U.S. DEPARTMENT OF THE TREASURY

Press Center

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

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Washington - Economy activity has slowed noticeably in the past several months, with weaker consumer and business spending, as well as corresponding impacts on the labor market. Financial market strains deepened further in September, disrupting the flow of credit to businesses and households, and affecting equity prices and consumer and business confidence. Policy actions taken in recent weeks have helped stabilize markets, but credit conditions remain strained. Against this backdrop, the housing market adjustment continues, and while energy prices rose to record levels in July, cutting into consumer budgets, they have fallen considerably in recent months.

The economy as a whole was growing moderately going into the third quarter. Real GDP increased by 2.8 percent in the second quarter, boosted in large part by a narrowing trade deficit. Exports continued to post solid gains, and imports declined. Outside of trade, however, growth was weak. A pick-up in consumer spending in the second quarter, reflecting the effects of stimulus payments, was largely offset by declines in business investment in equipment and software and residential homebuilding.

Growth slowed sharply in the third quarter, with real GDP declining by 0.3 percent at an annual rate. Consumer spending fell for the first time since 1991, subtracting 2-1/4 percentage points from third-quarter GDP growth. The drop in consumption was the largest since 1980. Business investment slipped by 1.0 percent in the third quarter, as outlays for structures slowed and spending for equipment and software declined for a third straight quarter. Residential investment, which has been a drag on growth since the start of 2006, subtracted 0.7 percentage points from real GDP growth.

GDP growth in the third quarter was supported by inventory investment, government spending, and another solid increase in net exports. Net exports contributed 1.1 percentage points to real growth in the third quarter, compared to a contribution of 2.9 percentage points in the second quarter.

October indicators suggest a weak start to the final quarter of this year. Consumer optimism as measured by the Conference Board fell to an all-time low in the wake of pronounced financial market volatility; regional manufacturing indicators from the New York Fed and the Philadelphia Fed point to a sharp slowdown in industrial activity; and high initial claims for unemployment insurance indicate a weak labor market. Trade has been a key driver of growth in recent quarters, but slowing economic activity in several important trading partners suggests that net exports will make a smaller contribution going forward.

The housing adjustment continues. Home sales are still sluggish, inventories of existing unsold homes remain at a historically high level, and prices continue to decline. The adjustment in new home inventories, however, is well underway, with inventories of new homes down from a peak of 572,000 in July 2006 to 394,000 in September. This adjustment mainly reflects the falloff in building, with the current pace of new residential construction the slowest in more than two decades. The slow pace of building permit issuance, the historically low level of builder confidence, and tight credit conditions suggest that a recovery in new home construction will take some time (though a stabilization of the decline in residential construction will remove an important drag from growth). House prices were down 5.9 percent in August from year-earlier levels according to the Federal Housing Finance Agency. Other measures such as the Case-Shiller measures of home prices likewise show continued price declines. Mortgage delinquencies and foreclosures rose to new highs in the second quarter. Increased foreclosures feed into home inventories and put additional downward pressure on home prices; homes sold at foreclosure tend to exhibit particularly large price declines.

The labor market has weakened notably against the backdrop of a slowing economy. Nonfarm payrolls fell by an average of 100,000 per month in the third quarter, compared to 77,000 jobs lost per month on average in the first half of 2008. Nonfarm payroll employment is down by about 750,000 jobs on net this year. The unemployment rate stood at a 5-year high of 6.1 percent in September.

Headline inflation accelerated sharply through the summer as energy prices spiked to record levels and food prices continued to climb rapidly; the recent sharp reversal of oil prices and the weak real economy, however, are likely to reverse these inflationary pressures. The consumer price index rose 4.9 percent in the twelve months ending in September, up from 2.8 percent in the year-earlier period. Energy prices shot up 23 percent over the latest twelve months, while food prices rose 6 percent. Excluding energy and food prices, core consumer price inflation remained contained. Over the year ended in September, core inflation was 2.5 percent, roughly within the narrow range that has prevailed over the past four years.

