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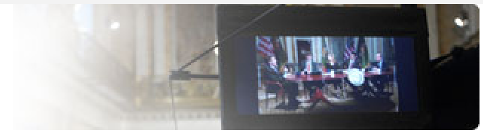

Director of the Office of Macroeconomic Analysis Ralph M. Monaco Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association April 27, 2009

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U.S.economic activity contracted sharply again at the start of 2009, more than a year after the economy slipped into recession. The housing correction entered its third year, financial market volatility persisted, and credit markets, though improved from the last quarter of 2008, remained impaired. Labor market conditions worsened notably. Over 2 million jobs were lost in the first quarter alone and the unemployment rate climbed to a 26-year high of 8.5 percent in March. The economy is still expected to contract through mid-year as the housing sector continues to adjust and imbalances in financial and credit markets dissipate, but there have been tentative signs that the pace of deterioration is slowing. Most economists see some growth in the second half of 2009, boosted by fiscal stimulus provided by the American Reinvestment and Recovery Act (ARRA) of 2009.

Data for growth in the first quarter will not be available until April 29, but economic indicators released thus far suggest that real GDP declined sharply again in the first three months of 2009. In the fourth quarter of 2008, real GDP fell by 6.3 percent at an annual rate – the largest quarterly loss since early 1982. That followed a 0.5 percent decline in the third quarter. Private forecasters are looking for about a 5 percent decline in the first quarter.

A sharp drop in consumer spending during the second half of 2008 was largely responsible for the downturn in economic activity. In both the third and fourth quarters, falling real personal consumption expenditures (PCE) accounted for close to 3 percentage points of the decline in real GDP. Consumer spending stabilized early in the first quarter, according to data available through February, and appears to be on track to make a modest positive contribution to growth in the first quarter.

Business investment in plant and equipment weakened further in the first quarter after falling by nearly 22 percent at an annual rate in the fourth quarter of 2008. Shipments of nondefense capital goods excluding aircraft – used to estimate equipment and software spending in GDP – fell by 35 percent at an annual rate in the first quarter, more than double the pace of decline recorded in the fourth quarter. This trend suggests that equipment and software investment continued to deteriorate in the first quarter even after falling by 28 percent at an annual rate in the final quarter of 2008. Business outlays for new construction were also down substantially through February, pointing to another decline in structures investment following the fourth quarter's 9.4 percent drop.

Residential investment fell further in the first quarter as well, although there were some modest signs of stabilization. Spending on residential construction declined rapidly through February and housing starts were down in March. Sales of new and existing homes continued to fall in the first quarter, although each showed some signs of stabilizing. One major measure of house prices, the Federal Housing Finance Administration (FHFA) home price index rose in each of the first two months of 2009, the first two month increase since April 2007. Despite modest signs of potential improvement, housing activity likely subtracted about a percentage point from real GDP growth in the first quarter, in line with the average reduction during each of the past twelve quarters. Housing is expected to remain a drag on the economy through at least the second quarter, but private forecasters see the housing sector beginning a gradual recovery in late 2009.

Exports, an important source of strength in the U.S. economy for much of the past two years, have trended lower since last July as economies around the world have moved into recession. In the fourth quarter, exports fell by nearly 24 percent at an annual rate in real terms, the largest quarterly decline since the early 1970s. The sharp decline in exports in the fourth quarter was mostly offset by a similarly sharp decline in imports such that net exports (exports less imports) subtracted only 0.2 percentage point from real GDP growth. Although exports rose slightly in February, they were down significantly compared with Q4. Imports, however, fell even faster, suggesting that foreign trade could still be a positive for GDP in the first quarter as imports fell even faster.

The broad-based decline in economic activity over the past several quarters has triggered large job losses and a rise in unemployment. Nonfarm payrolls declined by 663,000 in March marking the 15th straight month of such losses. More than 5 million (3.9 percent) jobs have been cut from payrolls since the recession began in December 2007. In percentage terms, the 15-month job loss total is the largest since July 1958. The unemployment rate jumped 0.4 percentage point to a 26-year high of 8.5 percent in March and has risen by 3.6 percentage points since December 2007. Weekly data on initial claims for unemployment insurance point to further job losses in April.

