

## **U.S. Economic Report 2H-2007**

(Source: Board of Governors of the Federal Reserve System's Monetary Policy Report to the Congress, February 27, 2008)

### **Summary**

The U.S. economy has weakened considerably since last July, when the Federal Reserve Board submitted its previous *Monetary Policy Report to the Congress*. Substantial strains have emerged in financial markets here and abroad, and housing-related activity has continued to contract. Also, further increases in the prices of crude oil and some other commodities have eroded the real incomes of U.S. households and added to business costs. Overall economic activity held up reasonably well into the autumn despite these adverse developments, but it decelerated sharply in the fourth quarter. Moreover, the outlook for 2008 has become less favorable since last summer, and considerable downside risks to economic activity have emerged. Headline consumer price inflation picked up in 2007 as a result of sizable increases in energy and food prices, while core inflation (which excludes the direct effects of movements in energy and food prices) was, on balance, a little lower than in 2006. Nonetheless, with inflation expectations anticipated to remain reasonably well anchored, energy and other commodity prices expected to flatten out, and pressures on resources likely to ease, monetary policy makers generally have expected inflation to moderate somewhat in 2008 and 2009. Under these circumstances, the Federal Reserve has eased the stance of monetary policy substantially since July.

### **Financial Markets**

The turmoil in financial markets that emerged last summer was triggered by a sharp increase in delinquencies and defaults on subprime mortgages. That increase substantially impaired the functioning of the secondary markets for subprime and nontraditional residential mortgages, which in turn contributed to a reduction in the availability of such mortgages to households. Partly as a result of these developments as well as continuing concerns about prospects for house prices, the demand for housing dropped further. In response to weak demand and high inventories of unsold homes, homebuilders continued to cut the pace of new construction in the second half of 2007, pushing the level of single-family starts in

the fourth quarter more than 50 percent below the high reached in the first quarter of 2006.

After midyear, as losses on subprime mortgages and related structured investment products continued to mount, investors became increasingly skeptical about the likely credit performance of even highly rated securities backed by such mortgages. The loss of confidence reduced investors' overall willingness to bear risk and caused them to reassess the soundness of the structures of other financial products. That reassessment was accompanied by high volatility and diminished liquidity in a number of financial markets here and abroad. The pressures in financial markets were reinforced by banks' concerns about actual and potential credit losses. In addition, banks recognized that they might need to take a large volume of assets onto their balance sheets--including leveraged loans, some types of mortgages, and assets relating to asset-backed commercial paper programs--given their existing commitments to customers and the increased resistance of investors to purchasing some securitized products. In response to those unexpected strains, banks became more conservative in deploying their liquidity and balance sheet capacity, leading to tighter credit conditions for some businesses and households. The combination of a more negative economic outlook and a reassessment of risk by investors precipitated a steep fall in Treasury yields, a substantial widening of spreads on both investment-grade and speculative-grade corporate bonds, and a sizable net decline in equity prices.

## **Gross Domestic Product**

Initially, the spillover from the problems in the housing and financial markets to other sectors of the economy was limited. Indeed, in the third quarter, real gross domestic product (GDP) rose at an annual rate of nearly 5 percent, in part because of solid gains in consumer spending, business investment, and exports. In the fourth quarter, however, real GDP increased only slightly, and the economy seems to have entered 2008 with little momentum. In the labor market, growth in private-sector payrolls slowed markedly in late 2007 and January 2008. The sluggish pace of hiring, along with higher energy prices, lower equity prices, and

softening home values, has weighed on consumer sentiment and spending of late. In addition, indicators of business investment have become less favorable recently. However, continued expansion of foreign economic activity and a lower dollar kept U.S. exports on a marked uptrend through the second half of last year, providing some offset to the slowing in domestic demand.

## **Inflation**

Overall consumer price inflation, as measured by the price index for personal consumption expenditures (PCE), stepped up to 3-1/2 percent over the four quarters of 2007 because of the sharp increase in energy prices and the largest rise in food prices in nearly two decades. Core PCE price inflation picked up somewhat in the second half of last year, but the increase came on the heels of some unusually low readings in the first half; core PCE price inflation over 2007 as a whole averaged slightly more than 2 percent, a little less than in 2006.