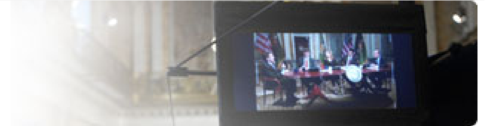
U.S. DEPARTMENT OF THE TREASURY

Press Center



Assistant Secretary for Economic Policy Phillip Swagel Treasury Borrowing Advisory Committee of the Securities Industry and Financial markets Association Statement

7/28/2008

HP-1103

Washington - The U.S. economy has continued to expand at a moderate pace despite the effects of the housing correction, financial market strains, and high energy prices. These developments have weighed on economic growth and the labor market since late 2007.

Real GDP growth was 1.0 percent at an annual rate in the first quarter of this year, after 0.6 percent growth at an annual rate in the fourth quarter of 2007. Net exports sustained growth, while consumer spending and business investment grew slowly, and housing investment fell sharply. A narrower trade deficit accounted for much of the first-quarter increase in GDP, contributing 0.8 percentage point to real growth. Real exports rose at a 5½ percent annual rate in the first quarter, while real imports declined slightly. Consumer spending growth moderated to a 1.1 percent annual rate and the growth of business investment slowed to just 0.6 percent. Residential investment plunged by nearly 25 percent at an annual rate in the first quarter, subtracting more than 1 percentage point from annualized real GDP growth for a third straight quarter.

Later this week, on Thursday, July 31, the Bureau of Economic Analysis (BEA) will release the advance estimate of GDP growth in the second quarter. BEA will also release revised data for 2005- 2007 GDP growth that incorporate more complete source data and methodological changes.

Available data suggest that growth picked up in the second quarter of 2008; the consensus of forecasts is for 2.3 percent growth at an annual rate. Consumer spending has been solid, boosted by nearly $80 billion in stimulus payments received by households. Data on capital goods shipments and on non-residential construction suggest that business investment in plant and equipment expanded at a moderate pace. Export growth remained robust through May, and trade appears poised to make another positive contribution to real GDP growth. Strength in these sectors will be offset by declines in residential investment and business inventory investment.

The housing correction has been a drag on GDP growth since 2006 and residential investment will likely subtract from GDP through the end of 2008. Overbuilding left home inventories far above normal levels; the key to stabilizing the housing market is to work through the inventories. Inventories of unsold new single-family homes have declined by 26 percent since their peak in July 2006, but remain near historically high levels. A decline in construction is a necessary part of the housing correction after years of overbuilding--and housing starts and building permits are down sharply. Single-family starts have fallen by 65 percent from their peak in January 2006 and in June slipped to a 17-1/2 year low.

A stabilization of home sales at a high enough level to outpace construction is the key to working through the inventories of new homes. New single-family home sales have been roughly flat for the past 3 months after having fallen by about 60 percent from their peak in July 2005. Existing home sales also show signs of stabilizing since the beginning of this year. These are fragile signs, however: new home sales stabilized for several months in the spring of 2007 before falling again.

Elevated inventories of unsold homes continue to weigh on house prices, which fell 4.8 percent over the year ending in May, according to figures from the Office of Federal Housing Enterprise Oversight (OFHEO). Other measures of home prices, including the S&P/Case-Shiller indices, indicate that home prices continue to decline in many major U.S. cities. Mortgage delinquencies and foreclosures are up sharply--the number of mortgages past due and the number of foreclosures started have both risen over 150 percent since early 2006. Rising foreclosures are a source of difficulty for many families. They also prolong the adjustment process for housing, since foreclosures add to the supply of homes on the market and because homes sold out of foreclosure put additional downward pressure on home prices. Subprime adjustable-rate mortgages are largely responsible for the elevated delinquency and foreclosure rates, but foreclosure starts on prime loans are rising as well, suggesting that credit difficulties have spread.