Inflation – an area of mounting concern about a year ago when energy prices rose to record levels – has moderated dramatically in recent months. Headline consumer prices fell by 0.4 percent in the twelve months ending in March after climbing 4.0 percent in the same period last year. The swing was due in large part to a reversal in the energy price run-up. Consumer energy prices fell by 23 percent over the latest twelve months, following a 17 percent jump in the year ending March 2008. Core inflation, a measure that excludes both energy and food prices, was a moderate 1.8 percent over the year ended March 2009, down from 2.4 percent over the year ended March 2008.

Private forecasters see real GDP shrinking once again in the first quarter but by somewhat less than the fourth quarter's 6.3 percent decline. The outlook for the second quarter is notably better, although activity is still expected to contract. Growth is expected to resume in the second half of 2009 as the impact of the federal government's fiscal stimulus package and other policy measures starts to be felt. Improvements in unemployment will tend to lag behind GDP growth, but should begin to stabilize and then decline as the recovery picks up steam.

Key policy actions taken during the first quarter are setting the stage for recovery in the second half of the year. The ARRA puts $787 billion toward stimulating domestic demand, and is expected to create or save an estimated 3.5 million jobs in a range of industries from clean energy to health care. Over 90 percent of these jobs will be in the private sector. By the end of 2010, the ARRA is expected to raise GDP by more than 3 percent.

In addition to the ARRA, the Treasury Department recently introduced several new initiatives to stabilize and strengthen our financial system under the umbrella of the Financial Stability Plan (FSP). The FSP includes the Capital Assistance Program (CAP), which is designed to ensure that major financial institutions have adequate capital to lend even in a worse-than-expected economic environment. The Public Private Investment Program (PPIP) will use private and government capital to purchase legacy assets in order to help jump-start the market for private real-estate-related assets that have been a core factor in the current financial crisis. In response to falling home prices, the Administration introduced the Making Home Affordable © Plan to support lower mortgage rates and help millions of homeowners refinance and avoid foreclosure. Finally, as a mechanism to unlock frozen credit markets, the Consumer and Business Lending Initiative was created to restart activity in the secondary markets for securitized loans, lower borrowing costs, and restore the flow of credit. Together these efforts will help lay the foundations necessary for economic recovery and clear the credit conduits to support future growth.

Credit market conditions have improved, but indicators suggest several important sectors remain challenged. The LIBOR-OIS spread – a measure of what banks perceive as the credit risk in lending to one another – stood at about 90 basis points in the week of April 23, far below the peak of 365 basis points recorded on October 10, but still high by historical standards. The spread between the Baa corporate bond rate (a measure of mid-level corporate bond quality) and the 10-year Treasury remained elevated at about 530 basis points; still, this is an improvement compared to the spread of 616 basis points recorded in early December. The rate on 30-year conventional mortgages eased to 4.80 percent in the week ended April 23, the sixth straight week the conventional mortgage rate was below 5 percent.

It will take time for the stimulus and credit market programs to have a meaningful impact and they will not come without significant costs in the short term. Partly as a result of these programs, the federal budget deficit is expected to rise to $1.75 trillion (12.3 percent of GDP) in fiscal year 2009 from $459 billion (3.2 percent of GDP) in fiscal year 2008 according to estimates provided by the Office of Management and Budget. The deficit is expected to narrow in subsequent years as the economy strengthens and temporary spending measures expire. Over the longer term, the deficit will average about 3 percent of GDP and the level of publicly held debt (net of the assets the government has acquired) will be stable at about 60 percent of GDP and in line with other developed nations.

The expenditures leading to these deficits represent an investment in near-term economic growth. Without the programs that these deficits support, the U.S. economy would be in much worse shape, and the conditions to support a recovery would take longer to take hold.

In sum, real GDP is expected to decline further in the near term and job losses and unemployment are likely to mount. However, there is reason to be cautiously optimistic about the outlook for the second half of 2009 and beyond. Growth is expected to resume, and federal efforts to stimulate the economy and restore stability to financial and credit markets will speed the process of steering the U.S. economy back on the path to long-term sustainable growth.