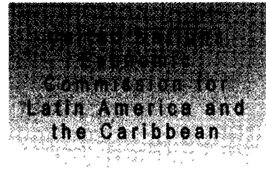

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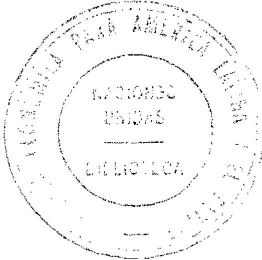
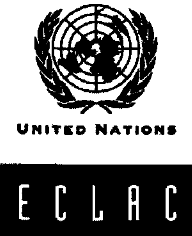
UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments





Washington, D.C. March 13, 2008

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U.S. ECONOMIC OUTLOOK

I. OVERVIEW

For the whole 2007, GDP rose by only 2.2%, below the economy's potential and the weakest growth rate since 2002. Residential investment fell by 17% for the year, compared with a decline of 4.6% in 2006. Personal consumption expenditures contributed 2.0% to 2007 GDP growth, with gross private domestic investment subtracting 0.79%. Net exports added 0.58% to growth, and government spending added 0.39%.

The U.S. economy grew at a 0.6% annual rate in the fourth quarter of 2007. Net exports remained strong in the fourth quarter, and were it not for the addition of trade, the economy would have contracted in the fourth quarter. Housing investment fell for the eighth consecutive quarter, subtracting 1.25% from growth.

Forecasts for U.S. Economic Growth

	Q1 2008(qoq)
What Markets Say	
National Association of Realtors	0.1%
Merrill Lynch	-0.1%
Moody's Economy.com	-0.5%
J.P. Morgan	0.0%
Wachovia	0.2%
Mortgage Bankers Association	-0.2%
Forecasts average	***-0.1%***

* All Forecasts as of *March 2008*, except for the Mortgage Bankers Association (*February* forecast).

A slumping housing sector, an expected reduction in nonresidential construction and waning consumer confidence is expected to weaken growth even further in the first-quarter of 2008. On average, growth is expected to contract at an annual pace of just about -0.1% in the first three months of the year according to market forecasts.

On February 13, President George W. Bush signed into law a US$ 170 billion fiscal stimulus package designed to push the U.S. economy back into health in the second half of the year. Both the Administration and the Congress hope that consumers will spend at least 40% of the US$ 300 to US$ 1,200 tax rebates that will be handed to them in May as the main part of the stimulus package. If successful, the plan could add up to 3 percentage points to U.S. GDP growth in the third quarter on an annualized basis.

The Labor Department reported that the U.S. economy lost 63,000 jobs in February. It was the second consecutive monthly decline and the third straight decrease for private-sector jobs. Without the government, which added 38,000 jobs in February, the private sector shed 101,000 jobs. Job losses broadened to include cuts by retailers and temporary help services in addition to the cuts in construction and manufacturing. Retail spending accounts for two-thirds of the U.S. economy, thus fears that the economy is already in recession increased after the release of this report. Following the February labor report's release, the Fed announced that it would inject about US$ 200 billion into the banking system by offering banks one-month loans at low rates and in return letting them pledge mortgage-backed bonds and even riskier assets as collaterals. Fed officials said that they were not reacting to the poor jobs data, but rather responding to the growing unwillingness or inability of investors to finance even routine business deals.

A few days later, on March 11, the Fed announced that it was pumping more cash into a tight credit market. The Fed will lend up to US$ 200 billion of Treasury securities to primary dealers. The Fed is attempting to ease short-term pressure on leveraged investors by making it possible to exchange AAA mortgage-backed bonds for Treasuries. The Fed also acted in conjunction with the European Central Bank, the Bank of Canada and the Swiss National Bank, and authorized increases in its existing swap lines with them. As in December, these three central banks cooperated with the Fed in a global coordinated effort to calm markets. This latest move brought the total amount of new short-term funds made available by the Fed over this past week to more than US$ 400 billion. Stock futures surged in response, with the Dow Jones climbing 3.6%, its biggest gain in over five years.

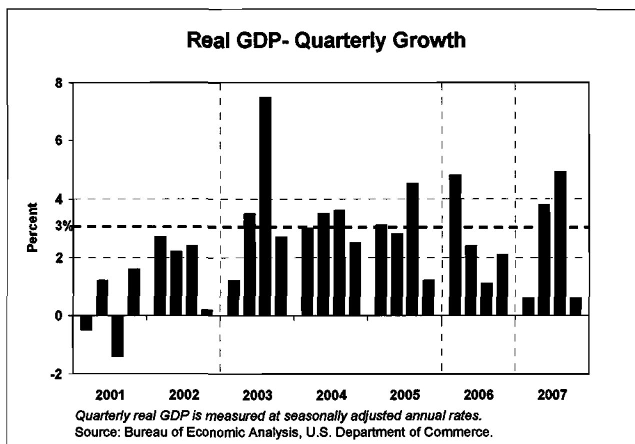
With the credit crunch increasingly worsening and no bottom to the housing woes in sight, the FOMC seems poised to deliver another steep interest-rate cut when they meet again in March 18. Futures markets have until recently put high odds on at least a 50 basis points cut. Following the recent announcements, however, the odds of a cut in the federal funds rate before the next meeting dropped, but the odds of a three-quarter point reduction on March 18 increased. The Fed needs now to keep a delicate balance. An aggressive cut could stir up inflation expectations, but a smaller cut could set off a negative reaction in the markets.

Risks to growth are to the downside, and if credit tightens further, monetary policy could prove ineffective. In addition, the Federal Reserve may face a policy dilemma if inflation does not slow as expected. The Personal Consumption Expenditure (PCE) price index excluding food and energy rose at an annualized 2.7% in the fourth quarter, above the Fed's comfort zone, and up from a 1.9% increase in the third quarter. Higher core inflation gives the Federal Reserve less maneuvering room.

