

DAILY GLOBAL  
COMMENTARY

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## Mr. Bernanke Attempts to Prop Up Dollar, but Is Incorrect About Assessment of Economy

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The ECB is widely expected to raise the policy rate at the July 3 meeting. This is not a terribly supportive action for the dollar. The Fed is in a tough spot and not in a position to raise the federal funds rate. The alternative is to talk about a strong dollar and raise the importance of inflation, which Bernanke has done in the past week. He was concerned about economic growth and inflation but inflation appears to be of greater significance.

The dollar's recent history shows a more than noticeable but gradual erosion in value since January 2002. As of June 9, 2008 the trade weighted dollar (71.13) has dropped about 36.8% from its peak in 2002 (see chart 1).

Chart 1  
Nominal Trade-Weighted Exch Value of US\$ vs Major Currencies  
3/73=100



In order to reduce the inconsistency of monetary policy for a strong dollar and a weak economy, the Fed appears to have moved the emphasis to inflation and the dollar. In doing so, Bernanke made these remarks last night.

*“Before turning to those issues, however, I would like to provide a brief update on the outlook for the economy and policy, beginning with the prospects for growth. Despite the unwelcome rise in the unemployment rate that was reported last week, the recent incoming data, taken as a whole, have affected the outlook for economic activity and employment only modestly. **Indeed, although activity***

*during the current quarter is likely to be weak, the risk that the economy has entered a substantial downturn appears to have diminished over the past month or so. Over the remainder of 2008, the effects of monetary and fiscal stimulus, a gradual ebbing of the drag from residential construction, further progress in the repair of financial and credit markets, and still-solid demand from abroad should provide some offset to the headwinds that still face the economy. However, the ongoing contraction in the housing market and continuing increases in energy prices suggest that growth risks remain to the downside.”*

With all due respect, we beg to differ with Bernanke’s assessment of the economy. On several counts, the economy is not improving! **First**, a new cycle low for banking index (PHLX) was recorded on June 9 (67.37), which implies that the credit crunch is not on its last legs. The recent Senior Loan Officers Survey showed significant tightening of loan underwriting standards across the board – consumer and business loans. The fragile status of banks suggests that additional tightening of lending standards should not be surprising. The broader implication is that economic growth will suffer a setback because credit is the oil that lubricates business activity.

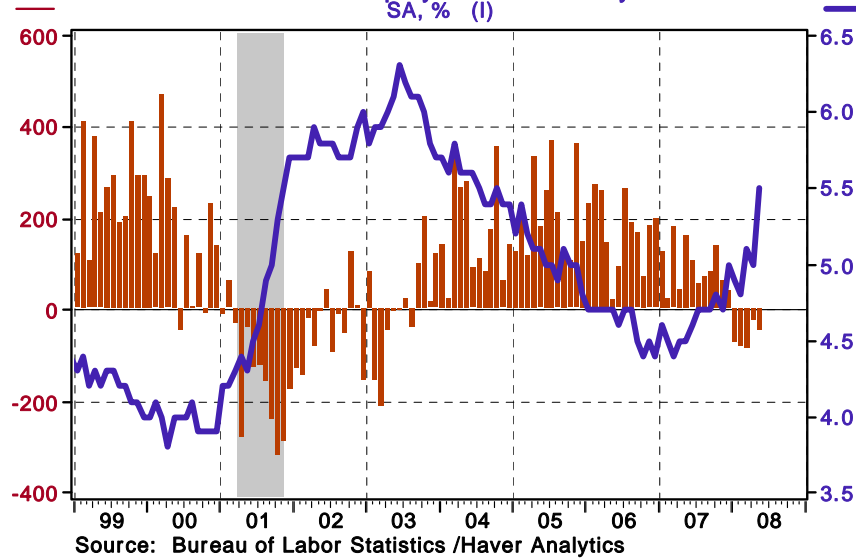
Chart 2



**Second**, economic reports continue to suggest that the fundamentals of the economy remain weak – (a). The unemployment rate at 5.5% and a year-to-date decline in payrolls of 324,000 is not symptomatic of improving conditions.

