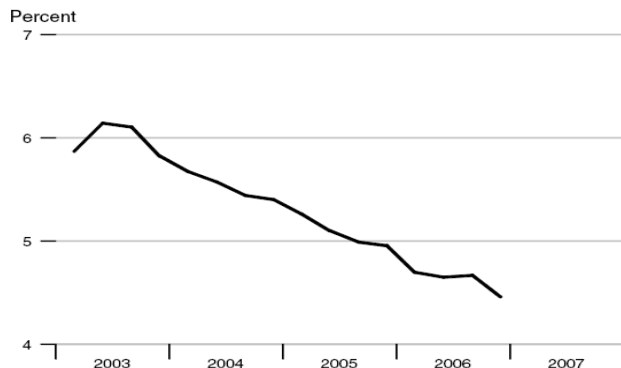
Source: www.federalreserve.com

JOB MARKET BY: DANIELLE WOO

Under the studies of Cletus C. Coughlin, he concluded that with turbulent times comes wavering belief in the system, in this case, the United States government. Last year, 2006, the Chicago Council on Global Affairs and a group of partners (Australia and Japan) surveyed the public for their view about the United States, China, India, and South Korea on various foreign policy issues. The American consensus felt that protecting the jobs of American workers should be top priority in U.S. foreign policy goals. The next three goals are: 1) preventing the spread of nuclear weapons, 2) combating international terrorism, and 3) securing adequate supplies of energy. From this study, it can be seen that public opinion helps explain why international trade legislation in the U.S. is so controversial. As many as sixty-seven percent from the study stated that there is an undesirable effect on American job security due to international trade. Approximately, thirty percent sees

an improvement of consumption, standard of living, and job security. As can be seen in the following chart – United States Employment has been increasing at a fluctuating rate every year, every quarter, with cases of employment decreases, and in an inverse, Unemployment has gradually decreased without un-employment increases since quarter 1 of FY2004.

Unemployment Rate



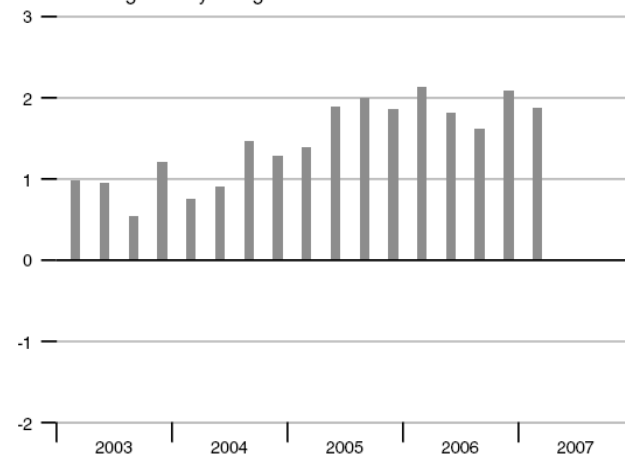
Popular fear of insecurity comes from the fact that China and India have become to merge themselves into the global economy. China is now a key to the rest of the world's manufactured goods, and India has become a widely accepted outsourcing location for services.

Like those who participated in the United States' conducted survey, surveyed population of Asian countries believe that protection of their country's jobs are of

United States

Employment

Percent change from year ago



highest priority in foreign policy. In China, protecting jobs was the highest-ranked foreign-policy priority; in South Korea, it was second behind promoting economic growth; and in India it was in a three-way tie with promoting economic growth and combating world hunger. In contrast to the United States' one-third percentage of the population that believe international trade promotes job security, India - forty-nine percent, South Korea - fifty-one percent (approximately half the