II. CURRENT ASSESSMENT

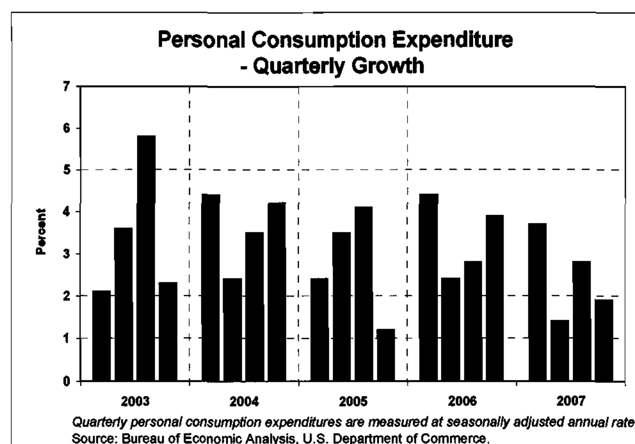
• GDP Growth

According to the preliminary estimates released by the U.S. Department of Commerce on February 28, the U.S. economy slowed sharply at the end of 2007. The economy grew at an annual rate of 0.6% in the fourth quarter of 2007, a much slower pace than in the third quarter, when the economy grew at 4.9%. The slowing was a result of declining inventories and slower growth in consumer spending, exports and federal government expenditures. U.S. economic growth ended the year at the same pace as it started: in the first quarter, the economy also grew at a rate of only 0.6%.



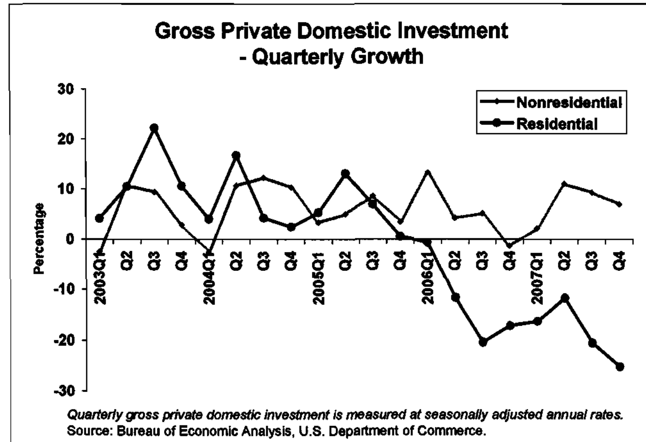
Quarterly real GDP is measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Consumer spending grew at a 1.9% pace in the fourth quarter, down from 2.8% in the third quarter. Falling house prices and a weak stock market have reduced household wealth, while slowing labor demand and the steep increase in oil prices have damped real income gains. Underlying problems in the economy, particularly in the housing market, suggest that consumer spending will continue to slow, with the most recent readings on real consumer purchases pointing to soft growth in the first quarter. Real consumer expenditure, which accounts for more than two-thirds of GDP, added 1.32% to fourth-quarter GDP growth.

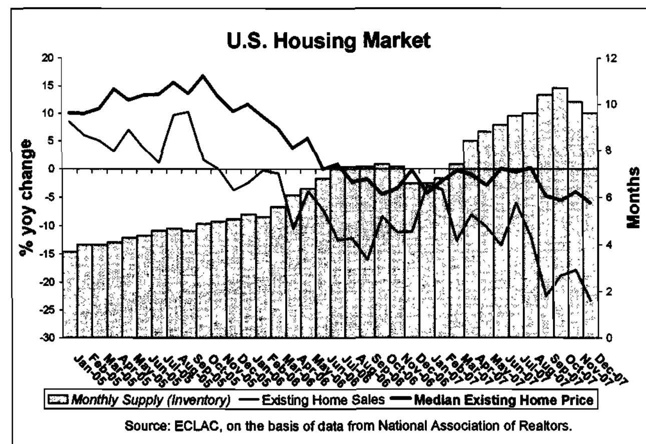


Quarterly personal consumption expenditures are measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Real nonresidential fixed investment, which represents overall business spending, increased 6.9% in the fourth quarter, compared with 9.4% in the third quarter. Investment in equipment and software increased 3.3%, following a 6.2% increase in the third quarter, and is expected to remain subdued in the near term, given the tightening credit conditions as well as the slowdown in economic activity. Investment spending in the second half of the year could receive some help from the accelerated depreciation provisions in the recently approved fiscal stimulus bill. However, the magnitude and timing of this help is very uncertain. Business spending added 0.72% to the economy's growth rate.



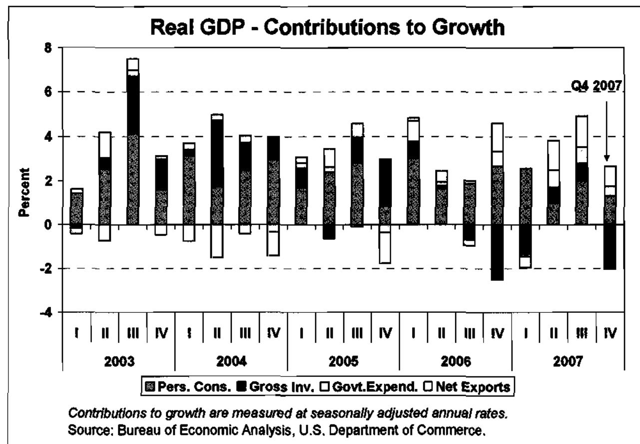
The housing market continued to weigh on the economy in the fourth quarter. Real investment in residential structures fell an annualized 25.2% in the fourth quarter, its eighth consecutive quarterly decline and the steepest decline since 1981, subtracting 1.25% from growth. Total fixed investment (residential and nonresidential) subtracted 0.53% from overall GDP growth in the fourth quarter.