Weakness in housing, credit market strains, and high energy prices have taken a toll on the labor market, which has stalled since late last year. Nonfarm payrolls fell by an average of 73,000 per month in the first six months of 2008. These were the first job losses in 5 years and together nearly offset the 453,000 jobs gained in the last half of 2007. The unemployment rate stood at 5.5 percent in June, up nearly a full percentage point over the past year.

Overall inflation recently hit a 17-year high, with the consumer price index up 5 percent in the 12 months ending in June; this compares to an increase of 2.6 percent in the year-earlier period. Surging energy prices and sharp increases in food costs are responsible for the pickup in consumer inflation. Excluding these categories, core consumer price inflation remained contained at 2.4 percent in the latest twelve month period through June. This was a pace of core inflation just 0.2 percentage point higher than in the year ended June 2007.

Consumer energy prices rose further in July, although at a slower pace than in April through June. Retail gasoline prices increased about 1 percent in the first three weeks of July to an average of $4.09 per gallon but have since fallen off somewhat. Gasoline prices had risen by an average of 7.6 percent in each of the prior 4 months, with the cost of regular gas up by more than 30 percent so far this year. Higher gasoline prices largely reflect oil market developments: between late 2007 and mid July of this year, the benchmark one-month futures price of West Texas Intermediate crude oil rose by more than 50 percent, closing at an all-time high of $145 per barrel on July 14. Oil prices have eased substantially since then, falling by nearly $25 to $123 per barrel as of last Friday (July 25). Though oil is still 70 percent more costly than a year ago, the recent drop in price is good news for consumers and businesses alike.

Elevated overall inflation has more than offset nominal wage increases so that real average hourly earnings are down by 1.8 percent for the year ending in June. The stimulus measures enacted early this year have countered some of the impacts of high energy prices and the slow job market, boosting real household income and thereby helping to sustain household spending. A total of 112.4 million stimulus payments were sent to households through July 11, totaling $92 billion. Around 12 million additional rebate payments are expected to go out through the remainder of 2008 and the first half of 2009 as additional people file returns or reconcile their 2008 incomes during the 2009 tax season. This includes stimulus payments that will go to the over 5 million seniors and veterans who must still file a simple tax return to receive their payment.

The economic slowdown and increased expenditures associated with slower growth and with the stimulus has had an effect on the federal budget. Today the Office of Management and Budget released the Mid-Session Review of the FY2009 Budget, which contains updated estimates of federal receipts, outlays, and the deficit for the next five years. For FY2008, the deficit is projected to be $389 billion, or about 2.7 percent of GDP. In FY2009, the deficit is projected to rise to $482 billion, about 3.3 percent of GDP. The rising deficits in FY2008 and FY2009 largely reflect the slowing economy and the stimulus package. Federal receipts are projected at 17.9 percent of GDP in FY2008 and FY2009, about 0.4 percentage point below the long-run average. As the temporary stimulus provisions end and the economy strengthens, receipts are projected to rise. Spending discipline and rising receipts would bring the federal budget to surplus in FY2012 and FY2013.

The Mid-Session Review is based on an updated economic forecast in which GDP growth in 2008 is projected to be 1.6 percent on a year-over-year basis, more than a percentage point lower than the forecast in the FY2009 Budget. The Mid-Session Review GDP forecast matches the private consensus projection for growth in 2008. The updated forecast projects relatively sluggish growth in 2009 (2.2 percent), which is 0.8 percentage point below the growth projected in the Budget. The economy is predicted to recover as the housing market stabilizes and financial turmoil recedes, with annual GDP growth picking up to average about 3.2 percent through 2013. This pace of growth would bring the unemployment rate down to 4.8 percent in 2012 after it increases in 2008 and 2009 as a result of sluggish growth.

Prompt and effective policy actions are supporting growth while adjustments in housing and financial markets continue. The fundamental strengths of the U.S. economy remain, notably strong underlying productivity growth and substantial flexibility and resilience. Over time, stronger growth will bring renewed job creation and higher incomes, and this in turn will result in rising federal receipts and move the fiscal position toward a balanced budget.

-30-