

Monday, October 13, 2008

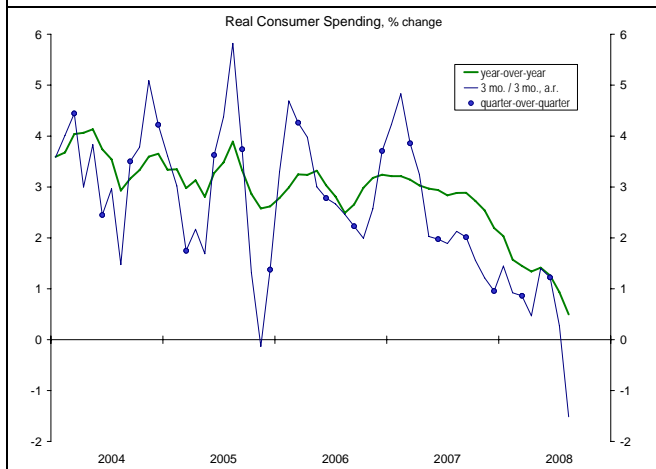
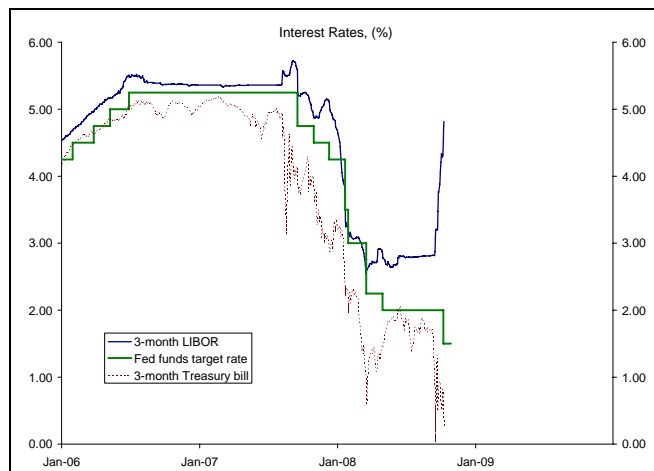
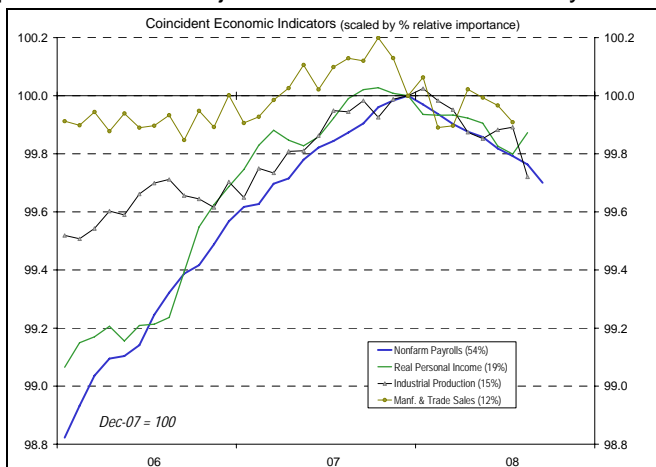
Economic Research – Scott J. Brown, Ph.D.

## The Credit Crisis Hits Harder

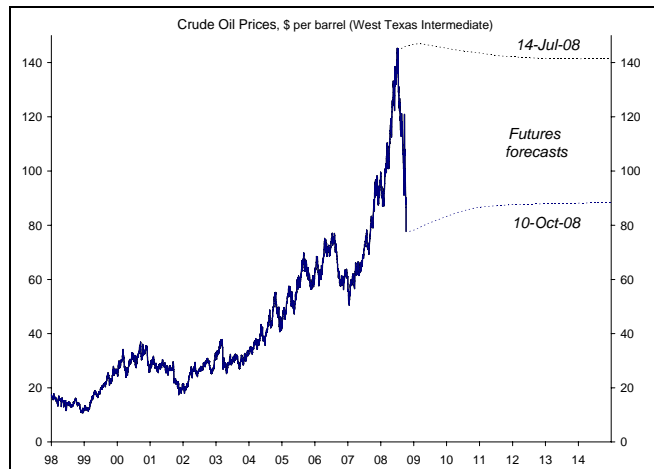
- Recent data have reflected more significant deterioration in the U.S. economy.
- An accelerating collapse in bank lending has threatened global economic growth.
- The Federal Reserve and other major central banks have lowered short-term interest rates and expanded efforts to provide liquidity. Governments of the U.S. and other industrialized countries have taken extraordinary measures to recapitalize the banking system.

The major monthly indicators used by the National Bureau of Economic Research to determine recessions have been trending lower since the end of last year. However, growth in real Gross Domestic Product was positive in both the first and second quarters. August personal income and spending data, which included downward revisions to expenditures in June and July, show that inflation-adjusted consumer spending (which accounts for 70% of GDP) was falling at a 2.0% to 2.5% annual rate in 3Q08. Part of that weakness reflects a pullback from tax rebate effects. However, high energy prices and a weak job market have taken a heavy toll.