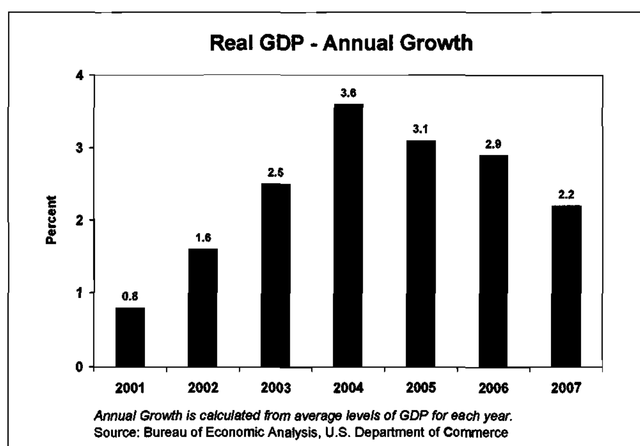
Credit problems have made it harder for future buyers to finance a home, deepening the house slump. In 2007, the inventory of unsold homes continued to pile up and builders continue to cut back, although monthly supply of unsold homes declined in November and December. By January of 2008, sales of existing single-family homes had fallen to more than 30% below their peak in September 2005, while the monthly supply of new homes for sales was more than twice its average level from 1997 through the summer of 2005.

Inventory building subtracted 1.49% from growth. In normal circumstances the decline in inventories would be a positive for growth in the first quarter of 2008. However, if businesses cut back on inventories because of concerns about the economy, they may be reluctant to increase their stockpiles in the next quarter. Moreover, most of the decline was in vehicles' inventories, indicating that there may be more reductions ahead as companies start to cut back on their inventories of other goods. Private businesses decreased inventories by US$ 10.1 billion in the fourth quarter, following increases of US$ 30.6 billion in the third quarter and US$ 5.8 billion in the second. Overall, gross private domestic investment subtracted 2.02% from GDP growth in the fourth quarter (-0.53% due to fixed investment, plus -1.49% due to inventories).

Federal spending increased only 0.9% in the fourth quarter, following an increase of 7.1% in the third quarter. State and local spending increased 3.0%, following an increase of 1.9% in the third quarter. Federal spending added 0.06% to the economy's growth rate, while state and local spending added 0.37%. Overall, government spending added 0.43% to growth in the third quarter.



Contributions to growth are measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.



Annual Growth is calculated from average levels of GDP for each year.
Source: Bureau of Economic Analysis, U.S. Department of Commerce

A shrinking trade deficit added 0.90% to overall growth. Higher exports of goods and services contributed 0.57% to overall GDP growth, while imports added 0.32%. Without trade's positive contribution, the U.S. economy would have contracted in the fourth quarter.

For the year as a whole, growth in 2007 was 2.2%, below the economy's potential and slower than in 2006, when the economy grew at a 2.9% rate. The major contributors to U.S. growth in 2007 were personal consumption expenditures, exports, nonresidential structures, and state and local government spending, which were partly offset by decreases in residential fixed investment and in inventory investment. Imports, which are a subtraction in the calculation of GDP, increased in 2007.

Housing was the most significant problem faced by the U.S. economy in 2007, and the decline in residential investment represented a large burden on economic growth. Growth in personal consumption expenditures slowed in 2007 as a result, to 2.9% from 3.1% in 2006. Given reduced access to home equity and a negative wealth effect from lower house prices, households have become more cautious with their expenditures. Moreover, Federal Reserve figures revealed that total household wealth fell US$ 533 billion to US$ 57,718 billion in the fourth quarter of 2007, as falling share prices added to the damage inflicted by declining house prices. The decline in household wealth has heightened concerns that households could pull back from spending as they become poorer and less able to have access to credit. Businesses, uncertain about future market conditions, are also becoming more cautious, as concerns over growth and tighter credit are now weighting on investment.

- **Sectoral Developments**

Industrial production declined at an annual rate of 1.0% (SAAR) in the fourth quarter, the first quarterly decrease since the fourth quarter of 2006. The capacity utilization rate was 81.5% in the fourth quarter, lower than the 82.0% in the third quarter. For the year as a whole, output increased by 2.1%, compared with 3.9% in 2006. Capacity utilization for the year was 81.6%, compared with 81.7% in 2006. Despite a softening in industrial activity in 2007, capacity utilization remained above 80%, suggesting that firms responded to solid, although flattening, demand.

Industrial production declined in October, but increased in November and was flat in December. The result in December was positive, in light of adverse conditions in the manufacturing sector. Manufacturing output fell 1.9% at an annual rate in the fourth quarter, led by a 13.1% decline in auto output (motor vehicles and parts). Pressures on the manufacturing sector are expected to remain in

coming months. Consumer spending is expected to slow, as well as business spending, and downward pressure on inventories may further aggravate weakness in industrial production.

The Fed's beige book survey reported that in the six weeks up to February 25 economic growth slowed, with two-thirds of the 12 Fed districts citing "softening or weakening in the pace of business activity." However, the ISM non-manufacturing index, which had plunged in January, bounced back in February. The index of 49.3 was still below the 50 level that marks the boundary between expansion and contraction, but it was a lot stronger than the 44.6 reported for January. Taken together, the beige book and the ISM survey suggest that the economy is growing at a weak pace, if growing at all, but do not indicate in a decisive way that the economy is heading to or is already in a recession.

