

U.S. Economic Report 1H-2008

(Source: Board of Governors of the Federal Reserve System's Monetary Policy Report to the Congress, July 15, 2008)

Summary

The U.S. economy remained sluggish in the first half of 2008, and steep increases in commodity prices boosted consumer price inflation. The housing market continued to contract, weighing on overall economic activity. Against a backdrop of mounting losses incurred by major financial institutions, financial market conditions deteriorated sharply further toward the end of the first quarter--a development that threatened to severely impair the functioning of the overall financial system and to hinder economic growth. In response, the Federal Reserve undertook a number of significant actions to address liquidity pressures faced by banks and other financial institutions, thereby augmenting the liquidity-enhancing measures implemented in the second half of 2007. Taken together, these measures fostered some improvement in the functioning of financial markets, but considerable strains persist. In view of the implications of the substantial reduction in credit availability and the continuing decline in housing activity for the economic outlook, the Federal Open Market Committee (FOMC) further eased the stance of monetary policy. After cutting the target federal funds rate 100 basis points in the second half of 2007, the FOMC reduced rates another 225 basis points over the first four months of 2008. The further easing of policy was seen as consistent with fostering price stability over time, given the Committee's expectation that a flattening-out of energy prices and increasing economic slack would damp inflationary pressures.

Financial Markets

Over the second quarter, financial market conditions improved somewhat--credit spreads generally narrowed, liquidity pressures ebbed, and financial institutions made progress in raising new capital. Still, asset prices continue to be volatile, and many financial markets and institutions remain under considerable stress. Very recently, the share prices of Fannie Mae and Freddie Mac dropped sharply on investor concerns about their financial condition and capital position. The

Treasury announced a legislative initiative to bolster the capital, access to liquidity, and regulatory oversight of the government-sponsored enterprises (GSEs). As a supplement to the Treasury's existing authority to lend to the GSEs, the Board of Governors established a temporary arrangement that allows the Federal Reserve to extend credit to Fannie Mae and Freddie Mac, if necessary.

Job Markets

The sluggish pace of economic activity in the first half of 2008 was accompanied by a further deterioration in the labor market. Private-sector payroll employment declined at an average monthly pace of 94,000, and the unemployment rate rose to 5-1/2 percent. Moreover, real labor income appears to have been flat in the first half of the year. Although wages rose in nominal terms, the purchasing power of those nominal gains was eroded by the rapid increases in consumer prices. Declining employment, stagnant real wages, and lower equity and home values weighed on consumer sentiment and spending. In addition, amid falling house prices and rising foreclosures, activity in the housing sector continued to decrease. The resulting softness in business sales and profits also made the environment for capital spending less hospitable. The weakness in overall domestic demand was partly offset by strong growth of exports, which were supported by a sustained expansion of foreign activity and a lower dollar.

Inflation

The substantial further rise this year in the prices of many commodities, especially oil and agricultural products, largely reflected strong growth of physical demand that outstripped supply in these markets. Although weakening economic activity and rising prices have tempered demand for commodities in many industrialized nations, demand has continued to grow in booming emerging market economies. However, supplies of commodities have generally not kept pace for a variety of reasons, including political tensions in some oil-producing nations, higher input costs, lags in the development of new capacity, and more recently, floods in the Midwest. To varying degrees, the resulting increases in materials prices have passed through into retail prices of energy, food, and some other items.

Overall consumer price inflation, as measured by the price index for personal consumption expenditures, remained elevated in the first half of 2008, largely because of the sharp increases in the prices of many commodities. The decline in

the foreign exchange value of the dollar has boosted import prices more generally and thus has also put upward pressure on inflation. Nonetheless, increases in labor costs and core consumer prices (which exclude the direct effects of movements in energy and food prices) have remained moderate. The rapid advance in overall prices has boosted some measures of inflation expectations: Near-term inflation expectations have risen considerably in recent months, and some indicators of longer-term inflation expectations have also moved up—a development that will require close monitoring in the period ahead.