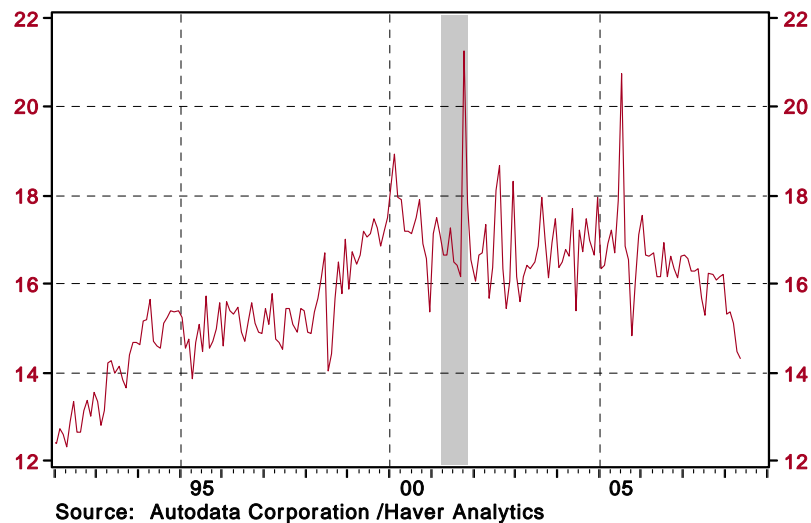
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Chart 3  
 ← All Employees: Total Nonfarm  
 Difference - Period to Period SA, Thous (I)  
 Civilian Unemployment Rate: 16 yr + →  
 SA, % (I)



(b). Auto sales have dropped for four out of five months of the year to a level last seen in mid-1995, excluding the strike-related decline in 1998. Consumer spending numbers for May will be published later in the month. Retail sales for May will be available on June 12. Rebate checks are expected to have lifted retail sales. But, rising gasoline prices are diverting consumer dollars away from other expenditures.

Chart 4  
 Total Light Vehicle Retail Sales {Imported+Domestic}  
 SAAR, Mil. Units (I)



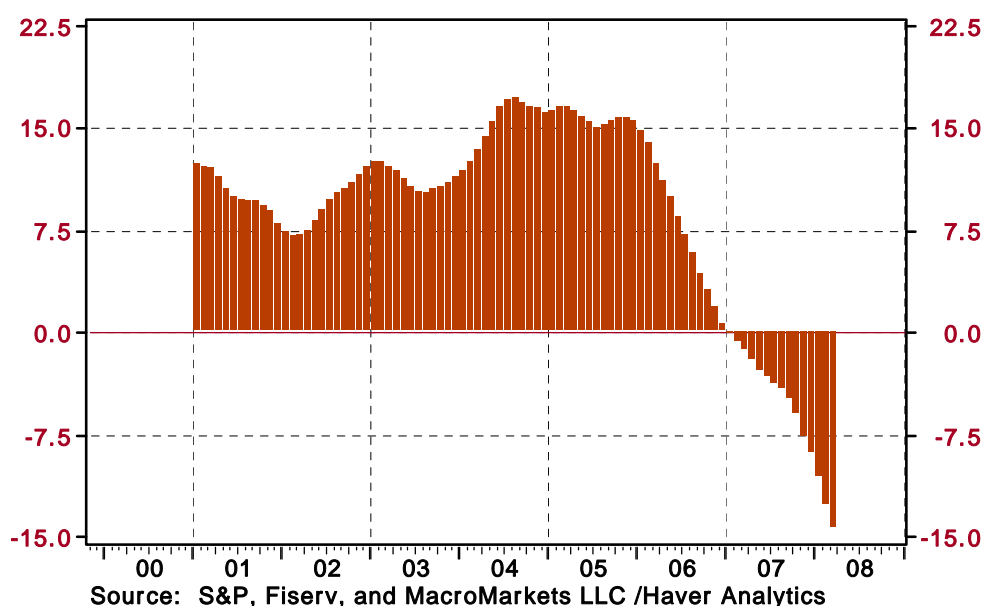
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(c). The large inventory of unsold homes is creating significant downward pressure on home prices. Currently, there is a 10.5-month supply of unsold homes (new and existing) versus a median of 6.4 month supply. Home prices are declining at an accelerated pace. The Case-Shiller Home Price Index fell 14.5% on a year-to-year basis in March, largest on record in the short history of the series.

Chart 5

**S&P/Case-Shiller Home Price Index: Composite 20**

% Change - Year to Year      NSA, Jan-00=100



(d). Net worth of households declined \$1.7 trillion in the first quarter of 2008. The combined loss in net worth of households in the last two quarters -- \$2.226 trillion -- is 68% of the loss in net worth of households during 2000-2002 and exceeds the loss in net worth recorded in 2001 (-\$1.01 trillion) and 2002 (-\$1.587 trillion). A part of the loss in net worth during the first quarter is related to a drop in home prices. This is the asset which has supported mortgage equity withdrawals. The important conclusion is that the decline in home prices has reduced the ability of households to borrow and support expenditures. Equity prices have recovered from the low of March 10, 2008 but the news on home prices remains grim. Against the backdrop of these economic numbers, Chairman Bernanke's comments need a complete explanation.