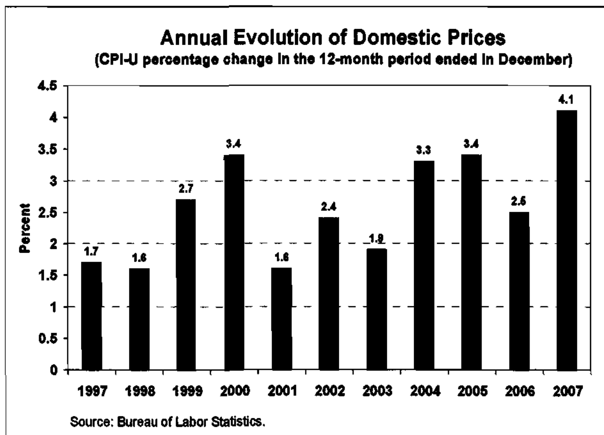
Industrial Outlook

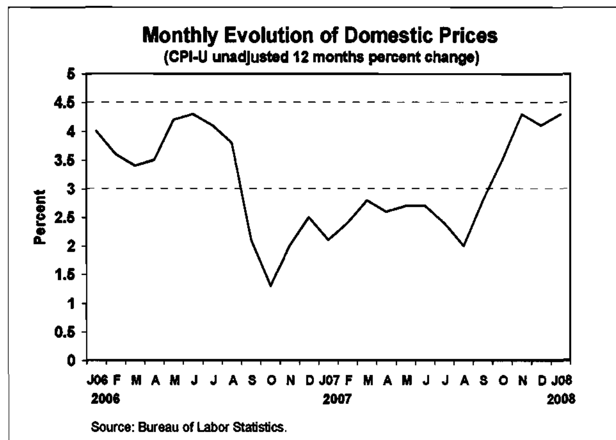
2007	Total Industrial Production		Capacity Utilization Rate (%)
	Index 2002=100	Percentage Change From Previous Period	Total Industry
2007 Q1	**112.2**	**1.1**	**81.3**
January	111.7	-0.5	81.1
February	112.5	0.8	81.6
March	112.4	-0.1	81.4
2007 Q2	**113.2**	**3.5**	**81.7**
April	113.1	0.6	81.7
May	113.0	-0.1	81.5
June	113.5	0.5	81.8
2007 Q3	**114.2**	**3.6**	**82.0**
July	114.2	0.6	82.2
August	114.1	-0.1	82.0
September	114.2	0.1	81.9
2007 Q4	**113.9**	**-1.0**	**81.5**
October	113.5	-0.6	81.4
November	114.0	0.4	81.5
December	114.1	0.1	81.5
Annual	**113.4**	**2.1**	**81.6**

Source: Federal Reserve.
Note: Quarterly changes are at annual rates. Annual changes are calculated from annual averages.

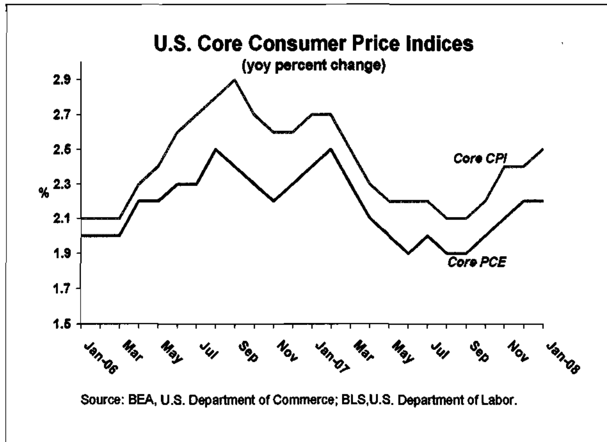
- **Inflation**

The Consumer Price Index for All Urban Consumers (CPI-U) increased at a seasonally adjusted annual rate (SAAR) of 5.6% in the fourth quarter, following an increase of only 1% in the third quarter. For the 12-month period ended in December, the CPI rose 4.1%, the highest annual inflation since 1997. This compares with an increase of 2.5% in all of 2006. The energy price index, after rising at a 27.8% SAAR in the first half of 2007, and declining at a 14.8% rate in the third quarter, went up again in the fourth quarter, advancing at a 37.1% annual rate. Energy costs rose at a 17.4% SAAR in 2007, what compares to an increase of 2.9% for all of 2006. The food index advanced at a 4.9% SAAR in 2007, after advancing 2.1% for all of 2006.





Excluding food and energy, the CPI-U advanced at a 2.7% seasonally adjusted annual rate in the fourth quarter, following increases of 2.5% in the third quarter and of 2.3% in each of the first two quarters of 2007. Core CPI advanced at 2.4% for all of 2007, what compares to a 2.6% rise for all of 2006. The deceleration reflects a slower advance in the index for shelter, and a downturn in the apparel index.



The Personal Consumption Expenditure (PCE) price index excluding food and energy, the most closely watched measure by the Federal Reserve, increased at an annualized 2.7% in the fourth quarter, rising beyond the Federal Reserve's comfort zone. In November and December of 2007, and in January of 2008 the core PCE readings were above 2%, considered to be the top threshold for the Federal Reserve (consistent gains above 2% are considered a concern for policymakers and investors).

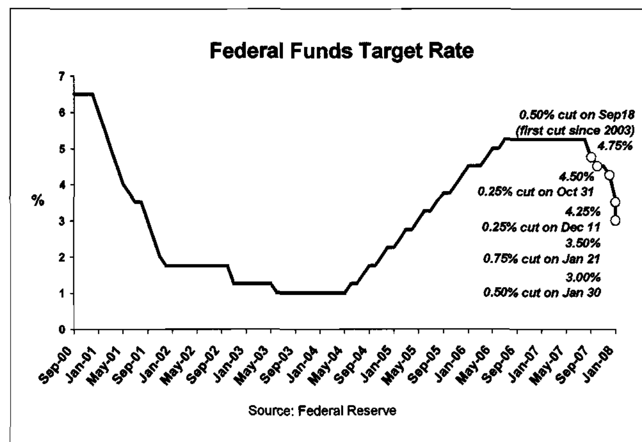
The producer price index, which measures wholesale inflation, increased 7.4% in 2007 according to the Labor Department, their steepest rise since 1981. Together with the increase in consumer prices, the increase in wholesale prices suggest that the fast price escalation on world commodities in 2007, particularly the fast increase in oil and grain prices, is moving through to what both consumers and businesses must pay in 2008. Wholesale prices rose 1% in January 2008, more than double what economists markets had forecast. Fuel prices were a major driver of the January increase, but prices also increased rapidly for a broad range of other items.