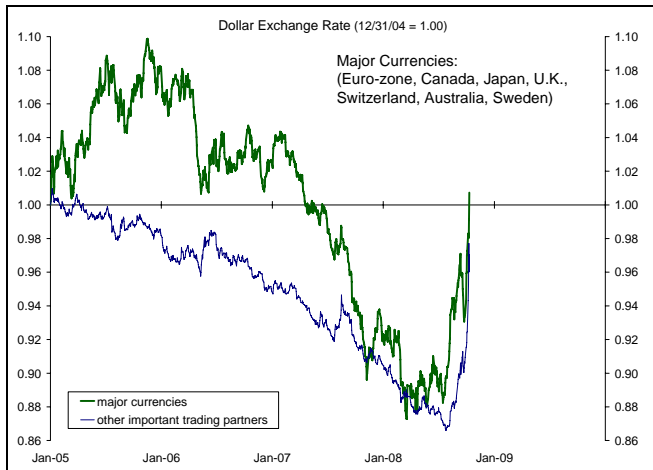
After months of piecemeal responses to financial sector problems, the Federal Reserve and Treasury have pursued a more comprehensive solution. Seeking to remove illiquid assets from the banking system, Treasury submitted a \$700 billion stabilization plan to Congress, approved with some modifications. On October 8, the Fed and other central banks lowered short-term interest rates by 50 basis points. Despite these and other efforts, credit conditions have become further strained. Global stock markets have fallen sharply amid fears of a global recession. The IMF is projecting global growth of 3% in 2009 (the IMF defines a global recession as growth below 3%), but cautioned that “the outlook is subject to considerable downside risks,” adding that a recovery is “likely to be unusually gradual.”



Banks have become increasingly reluctant to lend to each other and even to their best customers. U.S. banks had already been tightening terms and standards for loans through mid-summer. The lending situation has worsened considerably in recent weeks. There are increased reports of small- to medium-size companies having lines of credit scaled back or cut entirely.



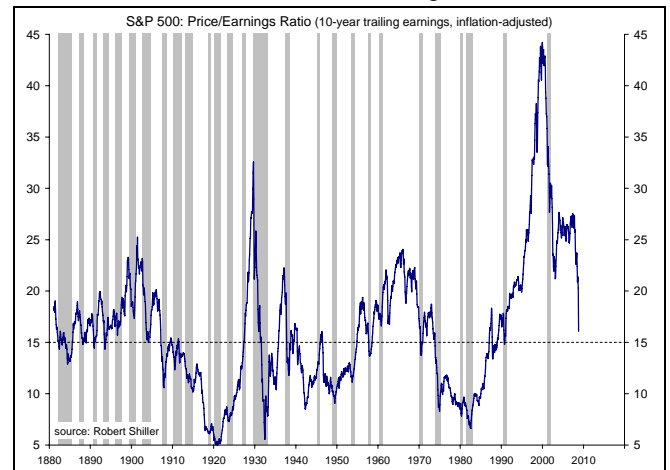
The weaker global outlook has contributed to a sharp drop in the prices of oil and other commodities. Amid supply disruptions, retail gasoline prices backed up following Hurricanes Gustav and Ike, but are now poised to fall sharply in coming weeks. For the household sector, the drop in gasoline prices will act like a tax cut, helping to shore up consumer spending. However, a deteriorating job market, a loss of housing and stock market wealth, and tighter lending conditions will weigh heavily against the household sector in the near term.



The credit crisis and weakening global economic outlook has led to a strengthening in the dollar, which will help reduce inflation pressure in the near term. For global policymakers, the level of exchange rates is generally less important than the speed of adjustment. Sharp currency moves tend to be destabilizing, adding to concerns about global economic growth.

The credit crisis has boosted the demand for Treasury securities (especially at the short end of the curve), and a weak economy normally pushes bond yields lower. However, rising federal budget deficit, as well as Treasury efforts to prevent short squeezes in some issues, should push long rates higher over time.

The stock market is a leading economic indicator, reflecting expectations of future growth in earnings. For most of this year, share prices had factored in some downside economic risk, but also a general expectation that growth would improve after a couple of quarters. In recent weeks, the economic outlook has deteriorated sharply. Weakness is expected to be more severe and longer lasting than anticipated earlier and the risks are tilted to the downside. Moreover, the collapse in bank lending is a serious economic worry and it is highly uncertain when the situation will begin to turn around.



Credit market worries and the plunge in global stock markets have the characteristics of a panic. Panics typically come on rapidly, but the resolution of their economic consequences takes some time. Recent moves by the central banks and various governments – and further efforts to come – will not turn things around right way, but they should help to shore up growth in 2009. The retreat in energy prices and the more pronounced weakness in the labor market give the Fed more leeway to lower short-term interest rates.