The trend toward rising headline inflation eased late in the summer, as energy and other commodity prices retreated sharply. Retail gasoline prices have fallen by $1.45 from their all-time high of $4.11 per gallon recorded in July, and now stand at $2.66 per gallon. Gasoline prices have moved lower with sliding crude oil prices. The benchmark one-month futures price of West Texas Intermediate crude oil has declined more than 50 percent from a record intraday high of $147 per barrel in mid July and on Friday closed at $67.81 per barrel. With the retreat in energy prices and the slowing of economic growth, headline inflation is expected to ease going forward.

Several factors are affecting consumer demand, including labor market conditions, high energy and food prices, and wealth declines from lower asset values. The summer surge in headline inflation cut into real wage growth, with real average hourly earnings falling by 1.9 percent over the year ended in September. Household wealth has been eroded by falling asset prices. House price declines have eaten away at the value of household real estate holdings, while equity market declines have reduced the value of financial assets. Between the third quarter of 2007 and the second quarter of this year, household net worth fell by $2.7 trillion – the first decline in household wealth since 2002. Further declines appear likely for the third and fourth quarters of this year.

The weak economy has also affected the Federal budget. In FY2008, the fiscal year just ended in September, the Federal deficit widened by $292 billion to $455 billion (3.2 percent of GDP). That followed three years of improvement during which the deficit narrowed to $162 billion (1.2 percent of GDP) in FY2007. The higher FY2008 deficit reflects the slowing economy and the economic stimulus package enacted in early 2008.

Financial market volatility reached unprecedented levels in recent weeks. Important parts of credit markets seized up and equity markets posted steep losses, triggered by uncertainty about the overall economy and about the performance and viability of a wide range of assets, as well as the financial institutions holding or providing contingent guarantees for those assets. These developments have clouded the outlook for the remainder of 2008 and early 2009, prompting forecasters to cut their projections for near-term growth. Most private-sector analysts expect activity to be weak into next year.

Although it will take time to work through the problems currently plaguing our financial system, recent measures undertaken by the federal government are expected to help stabilize financial markets and put the economy back on firm footing. The Emergency Economic Stabilization Act of 2008 (EESA), signed into law on October 3, gives the Treasury Department the ability to design and deploy a number of tools to restore the flow of credit to consumers and businesses. Specifically, the EESA empowers Treasury to use up to $700 billion to inject capital into financial institutions, to purchase or insure mortgage assets, and to purchase any other troubled asset that the Treasury and the Federal Reserve deem necessary to promote financial market stability.

The Capital Purchase Program announced by the Treasury allocates $250 billion to be used to inject capital into a wide range of banks. This action will shore up banks' capital positions, encourage the resumption of interbank lending, and translate into increased lending to consumers and business. The FDIC temporarily raised the deposit insurance limit from $100,000 to $250,000 per depositor per bank, and, in addition has temporarily guaranteed the newly issued senior unsecured debt of FDIC-insured institutions and their holding companies, as well as deposits in non-interest bearing deposit transaction accounts. The Federal Reserve has announced a number of actions to increase liquidity in financial markets, including launching several new liquidity facilities. These include the Commercial Paper Funding Facility (CPFF) program, which provides a broad backstop for the commercial paper market by funding purchases of commercial paper of three month maturity from high-quality issuers. The Federal Reserve has also started the Money Market Investor Funding Facility, which allows private special purpose vehicles to purchase assets from money market mutual funds and thereby works to restore liquidity to money markets.

There is some evidence that credit markets are beginning to thaw. The TED spread – the rate on 3-month interbank loans relative to the risk-free 3-month T-bill rate, and a measure of willingness of banks to lend to each other – has eased substantially. From a high of 457 basis points in early October, the spread has fallen about 200 basis points, even though it still remains elevated at about 260 basis points. (The TED spread averaged around 40 basis points prior to mid 2007, when the financial turmoil began in 2007.) Taken together, these policy measures are intended to boost liquidity and add capital to the financial system, thereby restoring confidence and stability in financial institutions so they can fuel continued economic growth.

In sum, economic conditions have deteriorated notably over the past few months. It will take time for financial markets to stabilize and for credit market strains to ease. In the meantime, economic activity is expected to remain weak into 2009. The Emergency Economic Stabilization Act of 2008, along with other policy actions, will help restore stability in financial markets and reduce uncertainty and improve confidence, fostering better economic performance over time.

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