

U.S. Economic Report 2H-2008

(Source: Board of Governors of the Federal Reserve System's Monetary Policy Report to the Congress, February 24, 2009)

Summary

The U.S. economy weakened markedly in the second half of 2008 as the turmoil in financial markets intensified, credit conditions tightened further, and asset values continued to slump. Conditions in the labor market worsened significantly after early autumn, and nearly all major sectors of the economy registered steep declines in activity late last year. Meanwhile, inflation pressures diminished appreciably as prices of energy and other commodities dropped sharply, the margin of resource slack in the economy widened, and the foreign exchange value of the dollar strengthened.

Financial Markets

The second half of 2008 saw an intensification of the financial and economic strains that had initially been triggered by the end of the housing boom in the United States and other countries and the associated problems in mortgage markets. The ensuing turmoil in global credit markets affected asset values, credit conditions, and business and consumer confidence around the world. Over the summer, a weakening U.S. economy and continued financial turbulence led to a broad loss of confidence in the financial sector. In September, the government-sponsored enterprises Fannie Mae and Freddie Mac were placed into conservatorship by their regulator, and Lehman Brothers Holdings filed for bankruptcy. The insurance company American International Group, Inc., or AIG, also came under severe pressure, and the Federal Reserve, with the full support of the Treasury, agreed to provide substantial liquidity to the company. In addition, a number of other financial institutions failed or were acquired by competitors. As a result of the Lehman Brothers bankruptcy, a prominent money market mutual fund suffered capital losses, which prompted investors to withdraw large amounts from such funds. The resulting massive outflows undermined the stability of short-term funding markets, particularly the commercial paper market, upon which corporations rely heavily to meet their short-term borrowing needs. Against this backdrop, investors pulled back broadly from risk-taking in September and

October, liquidity in short-term funding markets vanished for a time, and prices plunged across asset classes. Securitization markets, with the exception of those for government-supported mortgages, essentially shut down.

Employment

Reflecting in part the adverse developments in financial markets, economic activity dropped sharply in late 2008 and has continued to contract so far in 2009. In the labor market, the pace of job losses quickened considerably beginning last autumn, the unemployment rate has risen to its highest level since the early 1990s, and other measures of labor market conditions--for example, the number of persons working part time because full-time jobs are not available--have worsened noticeably. The deteriorating job market, along with the sizable losses of equity and housing wealth and the tightening of credit conditions, has depressed consumer sentiment and spending; these factors have also contributed to the continued steep decline in housing activity.

Gross Domestic Product

In addition, businesses have instituted widespread cutbacks in capital spending in response to the weakening outlook for sales and production as well as the difficult credit environment. And in contrast to the first half of the year--when robust demand for U.S. exports provided some offset to the softness in domestic demand--exports slumped in the second half as economic activity abroad fell. In all, real gross domestic product (GDP) in the United States declined slightly in the third quarter of 2008 and is currently estimated by the Bureau of Economic Analysis to have dropped at an annual rate of 3-3/4 percent in the fourth quarter; real GDP seems headed for another considerable decrease in the first quarter of 2009.

Inflation

The downturn in sales and production, along with steep declines in the prices of energy and other commodities and a strengthening in the exchange value of the dollar, has contributed to a substantial lessening of inflation pressures in the past several months. Indeed, overall inflation, as measured by the price index for personal consumption expenditures, turned negative in the fourth quarter of 2008; over the first three quarters of the year, overall inflation had averaged nearly 4-1/2 percent at an annual rate, largely because of sharp increases in food and energy prices. Core inflation--which excludes the direct effects of movements in

food and energy prices--also slowed significantly late last year and entered 2009 at a subdued pace. Mirroring the drop in headline inflation, survey measures of near-term inflation expectations have fallen to very low levels in recent months, while the latest readings on longer-term inflation expectations are similar to those in 2007 and early 2008.