Inflation remains a concern, although the current economic slowdown is expected to restrain inflation to some degree. The current mix of slow growth and persistent inflation has led many analysts to caution about the possibility of a stagflation scenario, similar to that of the 1970s. The Federal Reserve remains focused on slowing growth for now, and Chairman Ben Bernanke made it clear that slow growth is the bigger threat to the U.S. economy.

Higher-than-expected oil price increases should continue to be the main upside risk for inflation in 2008. Oil prices hit a record high on March 12, climbing above US$ 110 a barrel on the New York Mercantile Exchange. On some measures oil price closed higher in inflation adjusted terms than its previous peak in April 1980, at the height of the second great oil shock. Oil's rise is fueling gasoline prices, with the average U.S. retail price for a gallon of regular gas rising to a new high of US$ 3.225 this week, according to the U.S. Energy Information Administration. With growth slowing, energy increases will become harder to absorb and more likely to weigh on household budgets, what could worsen the economy's woes originating from the turmoil in credit and housing.

- **Monetary Policy**

Since September of 2007, the U.S. Federal Reserve has cut the federal funds rate five times, for a total of 225 basis points. The FOMC met two times in the fourth quarter of 2007, on October 31, cutting the interest rates by a further 25 basis points to 4.5%, and also lowering the discount rate by 25 basis points, to 5.0%, and on December 11, lowering the federal funds rate by 25 basis points once again to 4.25%, and the discount rate by 25 basis points to 4.75%. The Committee cited weakening economic growth, concern in



financial markets and slowing core inflation. On December 6, in a joint session of the FOMC and the Board of Governors, Board members and Reserve Bank presidents met through a conference call to review conditions in domestic and foreign financial markets and discuss two proposals aimed at improving market functioning. The first proposal was for the establishment of a temporary Term Auction Facility (TAF), which according to the Fed's minutes "would provide term funding to eligible depository institutions through an auction mechanism beginning in mid-December." Most participants viewed the TAF as a potentially useful tool. The second proposal was to set up a foreign exchange rate swap arrangement with the European Central Bank, and was considered "as a positive step in international cooperation to address elevated pressures in short-term dollar funding markets." The Fed's TAF, in conjunction with term financing from other central banks contributed significantly to easing funding strains in inter-bank lending markets, with a considerable narrowing of spreads taking place.[1] There were six auctions until the end of February, amounting to US$ 160 billion.

In January 2008, in a rare inter-meeting decision, the FOMC cut the federal fund target rate by 0.75 basis points to 3.5%. The cut was a response to the weakening of the economic outlook, as strain in financial markets intensified. Two days before the cut, foreign stock markets had seen big drops over intensifying fears of a recession in the U.S. After a three-day weekend U.S. stock markets were set to open lower. In face of a poor December employment report, continued contraction in the housing sector, weak investment numbers and declining business and consumer confidence, the FOMC chose to move quickly and decisively, in contrast with its actions in previous months. The Fed indicated in its minutes that there were concerns among participants that these developments could lead to an "excessive pull-back in credit availability and in investment."

A week later, at its schedule meeting on January 30, the Committee lowered its target for the federal funds rate again by 50 basis points to 3%. The FOMC mentioned in its statement that this action, "combined with the policy actions taken earlier, should help promote moderate growth over time." At the time of the release of the meeting's minutes the Fed also released its updated projections for growth and inflation. Virtually all of the Fed's projections have deteriorated considerably. Growth of real GDP for 2008 is now expected to be between 1.3% to 2.0% (compared to 1.8 to 2.5% in October), while core PCE inflation is expected to be between 2.0 to 2.2% (compared to 1.7 to 1.9% in October).

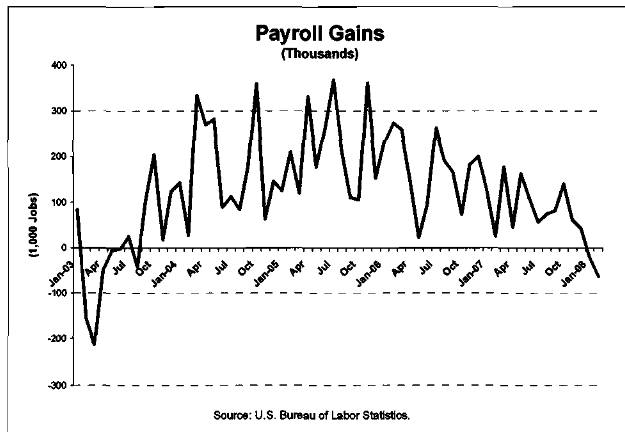
On March 7, the Federal Reserve announced that it will make US$ 200 billion available to lenders through two channels. It will raise the size of its TAF auctions to fight back against heightened liquidity pressures in financial markets, with the TAF auctions on March 10 and March 24 each to be increased to US$ 50 billion, an increase of US$ 20 billion from the amounts that were announced on February 29. According to the Fed, "to provide increased certainty to markets participants, the Federal Reserve will continue to conduct TAF auctions for at least the next six months unless evolving market conditions clearly indicate that such auctions are no longer necessary." The Fed also unveiled another US$ 100 billion in new one-month repurchases operations primarily for investment banks, accepting pledge mortgage-backed bonds and even riskier assets as collateral. The intention of the Fed was to absorb some of the liquidity risk facing the markets by offering cash in return for relatively illiquid assets. The announcement was meant to reassure investors that they will be able to cash in securities if they want, and thus prevent a panic selling that could push asset values down and cause further economic damage.

[1] Term inter-bank funding pressures are largely the result of the sharp decline in asset-backed commercial paper outstanding since mid-August, and a shifting in the demand for credit away from Money Funds and towards banks. The TAF program provides term reserves via the discount window rather than via the Fed's System Open Market Account (SOMA) and the benefit of the TAF program is that it allows banks to lock in funding for a specified period of time (28 to 35 days).

