

Economic Research – Scott J. Brown, Ph.D.

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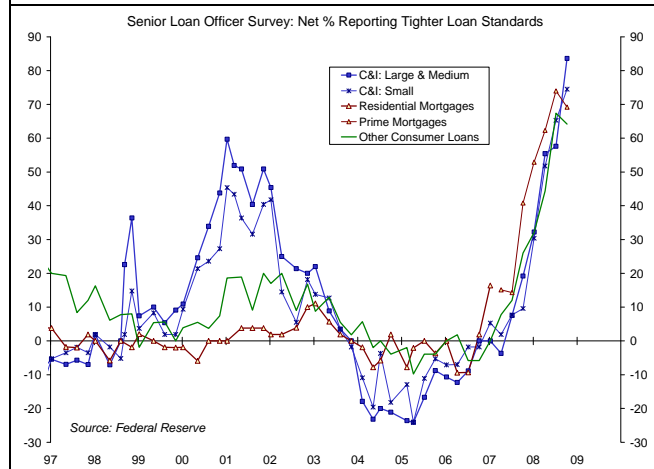
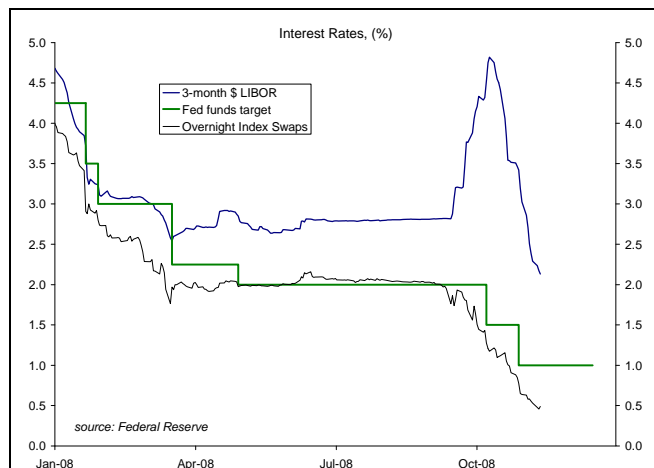
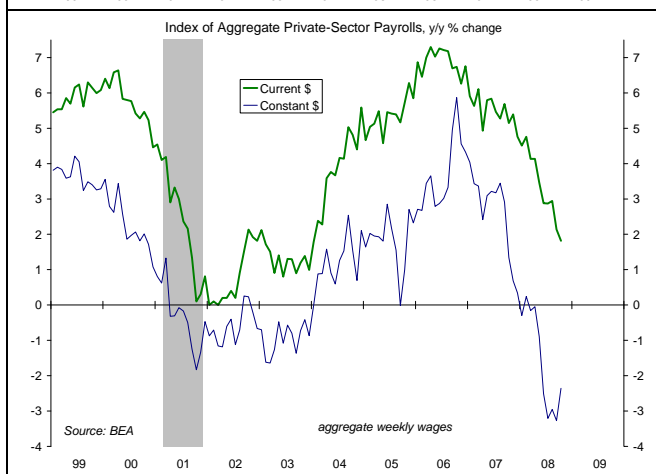
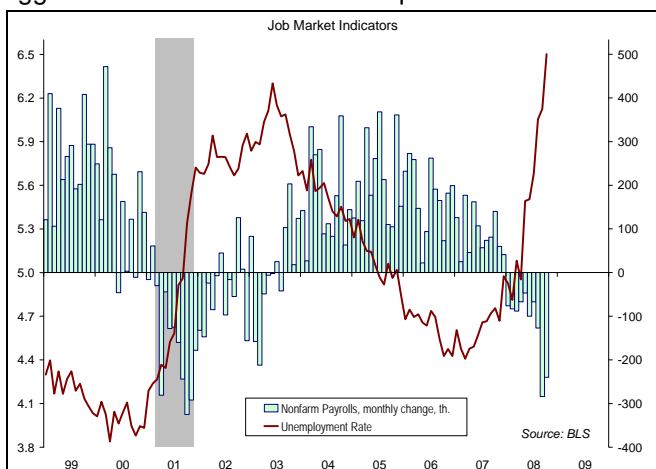
In The Middle Of The Storm

- Recent data have continued to reflect significant deterioration in the U.S. economy, with sharp weakness in consumer spending.
- Credit strains have begun to ease, but bank lending has tightened further. Lower energy prices should help to support consumer spending into 2009.
- The global economic outlook has worsened. Policy efforts, with more to come, have been massive. The Obama administration will hit the ground running, and has made the economy its top priority.