Employment

Percent change from year ago

	04.2	04.3	04.4	05.1	05.2	05.3	05.4	06.1	06.2	06.3	06.4	07.1
Canada	2.05	1.97	1.55	1.38	1.12	1.39	1.62	1.84	2.22	1.86	1.88	2.42
Euro Area	0.67	0.76	0.84	0.96	0.84	0.70	0.67	1.05	1.47	1.53	1.54	.
France	0.01	0.19	0.20	0.45	0.35	0.51	0.57	0.52	0.94	1.05	1.03	.
Germany	0.44	0.51	0.57	0.06	-0.33	-0.23	-0.05	0.11	0.72	1.00	1.13	.
Italy	0.33	0.38	0.03	0.43	0.07	-0.71	-0.51	1.09	2.04	1.88	1.51	.
Japan	0.19	0.23	0.12	0.19	0.44	0.59	0.50	0.55	0.25	0.13	0.72	.
United Kingdom	0.84	0.96	1.21	1.56	1.48	1.58	1.23	0.77	1.08	0.91	0.86	.
United States	0.90	1.46	1.28	1.38	1.88	1.99	1.85	2.12	1.81	1.62	2.08	1.87

Unemployment Rate

Percent

	04.1	04.2	04.3	04.4	05.1	05.2	05.3	05.4	06.1	06.2	06.3	06.4
Canada	7.34	7.25	7.04	7.12	6.96	6.86	6.72	6.49	6.41	6.20	6.43	6.15
Euro Area	8.80	8.87	8.80	8.77	8.77	8.67	8.43	8.40	8.20	7.90	7.77	7.60
France	9.58	9.60	9.61	9.59	9.61	9.66	9.70	9.72	9.72	9.55	9.32	9.09
Germany	9.40	9.57	9.60	9.60	9.73	9.73	9.13	9.23	8.80	8.30	8.40	7.93
Italy	8.14	8.15	7.87	7.91	7.89	7.66	7.70	7.54	7.33	6.79	6.58	6.53
Japan	4.91	4.65	4.78	4.54	4.56	4.35	4.33	4.48	4.25	4.09	4.14	4.07
United Kingdom	4.70	4.70	4.61	4.65	4.64	4.64	4.71	5.04	5.16	5.37	5.44	5.34
United States	5.67	5.57	5.44	5.40	5.26	5.10	4.99	4.96	4.70	4.65	4.67	4.46

population), and in China - sixty-five percent – is nearly two-thirds, all signify that Asians are inclined to believe that trade contributes to job security than job insecurity.

The majority (62 percent) of respondents to a September 2006 survey by the German Marshall Fund of the United States, however, believe that the U.S. government does a poor job in helping workers adjust to new competition.

Sources: www.bls.gov
stlouisfed.org
www.gmfus.org/doc/GMF

HOUSING MARKET BY: BRITTANY CONNORS

Will the weak housing market ever improve? Are gas prices really going to hit \$4? Is it even harder to find work now? Will business conditions and the economy get worse? These are just some of the many questions that Americans have been asking themselves lately. According to the Conference Board, as of April, the Consumer Confidence Index has declined further. This rose concerns in not only economists, but consumers as well.

The decline in consumer confidence did not come as a surprise to most individuals. Every month the Consumer Confidence Survey samples 5,000 U.S. households in order to get an understanding of their faith in the U.S economy. Back in March the consumer confidence index fell to a reading of 108.2 and fell ever further in April to a reading of 104.0. The Present Situation Index also decreased from 138.5 in March to a 131.3 in April. The Expectation Index fell from 87.9 to 85.8, which is its lowest level since August.

These declines according to the Conference Board Consumer Research Center are most likely due to a combination of weakening expectations in addition to a less favorable analysis of current day conditions of our economy. The April Decline was larger than most economists anticipated. Originally economists expected the index to fall no lower than 104.9. The decline in the Present Situation Index, which has not declined for six months, indicates not only further declines, but also a softening in the growth of the economy.

Consumers felt less positive in regards to the present-day conditions of the economy. According to the Conference Board Consumer Confidence Index, individuals that claimed conditions to be “good” decreased from 28.6 percent to 26.5 percent. Those that believe current conditions are “bad” increase to 15 percent from last months 14.5 percent. Labor market conditions were also a cause for concern for consumers in April. Jobs that are considered to be “hard to get” rose to 20.4 percent from 18.9 percent back in March. In relation to those results, jobs considered “plentiful” also fell to 27.8 percent from 30.3 percent. The release of this data also aided to the deflation of the initial rise in stock prices.