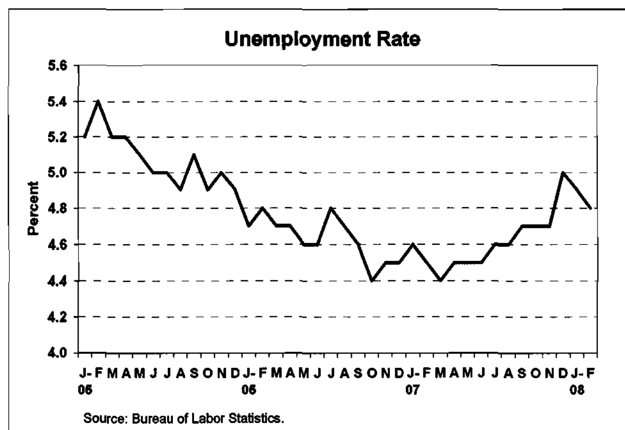
In addition, on March 11, in a second big intervention in three days, the Fed announced that it was pumping more cash into a tight credit market. The Fed revealed its boldest step yet to ease the credit crunch, saying that it will lend primary dealers in the bond market up to US$ 200 billion in Treasury securities for a term of 28 days and accept AAA-rated mortgage-backed securities as collateral in return. The initiative is called the Term Securities Lending Facility (TSLF) and it provides to a new set of financial institutions a chance to temporarily replace mortgage-backed assets – provided that they are AAA-rated securities – with Treasuries for period of 28 days at a time. The dealers continue to bear the market risk of the assets provided as collateral, but this latest initiative takes the U.S. central bank a step closer to the possibility of directly buying mortgage-backed securities. The FOMC also authorized increases in its existing temporary exchange-rate swap arrangements with the European Central Bank and the Swiss National Bank. These arrangements will now provide dollars in amounts of US$ 30 billion and US$ 6 billion to each bank respectively, representing increases of US$ 10 and US$ 2 billion. The Bank of Canada and the Bank of England also extended their liquidity support operations. The total boost provided by the Fed with this announcement amounted to US$ 236 billion, and combined with the earlier announcement, the Fed provided a total of US$ 436 billion of new short-term funds over this past week.

- **Labor Markets**

The labor market has shown fresh signs of distress. Nonfarm payrolls fell 63,000 in February, the most since June 2003, marking a second monthly decline, driving many market analysts to conclude that the two consecutive months of nonfarm payroll declines were a strong indication that the housing and credit crunch has spread to other sectors and that the economy has fallen into a recession. Jobs growth had been persistently negative in the manufacturing and construction sectors since the beginning of 2007, but in the recent report there was also loss of jobs coming from the service sector, signaling that the economic activity is slowing. Manufacturing firms cut 52,000 jobs, the 20th-straight monthly decline. Construction employment fell by 39,000, the eighth-straight monthly decline, and service-sector employment rose just 26,000, the slowest gain since 2005. Business and professional services companies cut 20,000 jobs, and the financial sector lost jobs for the seventh-straight month as a result of the recent turmoil in credit and mortgage markets. Jobs were added in leisure/hospitality industries, as well as in education and healthcare. The government added 38,000 jobs.



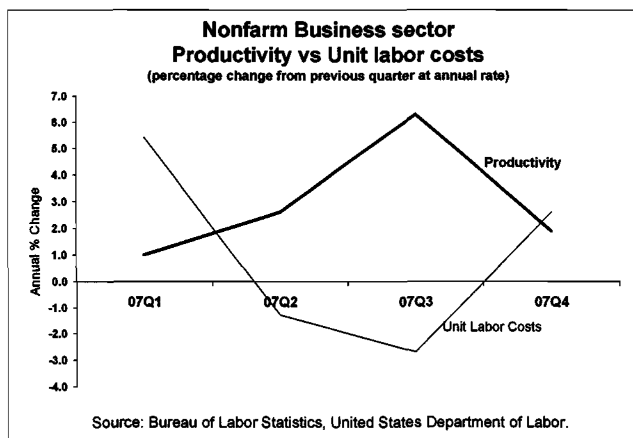
For the fourth quarter of 2007, the U.S economy created 241,000 jobs, more than the 212,000 created in the third quarter, but less than the 315,000 jobs created in the second quarter and the 328,000 jobs created in the first. For the year as a whole, 1.1 million of jobs were created, half of the number of jobs added in 2006 (2.1 million).



The unemployment rate ended the year at 5%, but it has eased since then to 4.8% in February. However, this should not be read as a sign of economic strength. The decline in

unemployment rate, which is calculated using a separate survey of households, was triggered by a 450,000 decline in the size of the labor force, not a rise in employment. The labor force participation declined significantly, to 65.9% in February from 66.1% in January and 66.0% in December 2007.

Fourth quarter productivity growth for the nonfarm business sector was 1.9% (SAAR), following 6.3% in the third quarter, which was the strongest quarterly growth in productivity in four years. Nonfarm unit labor costs increased an annualized 2.6%, following a decline of 2.7% in the third quarter. Since the economy almost came to a halt in the fourth quarter, the strong growth in unit labor costs raises inflation concerns. However, the Labor Department's February employment report supports the Fed's view that for the moment slowing growth is a bigger threat than inflation. The recent loss of payroll jobs could further push the economy down, driving it into negative territory.



For all of 2007, productivity increased 1.8%, compared with 1% in 2006, and growth in unit labor costs was 3.1%, compared to 2.9% for all of 2006.

- **Financial Markets**

2007 was a year marked by financial turmoil. It started with a spike in volatility in February after a 9% drop in the Shanghai market and heightened concerns over the prospects of a slowing U.S. economy, which quickly subsided. A series of financial spillovers from the deterioration of mortgage markets in the early summer developed into a full liquidity crisis in August, and stock prices plunged as a result. Following the fall in August in response to the crisis in credit markets, equity prices recovered and reached record levels in October, recuperating the previous losses. The S&P rose to 1,540 in October, the Dow Jones to 13,901, and the NASDAQ to 2,780. For the year as a whole equity prices posted double-digit gains, with the Dow Jones gaining 15.4%, the S&P 12.7% and the NASDAQ 13.9%.