Inflation-adjusted Gross Domestic Product fell a 0.3% annual rate in the third quarter, according to the government's advance estimate. That figure (which is subject to revision) understates the weakness. Domestic Final Sales (GDP less inventories and foreign trade), a measure of underlying domestic demand, fell at a 1.8% annual rate, and that was aided by a 5.8% spurt in government spending (otherwise, Domestic Final Sales would have fallen at about a 3.0% annual rate). Consumer spending fell at a 3.1% annual rate, the biggest decline since the second quarter of 1980.

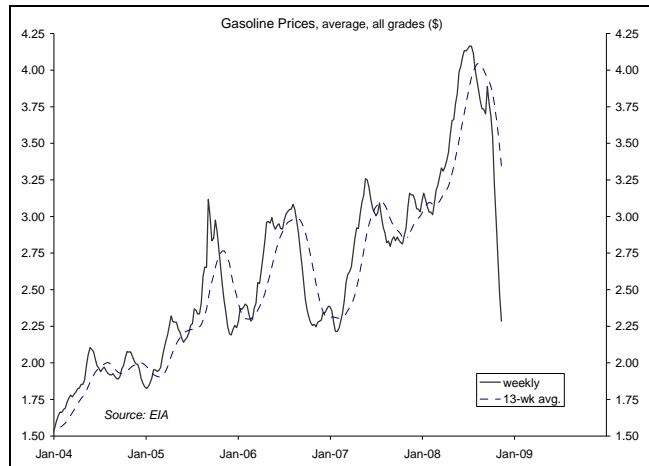
Consumer spending has been strained due to lagged effects of previous energy price increases, tighter credit, a loss of housing and stock market wealth, and a weakening labor market. Job losses have increased and the unemployment rate, at 6.5% in November, has been rising sharply. Nonfarm payrolls have fallen by 1.2 million since December. The number of unemployed stands at 10.1 million, 2.8 million more than a year ago. Aggregate wage income growth has slowed.

Credit market conditions remained significantly strained, but the worst appears to be behind us. Interbank lending rates have been falling gradually.



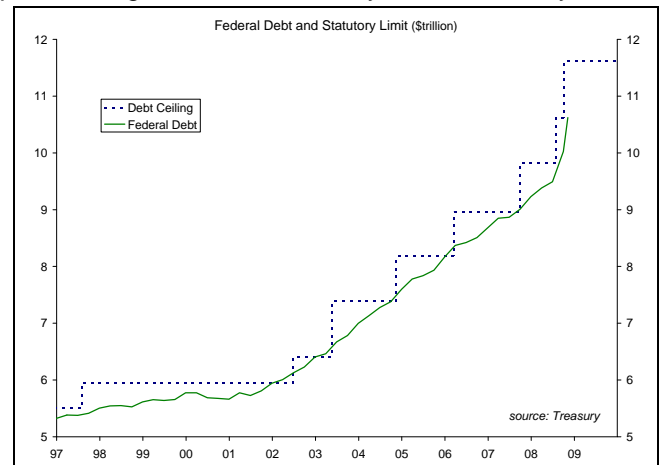
Despite Federal Reserve interest rate cuts and efforts to promote financial system liquidity, banks have continued to tighten terms and conditions for all types of consumer and business loans. The tightness in lending is the major threat to the economy. Policymakers are said to have applied moral suasion, calling on banks to lend newly replenished capital. Yet, banks are naturally reluctant to lend more in the current environment. Over time, lending conditions should begin to relax, but the situation is unlikely to improve anytime soon.

The global economic outlook has continued to deteriorate. The IMF recently lowered its projection of 2009 global growth to 2.2%, vs. a 3.0% forecast made just a month earlier (the IMF defines a global recession as global growth less than 3.0%). The major industrialized economies, including the U.S., appear to be in recession. Emerging economies are slowing sharply. Central banks have cut interest rates (with more to come) and foreign governments are making significant efforts to counter the downturn.



The weaker global growth outlook has contributed to declines in the prices of oil and other commodities. Average gasoline prices in the U.S. are now nearly half of their mid-July peak. The drop in gasoline prices will act like a tax cut of more than 1% on income. However, the impact on spending will arrive with a lag (the 13-week average gives a good approximation). Still, the loss in wealth and tighter credit will likely be more dominant factors into 2009. Consumers appear to be adjusting spending patterns significantly. While it's good, over the long run, for households to save more, a sharp adjustment is worrisome. If everyone saves more, they will be spending less, and the overall economy will be a lot weaker than it would have been otherwise.