Like many American’s Lynn Franco, director of the Conference Board’s consumer research center, feels the rising gas prices are to blame. Franco stated, “the rising prices at the gas pump likely played a key role in dampening the mood of consumers in April.” Unfortunately the increase at the pumps is only a taste of what is in-store for us in months to come. In many states gas is already above \$3 a gallon and is expected to hit as high as \$4 a gallon by the summer. One big factor driving the prices is that gasoline inventories continue to fall. With refining activity falling and demand for oil rapidly increasing most drivers are cringing every time they get behind the wheel. So far states such as California, Hawaii, Oregon, Washington and Nevada all have average gas prices of around \$3.35. John Kilduff an analyst at Man Financial in New York believes that those states, the New England region of the United States as well as the northern Midwest will all see gas prices hitting \$4 a gallon by early summer.

But we can not blame everything entirely on the decline of refining activity. One of the biggest factors for our gas grief is the fact that we can’t seem to get enough of it. If we continue to be so gasoline dependent nationwide prices should have no trouble breaking the inflation-adjusted record of \$3.06 a gallon set back in 2005 when Hurricane Katrina hit the gulf coast. Other countries in Europe such as the Netherlands already know what its like to be spending most of their paycheck on gas considering gas prices range anywhere from \$6-\$7 on average.

In addition to the higher gasoline prices the continued declines in the housing market are also behind the weaknesses seen in April. Ian Shepherdson, chief U.S.

economist at High Frequency Economics, stated, “only 2.7% of consumers said they plan to buy a home in the next six months.” If this is true it will be the lowest level in 10 years. Most importantly, the uneasiness of the subprime-mortgage market is effecting consumers’ perceptions of the housing industry. This lack of interest in home buying explains the 8.4% decrease in existing homes sold. The National Association of Realtors claims this to be the biggest drop since January 1989. The latest signs of the weakening of the housing market show a record number of homes sitting vacant and for sale in the United States. The percentage of Americans owning homes has also slipped slightly. According to RealtyTrac there has also been a 47 percent upsurge year-over-year in foreclosures. The housing market was considered to be the biggest factor behind the first quarter slow down that we are experiencing in the economy.

Inflation excluding food and energy also played a role in the consumers’ lack of confidence when it rose 2.2 percent in the first quarter. But, not all news was bad for the state of the economy. Wages and salaries went up 1.1 percent, which has been an all time high since 2001. Consumers although experiencing lack of confidence in the economy continued to shop; therefore aiding the booming economy by spending 3.8 percent. Although slightly weaker than the last quarter the results were still solid. Despite the rising gas prices and the major housing slump consumers still remained resilient. A reason for this is that the job markets have managed to stay in relatively decent shape. The why unemployment rate is another reason consumers are trying to think on the upside, since it dropped to a five year low of 4.4 percent back in March.

Sources: www.marketwatch.com

www.cnnmoney.com

www.conference-board.org

www.biz.yahoo.com

THE SUB-PRIME MARKET BY: MICHAEL HAGGERTY

When discussing the subject of banking, the housing market or mortgages (the topic of prime and sub-prime markets) are bound to come up. A discussion on the

topic would focus mainly on the rates and loans attributed with the market. The prime rate is the rate charged to borrowers who are deemed the most credit worthy. The prime rate is generally set 3 percent above the Federal Funds Rate. Changes in the rate only occur when banks need to alter the rate at which borrowers obtain funds. The best place to view the prime rate would be in the Wall Street Journal under their Prime Rate Index. The prime rate is mainly used for calculating mortgages and other variable rate loans as well as the calculation of some private student loans. Many credit card companies that use variable interest rates base their rates on the prime rate plus a fixed value.