The economic impact of the financial turmoil that started last summer has yet to be fully felt. According to Chairman Ben Bernanke, the disruption of the credit process is not near the end just yet. Evidence from banks themselves and from the Fed's surveys indicates that the lending system has been severely disrupted and that banks aren't lending as readily as they used to, even to one another. The banks' reluctance to lend money to borrowers is reflected in the gap between the yields on short-term Treasury notes and on money available for borrowing in the

Stock Prices

	Dow Jones Industrial Average	S&P 500	Nasdaq
2003	8,993.59	965.23	1,647.17
2004	10,317.39	1,130.65	1,986.53
2005	10,547.67	1,207.23	2,099.32
2006	11,408.67	1,310.46	2,263.41
2007	13,169.98	1,477.19	2,578.47
Growth Rates %			
2004	14.72	17.14	20.60
2005	2.23	6.77	5.68
2006	8.30	8.55	7.82
2007	15.44	12.72	13.92
Monthly Stock prices			
2007			
January	12,512.89	1,424.16	2,453.19
February	12,631.48	1,444.79	2,479.86
March	12,268.53	1,406.95	2,401.49
April	12,754.80	1,463.65	2,499.57
May	13,407.76	1,511.14	2,562.14
June	13,480.21	1,514.49	2,595.40
July	13,677.89	1,520.70	2,655.08
August	13,239.71	1,454.62	2,539.50
September	13,557.69	1,497.12	2,634.47
October	13,901.28	1,539.66	2,780.42
November	13,200.58	1,463.39	2,662.80
December	13,406.99	1,479.23	2,661.55

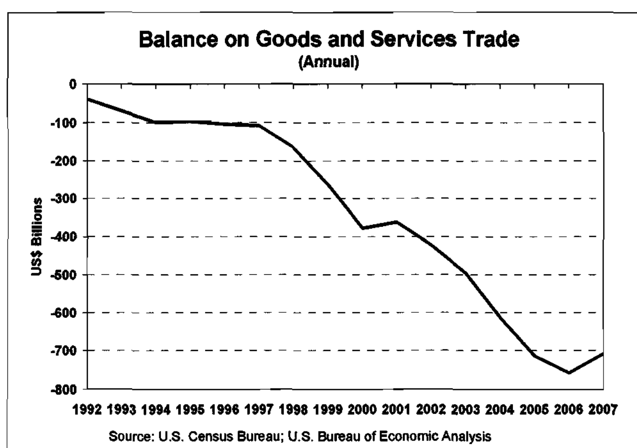
Source: Economic Indicators, U.S. Government Printing Office.

London interbank markets, which is currently five times the average of the past 20 years according to Merrill Lynch data.[2]

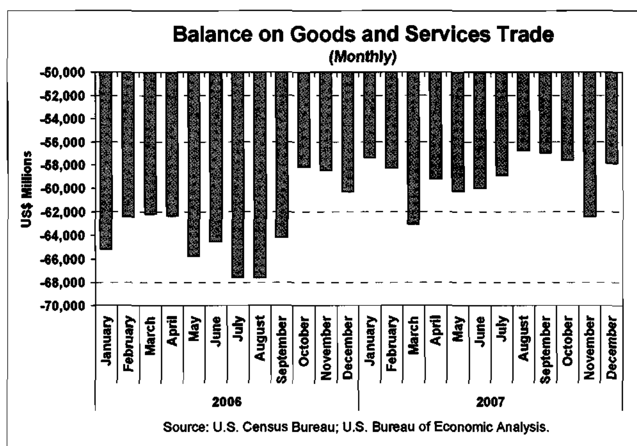
There was a net inflow of capital in the fourth quarter of US$ 300 billion according to the Treasury International Capital (TIC) report. Despite the weaker dollar, the U.S. trade deficit widened in the fourth quarter to US$ 180 billion from US$ 174 billion in the third quarter. Capital flows were more than enough to finance the deficit in the current account. In December, net capital flows at a positive US$ 60.4 billion slightly exceeded the December trade deficit in goods and services of US$ 58.8 billion.

- **External Sector**

According to the Bureau of Economic Analysis and the Census Bureau, the U.S. goods and services deficit narrowed by US$ 50 billion in 2007 (6.6%), from US$ 759 billion in 2006 to US$ 709 billion. Despite the decline, the 2007 deficit was the third largest on record and roughly double what it was in 2001, when it last experienced an annual decline. The data provided support for the notion that the slowing U.S. economy is in some measure being held up by exports, which grew by 12.6% to a record US$ 1,628 billion in 2007. Imports rose by 6%. As a percentage of U.S. GDP the goods and services deficit was 5.1% in 2007, down from 5.7% in 2006.



Trade has turned into a boost to real GDP growth, and in 2007 trade contributed 0.6% to the real GDP growth.[3] The trade balance was also a positive for fourth-quarter growth, contributing 0.9% to overall growth. This is significant because of the turmoil in credit markets stemming from the subprime mortgage problems, the weakening of the housing sector and the domestic auto sector.



The U.S. goods and services trade deficit – propped up by a weak U.S. dollar and sluggish domestic demand – narrowed by 7.3% to US$ 57.9 billion in December from

[2] If total losses from the credit crisis are large, and they are expected to be, banks and other lender will be forced to scale back lending in response to those losses. The cutback in response to a US$ 400 billion loss, for example, is estimated at close to US$ 2 trillion, according to Jan Hatzius of Goldman Sachs. According to these estimates, US$ 1 trillion of this lending cutback would be felt by households and nonfinancial businesses, while the other half would be absorbed by other financial firms. The cutback would trim 1% to 1.5% from economic growth in 2008, and it would come on top of other negative forces already in the way, such as declining home-building demand and consumer spending.