Barack Obama won the presidency by a wide margin. While the Republican campaign branded him a socialist, that's not the case. Obama has surrounded himself with competent, experienced advisors, and has made the economic recovery his top priority. Obama ran on a platform for middle class tax cuts and a higher marginal tax rate for those at the upper end of the income scale. The middle class are likely to be pushed through quickly. The upper-end tax increases should be postponed. Obama will inherit a deteriorating budget situation. The national debt has risen by \$600 billion since the end of September. The new administration will have to deal with the deficit eventually, but the economic recovery is a much greater concern. Congress may push through further stimulus by the end of the year.



There is still a very high level of uncertainty in the economic outlook, and the risks are tilted mostly to the downside. Policy efforts should support growth in 2009.

The Fed is poised to lower short-term interest rates further, but the actual overnight lending rate has been trending well below the Fed funds target. The Fed is now paying interest on excess reserves, which was supposed to put in a floor on the overnight rate. However, institutional anomalies may keep rates low.

	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	2007	2008	2009
GDP (↓ contributions)	4.8	-0.2	0.9	2.8	-0.3	-3.0	-0.5	0.6	1.9	2.0	2.0	1.4	-0.1
consumer durables	0.2	0.0	-0.3	-0.2	-1.1	-1.2	-0.2	0.1	0.2	0.2	0.4	-0.3	-0.4
nondurables & services	1.3	0.6	0.9	1.1	-1.2	-0.6	0.3	0.8	1.2	1.4	1.6	0.6	0.3
bus. fixed investment	0.9	0.4	0.3	0.3	-0.1	-0.6	-0.5	-0.3	0.1	0.2	0.5	0.3	-0.3
residential investment	-1.1	-1.3	-1.1	-0.5	-0.7	-0.3	-0.2	-0.1	0.0	0.1	-1.0	-0.9	-0.2
government	0.8	0.2	0.4	0.8	1.2	0.1	0.1	0.2	0.2	0.2	0.4	0.6	0.3
Domestic Final Sales	1.9	-0.1	0.1	1.5	-1.8	-2.6	-0.5	0.6	1.7	2.1	1.9	0.3	-0.3
exports	2.5	0.5	0.6	1.5	0.8	-0.7	-1.4	-1.0	-0.4	0.1	0.9	1.0	-0.6
imports	-0.5	0.4	0.1	1.4	0.4	0.9	0.9	0.4	0.0	-0.4	-0.4	0.4	0.6
Final Sales	4.0	0.8	0.9	4.8	-0.8	-2.4	-1.0	0.0	1.2	1.8	2.4	1.7	-0.3
ch. in bus. inventories	0.7	-1.0	0.0	-1.5	0.6	-0.5	0.4	0.6	0.7	0.2	-0.4	-0.3	0.2
Unemployment, %	4.7	4.8	4.9	5.3	6.0	6.7	7.3	7.6	7.7	7.8	4.6	5.7	7.6
NF Payrolls, monthly, th.	71	80	-82	-71	-159	-260	-160	-120	-60	-20	91	-143	-90
Cons. Price Index (3 mo)	2.5	6.2	3.1	7.9	2.6	-6.1	1.5	2.1	2.2	2.3	4.1	1.9	2.0
excl. food & energy	2.5	2.6	2.0	2.5	2.7	1.7	1.8	2.0	2.0	2.1	2.4	2.2	2.0
PCE Price Index (q/q)	2.5	4.3	3.6	4.3	5.4	-4.0	-0.1	1.8	2.0	2.0	2.6	3.5	0.8
excl. food & energy	2.1	2.5	2.3	2.2	2.9	1.9	1.6	1.8	1.9	1.9	2.2	2.3	2.0
Fed Funds Rate, %	5.09	4.49	3.18	2.09	1.96	0.46	0.28	0.35	0.94	1.21	5.02	1.92	0.70
3-month T-Bill, (bnd-eq.)	4.4	3.5	2.1	1.7	1.5	0.3	0.4	0.5	1.1	1.3	4.5	1.4	0.8
2-year Treasury Note	4.4	3.5	2.0	2.4	2.4	1.4	1.4	1.5	3.2	3.4	4.4	2.0	2.4
10-year Treasury Note	4.7	4.3	3.7	3.9	3.9	3.8	3.8	3.9	4.4	4.6	4.6	3.8	4.2