The economy's path over the next several quarters is highly uncertain, but near-term weakness is likely.

	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	2007	2008	2009
GDP ( <i>↓ contributions</i> )	4.8	-0.2	0.9	2.8	<b>-0.8</b>	<b>-1.2</b>	<b>-0.1</b>	<b>1.2</b>	<b>2.1</b>	<b>2.2</b>	2.0	<b>1.4</b>	<b>0.5</b>
<i>consumer durables</i>	0.2	0.0	-0.3	-0.2	-1.0	-0.4	-0.1	0.1	0.2	0.2	0.4	-0.2	-0.2
<i>nondurables &amp; services</i>	1.3	0.6	0.9	1.1	-0.6	-0.2	0.4	0.8	1.3	1.4	1.6	0.7	0.4
<i>bus. fixed investment</i>	0.9	0.4	0.3	0.3	-0.2	-0.3	-0.2	-0.1	0.2	0.3	0.5	0.3	-0.1
<i>residential investment</i>	-1.1	-1.3	-1.1	-0.5	-0.6	-0.3	-0.1	-0.1	0.0	0.1	-1.0	-0.9	-0.2
<i>government</i>	0.8	0.2	0.4	0.8	0.3	0.4	0.2	0.2	0.2	0.2	0.4	0.5	0.3
Domestic Final Sales	1.9	-0.1	0.1	1.5	<b>-2.0</b>	<b>-0.9</b>	<b>0.1</b>	<b>0.9</b>	<b>1.8</b>	<b>2.2</b>	1.9	<b>0.4</b>	<b>0.2</b>
<i>exports</i>	2.5	0.5	0.6	1.5	1.2	-0.4	-0.8	-0.6	-0.3	0.1	0.9	1.0	-0.2
<i>imports</i>	-0.5	0.4	0.1	1.4	-0.2	0.6	0.4	0.2	0.0	-0.4	-0.4	0.4	0.3
Final Sales	4.0	0.8	0.9	4.8	<b>-1.1</b>	<b>-0.7</b>	<b>-0.4</b>	<b>0.5</b>	<b>1.5</b>	<b>2.0</b>	2.4	<b>1.8</b>	<b>0.3</b>
<i>ch. in bus. inventories</i>	0.7	-1.0	0.0	-1.5	0.3	-0.5	0.3	0.7	0.6	0.2	-0.4	-0.3	0.1
Unemployment, %	4.7	4.8	4.9	5.3	6.0	<b>6.6</b>	<b>7.0</b>	<b>7.3</b>	<b>7.5</b>	<b>7.6</b>	4.6	<b>5.7</b>	<b>7.3</b>
NF Payrolls, monthly, th.	71	80	-82	-71	-100	<b>-170</b>	<b>-60</b>	<b>-75</b>	<b>20</b>	<b>40</b>	91	<b>-106</b>	<b>-19</b>
Cons. Price Index (3 mo)	2.5	6.2	3.1	7.9	<b>3.2</b>	<b>-5.4</b>	<b>1.7</b>	<b>2.1</b>	<b>2.2</b>	<b>2.3</b>	4.1	<b>2.2</b>	<b>2.0</b>
<i>excl. food &amp; energy</i>	2.5	2.6	2.0	2.5	<b>2.8</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.1</b>	2.4	<b>2.3</b>	<b>2.0</b>
PCE Price Index (q/q)	2.5	4.3	3.6	4.3	<b>5.6</b>	<b>-3.6</b>	<b>0.5</b>	<b>1.9</b>	<b>2.0</b>	<b>2.0</b>	2.6	<b>3.5</b>	<b>1.1</b>
<i>excl. food &amp; energy</i>	2.1	2.5	2.3	2.2	<b>3.1</b>	<b>2.0</b>	<b>1.8</b>	<b>1.9</b>	<b>1.9</b>	<b>1.9</b>	2.2	<b>2.3</b>	<b>2.0</b>
Fed Funds Rate, %	5.09	4.49	3.18	2.09	2.02	<b>1.19</b>	<b>1.00</b>	<b>1.00</b>	<b>1.14</b>	<b>1.41</b>	5.02	<b>2.12</b>	<b>1.14</b>
3-month T-Bill, (bnd-eq.)	4.4	3.5	2.1	1.7	1.5	<b>0.9</b>	<b>1.0</b>	<b>1.0</b>	<b>1.2</b>	<b>1.5</b>	4.5	<b>1.4</b>	<b>1.2</b>
2-year Treasury Note	4.4	3.5	2.0	2.4	2.4	<b>1.7</b>	<b>2.2</b>	<b>2.8</b>	<b>3.4</b>	<b>3.8</b>	4.4	<b>2.1</b>	<b>3.1</b>
10-year Treasury Note	4.7	4.3	3.7	3.9	3.9	<b>3.9</b>	<b>4.4</b>	<b>4.7</b>	<b>5.0</b>	<b>5.2</b>	4.6	<b>3.8</b>	<b>4.8</b>