[3] From 2001 to 2005 trade was a consistent drag on economic growth according to Moody's Economy, shaving one-half to a percentage point from real GDP growth.

US$ 62.4 billion in November, which was better than the consensus call. The deficit was 14.4% lower than its peak in August of 2006. The goods trade deficit shrank by US$ 4.8 billion to US$ 67.9 billion, while the services surplus decreased by 0.3 billion to US$ 10.1 billion. The petroleum deficit reached a new record low, worsening by US$ 1.3 billion to US$ 31.4 billion. Excluding petroleum, the goods deficit improved sharply by US$ 5.9 billion to US$ 34.8 billion, the largest monthly change in the series 18-year history. Total exports increased by 1.5% mom, while imports decreased by 1.1% mom.

Crude oil prices surged to an all-time high of more US$ 110 a barrel on March 12. Oil prices have been boosted by higher demand from emerging markets, especially China, and have also been supported by financial flows into the commodities markets and the weakness of the U.S. dollar, which sank to a record low of US$ 1.55 per euro. Going forward, record high oil prices should increase the nominal value of imports, which will be an obstacle to further improvements in the trade balance. On the other hand, imported goods are getting expensive because of the weakening dollar, a trend that should put downward pressure on imports. A weak dollar also boosts exports. The combined effect of these trends could be a lower trade deficit in coming months. However, how much the trade deficit can improve and how much it will support economic growth, will be largely determined by how far oil prices will rise.

The goods deficit with China narrowed to US$ 18.8 billion, 21.5% less than in November and 0.6% less than December a year ago. According to Moody's Economy the imbalance between China and the U.S. has been moderating, as the Yuan has been appreciating against the dollar at a rate of 0.4% per month since the second half of 2006. However, for the year as a whole, the trade deficit with China rose by 10.2% to US$ 256.3 billion – its highest level on record – and China overtook Canada as the biggest source of U.S. imports.

III. LOOKING AHEAD

- Current market projections for real GDP growth in 2008 have been lowered in light of recent events, and now range from 0.8% to 2.7%. Private sector projections range from 0.8% to 2.2%.

Forecasts for Annual U.S. Economic Growth

	Real GDP		
	2008	Date of Forecast	Previous Forecasts
A. What Government Agencies Say			
FED*	1.3 - 2.0%	*Feb-08*	*1.8-2.5% in Oct-07*
Council of Economic Advisors*	2.7%	*Nov-07*	*2.7% in Jun-07*
CBO	1.9%	*Feb-08*	*2.9% in Aug-07*
B. What Markets Say			
Goldman Sachs	0.9%	*Mar-08*	*1.8% in Dec-07*
National Association of Realtors	1.5%	*Mar-08*	*2.8% in Nov-07, 2.2% in Feb-08*
Merrill Lynch	0.8%	*Mar-08*	*1.4% in Nov-07*
Moody's Economy.com	1.5%	*Mar-08*	*2.3% in Nov-07*
Credit-Suisse	2.2%	*Dec-07*	
The Economist Intelligence Unit	0.8%	*Mar-08*	*1.5% in Dec-07*
JPMorgan	1.2%	*Mar-08*	*2.2% in Dec-07, 1.9% in Feb-08*
Securities Industry and Financial Markets Association (SIFMA)	2.1%	*Dec-07*	*2.8% in Jun-07*
Wachovia	1.7%	*Mar-08*	*2.7% in Nov-07*
Mortgage Bankers Association*	1.6%	*Feb-08*	*2.4% in Nov-07*
C. What International Organizations Say			
United Nations DESA	2.0%	*Jan-08*	
OECD	2.0%	*Dec-07*	
IMF	1.5%	*Jan-07*	*1.9% in Oct-07*

* forecast on a Q4 to Q4 basis.

Note: the CBO and IMF forecasts on a Q4 to Q4 basis are 1.6% and 0.8% respectively, while the SIFMA forecast remains the same, at 2.1%.

- The latest Labor Department's payroll report came out worse than expected, pointing to a second consecutive month of job losses and sharp deterioration in private sector hiring. The private sector has shed jobs for three consecutive months now. The job losses in February – in addition to soaring energy prices, the ongoing credit crunch and the continuing decline in housing prices – increased fears that the economy may be already in a recession. Forecasts for real GDP growth in 2008 made as recent as February may soon be revised downwards as a result.

- In fact, most economists now believe that the U.S. economy is already in recession, and the concern now is how deep it will be and how long it will last. The economy should receive a boost from the fiscal stimulus in the second half of the year, but many expect it to be short-lived, with growth faulting again right after. There is also an increasing perception that monetary policy alone might not be able to contain the risk of a deep recession given the constraints imposed by inflation.

- The Federal Reserve has announced the injection of a significant amount of liquidity in short-term funds markets in the course of the past week. However, some market analysts point out that the Fed's efforts will not eliminate the underlying causes of the economy's problems: the declining home prices and escalating surge in mortgage defaults, although they do bring a dose of relief from short-term liquidity constraints. The Fed has increased pressure on lenders to recapitalize and write down the value of home loans. It has also increased support for policies that can make loan restructuring and financing of new homes through the Federal Housing Administration easier.

- The fear of a severe recession is leading many experts to advocate more policy intervention. John Lipsky, deputy manager director of the IMF, urged governments to make plans to increase spending to stimulate economic growth and rescue troubled financial institutions if the housing crisis and credit crunch worsens further. He raised the possibility of what he called a "global financial decelerator," when rising defaults aggravate the credit crunch, prompting banks to stop making loans and sell existing loans and securities on their balance sheets at distressed prices, reducing lending further and choking the economy. For its part, the U.S. Treasury is set to release a report examining the reasons behind the subprime mortgage meltdown, and specific recommendations are expected at a later date.