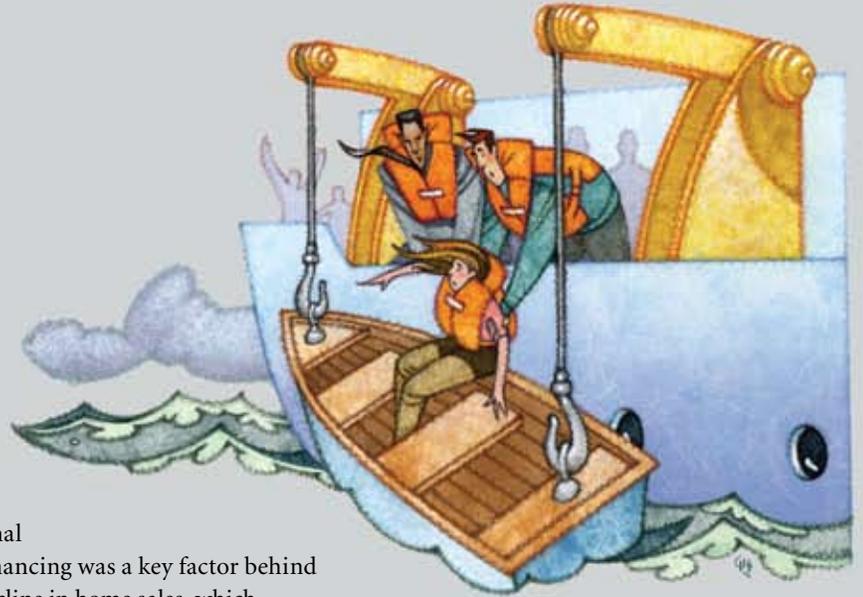


Man the Lifeboats!

By Kevin L. Kliesen



Last year was an historic year for the U.S. economy. To begin with, crude oil, gasoline and commodity prices rose to record-high levels, causing inflation to accelerate rapidly. Over the first seven months of 2008, inflation was running at about a 6.25 percent annual rate. These higher prices reduced the purchasing power of households and narrowed profit margins of many firms, causing a drag on consumption and business fixed investment.

Since August 2008, oil prices have plunged and the near-term inflation outlook has improved considerably. In fact, the CPI declined at about an 8.25 percent annual rate between July and November. This development has led some economists to speculate about the possibility of deflation, which is defined as a falling aggregate price level (GDP price index). Thus far, however, most economists view the decline in the CPI as a reflection of (i) falling energy and commodity prices and (ii) the sharp slowing in actual and projected domestic and global economic growth. Most economists do not expect a fall in the GDP price index this year.

Falling prices of equities and houses were two developments in 2008 that reduced the wealth of the nation's households and created enormous uncertainty about the strength of the economy heading into 2009. The S&P 500 was down by nearly 50 percent at one point in 2008, while house prices had fallen nationally by about 13 percent from September 2007 to September 2008.

Financial stresses and their associated fallout took a toll on key industries last year. The housing industry faced its worst economic conditions since the 1981-82 recession; the downturn that began in early 2006 showed few signs of bottoming. The

demise of nontraditional mortgage financing was a key factor behind the sharp decline in home sales, which caused a surge in the number of unsold homes, thus putting downward pressure on house prices. Likewise, automotive manufacturers were also hit especially hard. In November, the CEOs of Chrysler, Ford and General Motors, faced with plummeting sales and bloated inventories, appealed to the U.S. Congress for government-backed loans.

On their balance sheets, a large number of banks and other financial institutions held securities whose underlying value was tied to houses purchased with these nontraditional mortgages. As house prices fell, defaults and foreclosures rose, and the value of these assets declined. In response, a large number of U.S. financial institutions either failed, were taken over or received considerable financial assistance from the Federal Reserve or the U.S. Treasury last year. The much broader market for credit derivatives, which many firms and investors use to hedge against financial default, also contributed to the turmoil.

In response to these developments, the Federal Reserve adopted a two-track strategy. First, the Federal Open Market Committee reduced its federal funds target rate, down to 1 percent by Oct. 29 and then to a range of 0 to 0.25 percent on Dec. 16. Second, the Federal Reserve implemented several new lending facilities designed to offset the reduction in credit availability faced by many financial and nonfinancial firms. The result was the largest year-to-year percentage increases in the nation's stock of high-powered money (monetary base) ever seen. Policymakers are confident

that this enormous injection will eventually spur increased lending and a rebound in economic growth.

Through it all, the nation's economy managed to grow at a moderate pace over the first half of 2008 (about 1.75 percent)—even though the National Bureau of Economic Research determined that the U.S. economy entered into a recession in December 2007. The United States also benefited from a strong world economy in recent years that was a boon for U.S. exporters. By late summer, though, it was clear that both the U.S. and most of the world's largest economies were either in a recession or were sliding into one. In the third quarter of 2008, the U.S. economy contracted at a 0.5 percent annual rate, and most forecasters expect an even larger decline in the fourth quarter. The consensus of most forecasters is that the U.S. economy will continue to contract over the first half of 2009, with only modest growth in the third and fourth quarters.

By the fourth quarter of 2009, the unemployment rate is projected to average about 8 percent. It is possible that this recession will be somewhat deeper and longer than the fairly mild recessions experienced in 1990-91 and 2001. It is too early to tell if the recession will be as severe as those seen in 1973-75 and 1981-82. 

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