The sub-prime market is relatively new and due to its recent media coverage, will be the focus of this paper. The sub-prime rate is the rate charged to those with little or no credit history. Due to borrowers, being unable to apply for loans under the traditional criteria, sub-prime lending was created in the mortgage market (based on sub-prime rates). The two major benefits of sub-prime lending are that it increases the number of homeowners and that it offers an opportunity for homeowners to create wealth.

Traditionally the minimum lending standards are based on a number of different factors including the borrower’s income, payment history, down payment, and the underwriter’s knowledge of the borrower. This approach is characterized as nonprice credit rationing. In the sub-prime market, various pricing tiers and product types have been introduced. As a result, the sub-prime market has become more like price rationing or risk-based pricing. Risk based pricing is evident because of the different interest rates between the prime and sub-prime loans. What this means is that the sub-prime market practices price discrimination based on different factors such as delinquent payments, foreclosures, bankruptcies, debt ratios and credit scores. The difference between the prime and sub-prime rate is called the sub-prime premium, which is usually around 2 percentage points and is applied to the borrower.

The distinguishing feature between a prime and sub-prime loan is that the upfront and continuing costs are higher for sub-prime loans. Upfront costs consist of application fees, appraisal fees, and other fees associated with establishing a mortgage. Continuing costs consist of mortgage insurance payments, principle and interest payments and local fees such as property tax and

assessments. Sub prime borrowers may also be subjected to a prepayment penalty or a balloon payment. "A prepayment penalty is a fee assessed against the borrower for paying off the loan early – either because the borrower sells the house or refinances the high-rate loan...a balloon payment requires the borrower to pay off the entire outstanding amount in a lump sum after a certain period has passed, often five years."

The sub-prime market is considered extremely complicated and due to this, many consider it to be of great promise and great peril. Due to its ability to expand the market to those who may not normally be considered, sub-prime lending has become prevalent in neighborhoods with high concentration of minorities and weak economic conditions. However, the nature of expanding the market to those with questionable credit brings into account the relation of delinquent payments and defaulted loans with bad credit. This relation is the primary cause for why interest rates are much higher than those for prime loans.

The growth of the sub-prime market can be attributed to many factors. Lenders were not always able to charge high rates and fees to borrowers and it wasn't until the 1980's when lenders would see a change. In 1980 the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) was enacted which preempted state interest rate caps. In 1982, the Alternative Mortgage Transaction Parity Act (AMTPA) permitted the use of variable interest rates and balloon payments. DIDMCA and AMTPA set the groundwork for the sub-prime market but sub-prime lending would not become large scale until the Tax Reform Act of 1986 (TRA). The TRA had increased the demand for mortgage debt. This was done by prohibiting the deduction of interest on consumer loans but allowing interest deductions on mortgages for primary residences and one additional home. The sub-prime mortgage market did not gain national attention until the mid to late 1990s with the real estate boom.

With the growing demand, financial markets have continued to increase securitization on sub-prime loans. The rate of securitization has grown from less than 30 percent in 1995 to over 58 percent in 2003. Since most loans insured by the government are securitized, the sub-prime mortgage market has become similar to that of the prime market. Securitization is the repackaging, pooling and reselling of loans to investors as securities.

Fueled by the housing boom, the sub-prime market has gone from less than 5% of all new mortgages in 1994 to about 20% or \$600 billion currently

Influenced by the growing demand and the real estate boom, lenders were motivated to make as many loans as possible. This was done by granting mortgages with low starter/teaser interest rates to high-risk borrowers. The borrowers that received these loans had little or no documentation of their financial capacity to pay the debt, allowing them to have virtually no stake in the property if a problem were to occur. By doing this the lenders were taking a gamble by hoping that property prices would continue to rise, thus allowing the borrowers to refinance their way out of trouble or have the ability to sell for a profit. As a result of lenders greed and borrowers inability to pay, the market is starting to feel the affects of sub-prime lending.

