

Answer on Question #44107 – Economics – Other

Use the aggregate expenditure model developed in this chapter to explain the following statements:

- a. Coming amid continued turmoil in the financial and credit markets, the report sent stocks lower, with the Dow Jones Industrial Average falling 146.70 points Friday to close at 11,893.69.

Solution

Aggregate expenditure (AE) is the sum of consumption, investment, government purchases, and net export. Of these four sectors, the consumption represents the largest share. U.S. employers shed 63,000 jobs last month, the most in five years, reinforcing a widening view that the U.S. is falling into recession. Among economists and politicians, the debate is shifting to how deep the downturn will be and how to ease it. The jobs dropoff came after the nation lost 22,000 jobs in January, the Labor Department said. In the past, such back-to-back monthly employment declines have occurred only around recessions. Coming amid continued turmoil in the financial and credit markets, the report sent stocks lower, with the Dow Jones Industrial Average falling 146.70 points Friday to close at 11,893.69. The index lost 3% for the full week.

The big financial news of the day was that Thornburg Mortgage Inc., which has big holdings of mortgage-backed securities, warned it is at risk of going under. Carlyle Capital Corp., an Amsterdam-listed investment fund affiliated with private-equity giant Carlyle Group, reported a new wave of demands by lender to put up more collateral. Easing the worries slightly, the Federal Reserve said it is stepping up efforts to restore credit markets to health by injecting cash into money markets and making larger direct loans to banks. The Fed's actions were an effort to bring down interest rates banks charge to one another and stabilize the market for mortgage-backed securities, whose falling prices have lowered the value of the collateral posted by firms that hold large quantities of them, such as Thornburg and Carlyle. As banks demand more collateral and the firms are forced to sell assets, prices fall further.

Roughly \$8 billion worth of bonds held by Thornburg were thrown on to the market in the past two days as the company struggled to raise cash and lenders liquidated its assets. Before the employment report, many economists had said the labor market, while weakening, wasn't signaling that the economy was in a recession. Many changed their tune Friday, saying it's probable the U.S. economy, punished by falling home prices and troubles at financial institutions, is already in a recession. Private-sector jobs fell by 101,000, the third straight month of declines. The February unemployment rate edged down to 4.8% from 4.9%, but only because some job-seekers quit looking for work.

"I believe we are facing the most serious...economic and financial stresses that the U.S. has faced in at least a generation -- and possibly much longer," Lawrence Summers, who was Treasury secretary during the Clinton administration, said Friday at a Stanford University conference. "We are in nearly unprecedented territory with respect to financial strain." Edward Lazear, chairman of President Bush's Council of Economic Advisers, told reporters, "I'm still not saying that there is

a recession," but "there is no denying that when you get negative job numbers, realistically the economy is less strong than we had hoped it would be."