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## Nominal Trade Gap Widens, Mostly due to Imported Oil

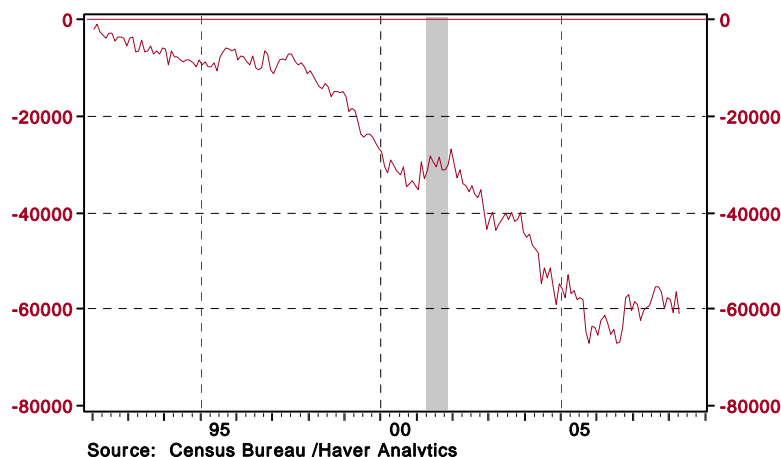
The trade deficit of the U.S. economy widened to \$60.9 billion in April from a revised \$56.5 billion deficit in March (previously estimated as \$58.2 billion). Most of the widening of the trade deficit was due to a higher oil import bill. The petroleum-related trade deficit widened to \$34.5 billion from \$30.2 billion in March. The price of a barrel of imported crude oil increased nearly \$7.00 in May. In addition to higher prices, the quantity of imported oil also rose in May. The non-petroleum trade gap of goods was virtually unchanged.

### International Trade – April 2008

	Trade Balance			Exports (m-o-m % change)		Imports (m-o-m % change)	
	Goods & Services	Goods	Goods - 2000\$	Goods & Services	Goods - 2000\$	Goods & Services	Goods - 2000\$
Oct-07	-56.3	-67.7	-51.8	0.9	0.3	1.1	-0.2
Nov-07	-59.9	-71.7	-52.5	0.8	0.0	2.3	0.4
Dec-07	-57.6	-69.5	-50.2	0.6	0.1	-0.7	-1.6
Jan-08	-57.9	-70.1	-50.4	2.8	1.5	2.1	1.1
Feb-08	-60.6	-72.5	-51.2	2.2	2.4	2.9	2.2
Mar-08	-56.5	-68.4	-47.0	-1.9	-4.7	-3.3	-6.0
<b>Apr-08</b>	<b>-60.9</b>	<b>-72.9</b>	<b>-46.9</b>	<b>3.3</b>	<b>4.5</b>	<b>4.5</b>	<b>2.9</b>

Exports of goods and services increased 3.3% in April. Inflation adjusted exports of goods rose 4.5%, reflecting gains in exports of capital goods excluding autos (+5.5%), consumer goods excluding autos (+6.1%), and autos (+6.5%). Exports are projected to make noticeable contributions to GDP in the quarters ahead. Imports of good and services increased 4.5%, after a 4.7% decline in the prior month. Inflation adjusted imports of goods moved up 2.9% in April, following a 6.0% drop in March. Imports of capital goods excluding autos (+2.7%), consumer goods excluding autos (+1.6%), and autos (+4.6%) rose in April after each of them posted declines in March.

Chart 6  
Trade Balance: Goods and Services, BOP Basis  
SA, Mil.\$



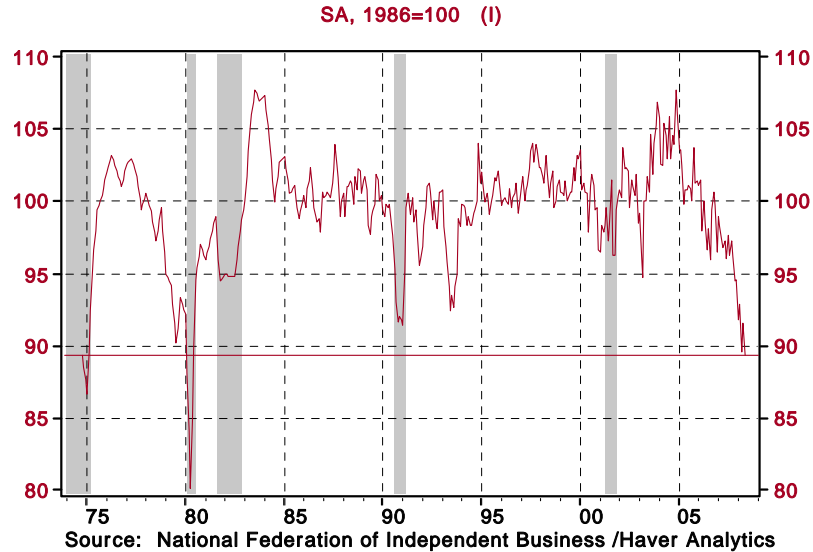
The trade gap vis-à-vis China (\$20.2 billion vs. \$16.01 billion), EU (\$8.5 billion vs. -\$7.5 billion in March), Canada (\$7.6 billion vs. \$6.4 billion in March), and Japan (\$7.56 billion vs. -\$7.49 billion in March) widened in April.