Sub-prime loans have a probability that is six times higher than prime loans to default. The result of the high probability to default is limiting access to financial markets, foreclosures, and the loss of any wealth and equity achieved through house appreciation on mortgage payments. Foreclosures have a negative impact on neighborhoods by lowering the value of properties. One of the causes of the increasing foreclosures is poor underwriting. Underwriting is the detailed credit analysis done by the lender before granting a loan. The analysis is based on the financial information provided by the borrower (employment history, salary), publicly available information (credit history) and the lender's evaluation of the borrower's need and ability to pay.

The response to the growing number of delinquencies and foreclosures of what is becoming known as the sub-prime mess, is restriction. Regulators are applying lending restraints and standards (emphasis on better underwriting, improved documentation, debt-to-income analysis) where Congress is discussing action towards improving consumer protection laws. Some analysts and critics have even speculated the worst by stating that the sub-prime mess will not only affect the housing market, but overall economy as well as the possibility of a recession. Despite the new restrictions, the sub-prime mortgage has been 20 percent of the nation's lending volume for the last two years.

David Lereah, the chief economist of the National Association of Realtors (NAR) predicts "that about 10 to 25 percent of sub-prime households to be

unable to secure a mortgage loan because of today's stricter lending standards." Mr. Lereah goes on to explain that even though households will be restricted, they will eventually be able to afford a house due to growing income or saving for a down payment. His suggestion for the long term and short term is "the long term health of the housing market will probably stay in tact. In the near term, I would expect home sales to fall by 100,000 to 250,000 annually during the next two years due to tighter underwriting practices, slowing the nation's housing recovery."

'As for an impact on the economy itself, Mr. Lereah outlines four things that can occur. They are: one; if poor underwriting occurred in the sub-prime market, it is more likely this practice was carried over to Alt A and maybe the prime market. Two; with lenders being controlling and cautious they may be restricting some households from getting prime loans even though they can afford it. Three; the strong attention from the media may reduce overall consumer confidence. Four; the increasing amount of foreclosures could lower the prices and demand for homes.

Some researchers have come to the conclusion that both prepayment penalties and balloon payments are a reason for the high foreclosure rates. Others have come to the conclusion that lenders are using predatory tactics on naïve borrowers. Some of the tactics are to give borrowers absorbent fees and extremely high rates, tell the borrower their credit score is lower than it is, as well as pressuring a homeowner to refinance their mortgage frequently (so that the lender can charge high closing fees and add closing costs into the mortgage). The lender gains from these tactics from the profits they constantly get from closing fees as well as potentially acquiring the house.

The Center for Responsible Lending (CRL) predicts that 1 out of 5 sub-prime mortgages given between 2005 and 2006 will fail. The center also states that failure of these mortgages could cost Americans about \$164 billion in lost equity from 1998 to 2006. Where CRL offers a pessimistic view, Mortgage Banker's Association (MBA) states that CRL fails to recognize the fact that 85 to 90 percent of sub-prime borrowers do not default on their loans.

On March 27, 2007, John Robbins, the chairman of MBA, testified before the House of Representatives Financial Services Committee's subcommittee. In his statement to the subcommittee on Financial Institutions

and Consumer Credit, Robbins stated that "the sub-prime market should be stabilized, consumers facing foreclosure should receive assistance, and steps should be taken to avoid a recurrence of this phenomenon." The Federal Reserve's response is that Chairman Ben Bernanke's perspective is that lenders have failed to calculate the borrower's ability to repay their mortgages. Bernanke recommends that a federal anti-predatory lending law should be taken into consideration. The chairman of the Federal Reserve Bank of Dallas's Board of Directors, James Hackett, stated that the "financial system and economy is strong enough to weather the storm, and argued that regulatory agencies are striving to avoid radically changing credit standards, which could additionally slowdown the U.S. housing industry and economy." With all the different perspectives on the sub-prime market it is very hard to tell what is truly happening, however some of the critic's predictions are starting to manifest.

On April 2, New Century Financial Corp filed bankruptcy. As one of the nation's largest sub prime mortgage lenders it has joined the growing list of lenders trying to survive the struggling market. The sign that the sub-prime market is expanding its impact came from a report from M&T Bank Corp. Located in Buffalo, NY M&T Bank Corp reported, "that a recent auction shows investors don't want to buy its Alt-A loans. Bank officials feel the sub-prime home loan mess is inching up the mortgage ladder and hurting the rest of the market."

With the growing media coverage, as well as the mixed actions by the sub-prime market, little has been conveyed of the borrower's perspective, until now. On April 12, 2007, consumer groups called on Congress to reform the bankruptcy laws. The main purpose of the groups is to see a revision in the federal bankruptcy code that excludes home loans from bankruptcy protection. Bankruptcy is not the borrower's first choice but in their eyes, is the only way they can hold on to their home.

Some of the specific demands the consumer groups are calling for are: amending Chapter 7 of the bankruptcy code, end the bankruptcy code's special treatment of home mortgages, remove time consuming credit counseling requirements, curb excessive fees during bankruptcy, end mandatory arbitration in bankruptcy, and create a minimum homestead exemption for the elderly. Besides changes in the bankruptcy laws, there have

been calls for lawmakers to provide federal aid to assist the troubled homeowners.

However, there are some who are against the reforming of the bankruptcy laws. Floyd Stoner who is the executive director for congressional relations policy at American Bankers Association stated, "The focus should be on working with borrowers in financial distress, rather than focusing on changing bankruptcy as the first response to these concerns." Chris Stinebert, the chief executive of the American Financial Services Association stated that changing the bankruptcy laws would not stop the rising foreclosures. Mr. Stinebert also stated, "Laws that prevent mortgage terms from being changed in bankruptcy gives lenders the predictability and uniformity they need to continue to make loans to deserving borrowers [and] the last thing the real estate market needs right now is more uncertainty."

The sub-prime mess cannot be viewed as a one sided issue. On one side, you have lenders who were unaware and lenders who took advantage. The other side consists of borrowers who truly need the sub-prime market to get a home and the select few who knew that they could not afford it but hoped for the best. This is the nature of such things and the nasty sides are always revealed and focused on. Besides finding ways to assist the borrowers, I feel that congress and the Federal Reserve should focus on ways to contain and ensure that this mess does not happen again.

My two final points, are one of concern and one of observation. The note of concern to consider is if congress does reform the bankruptcy laws, is the government suppose to eat the debt of two million borrowers who are in danger of foreclosing? One observation that can come from this whole sub-prime mess is that the knowledge of the sub-prime market was not widely known. As a result, congress should consider finding ways in educating the public on financial matters. By doing so, some problems may be averted in the future.

Sources: www.reuters.com/article

www.marketwatch.com

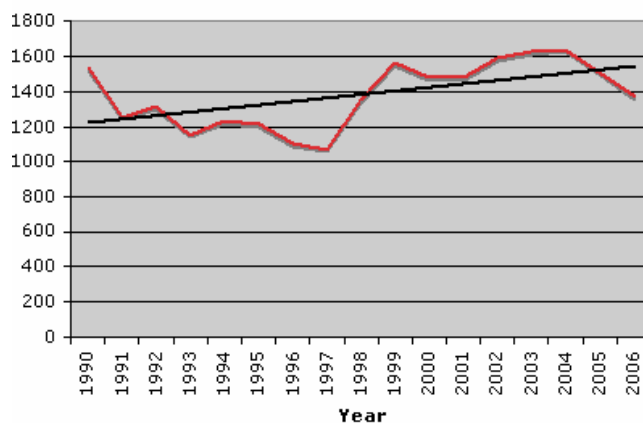
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THE LOCAL ECONOMY