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## Small Business Survey – Gloomy Outlook Again

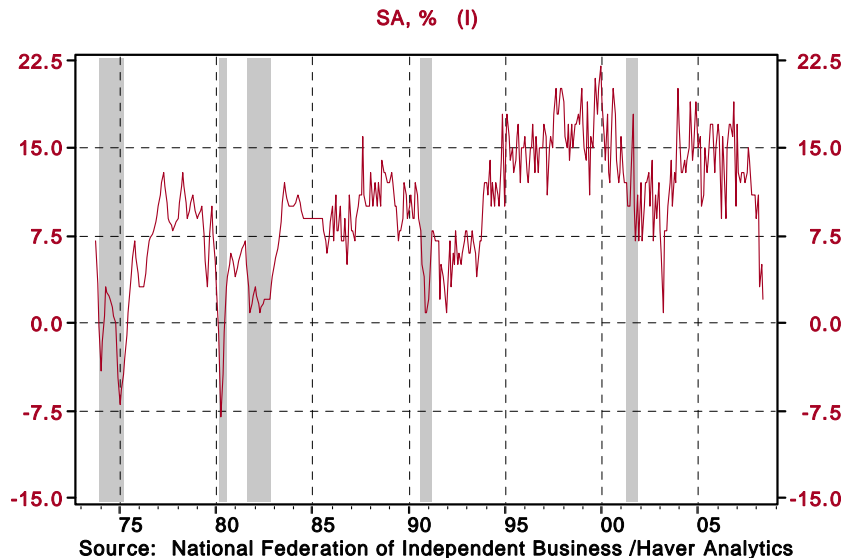
The NFIB Survey for May paints a gloomy picture of business conditions among small businesses. The Small Business Optimism Index dropped to 89.3 in May – a new cycle low and the lowest since April 1980.

Chart 7  
NFIB: Small Business Optimism Index



The net percentage of firms planning to increase employment was only 2.0% in May, the lowest since March 2003. This reading matches levels seen in prior recessions (see chart 8).

Chart 8  
NFIB: Percent Planning to Increase Employment, Net



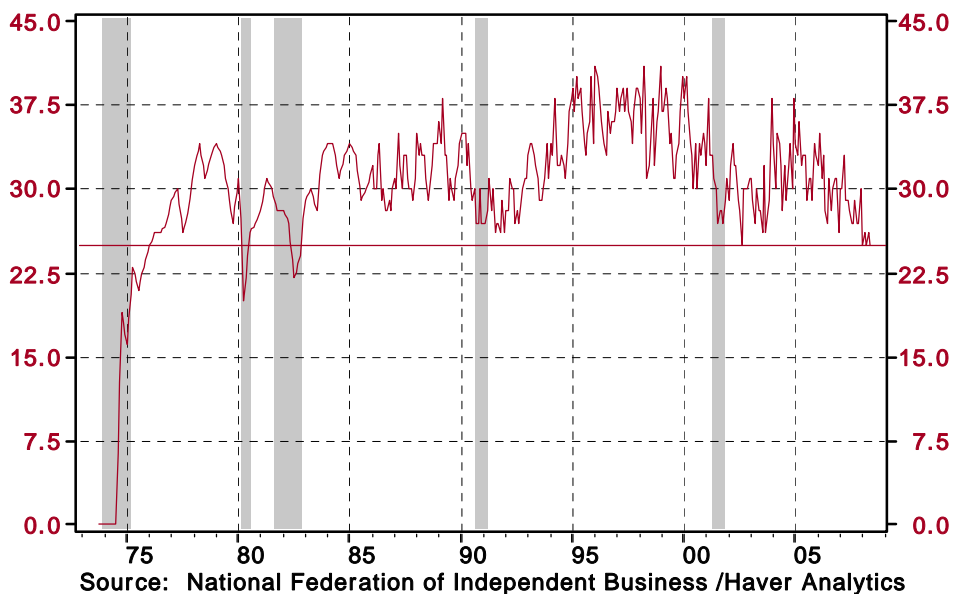
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The percentage of firms planning to increase capital expenditures (25%) in the next 3-6 months is at a new cycle low.

Chart 9

**NFIB: Percent Planning Capital Expenditures next 3 to 6 Months**

SA, % (I)



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