BY: MICHAEL HAGGERTY

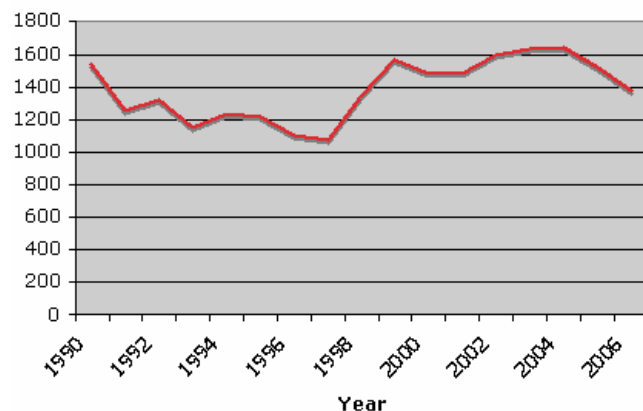
There has been substantial growth in new housing in Monroe County since 1990. This is evident in the amount of building permits filed each year (Figure 1.)

**Total Residential Building Permits
Monroe County, PA 1990-2006**



The growth of new housing started on a decline from 1990 with 1534 permits to 1997 with 1071 permits. Between 1997 and 1999 there was a jump from 1071 permits to 1565. From 1999 to 2001 the permits dipped a little and then the total permits filed in Monroe County would reach the highest total over the 17 years in 2004 at 1644 permits. Since 2004 though it has been on the decline from 1514 in 2005 and 1372 in 2006. However if you look at Figure 2, despite the dips over the past 17 years the total amount of permits have been on the rise

**Total Residential Building Permits
Monroe County, PA 1990-2006**



(depicted by the trend line).

As for the possibility of seasonality affecting the amount of permits Figure 3 depicts the difference in the four quarters from 2000-2006 and the first quarter in 2007. There has been some seasonality with the peaks being in the second quarter (May-Aug) which makes sense considering in the warmer months building new houses would be at it's highest. However the possibility of a decline in the amount of houses being built in Monroe County may be evident in the way the quarters behaved in 2005 and 2006. The peaks in both 2005 and 2006 are lower than those in the previous years, which is suggestive of a decline in new housing.

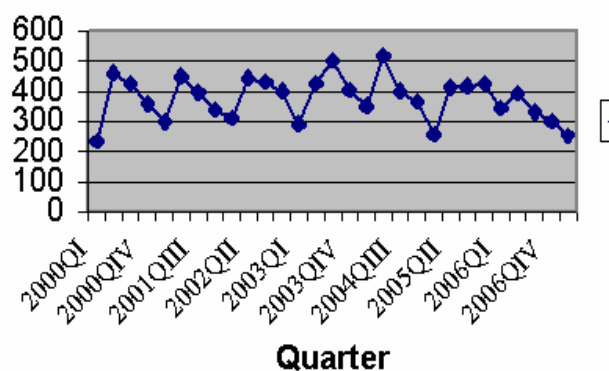
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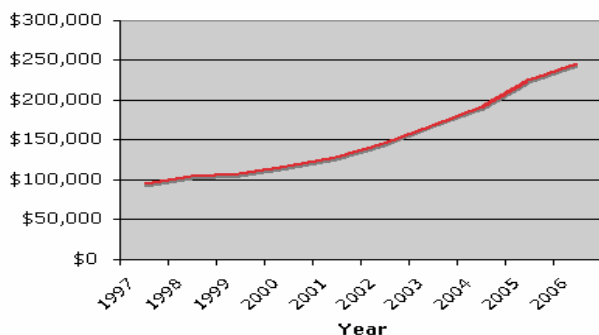
Editors Note: In E-News Volume 13 Issue 1, the article entitled State of the National Economy written by Micheal Haggerty, was co-authored by Justin Clinton.

**Total Residential Building Permits
by Quarter 2000-2007**



Despite some of the dips in building permits and the affects of seasonality the housing market seems to be unaffected by it. Since 1997 the average list price for a residential single-family house has been on the rise. In 1997 the average price was \$95,315 to \$258,635 in 2007 (Figure 4).

**Average List Price for
Single Family Residential Housing
1997-2006**



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