

Oct 6, 2008

Economic Commentary

New Forecast

The long-term prospects for the US economy remain bright, but the economy was flat in the third quarter and appears ready to contract in the fourth quarter. As a result, it is likely the National Bureau of Economic Research – the “official” US arbiter for business cycle dating – will eventually declare we are in recession.

Economic indicators reported last week were generally weak, particularly auto sales, which are largely credit dependent. Moreover, the credit crunch worsened in late September, suggesting weaker consumption and business investment in October.

We are witnessing economic weakness the source of which is different than every recession in the past 100 years. Other recessions have been caused by some combination of monetary tightness, higher taxes, or protectionism. The current weakness is not due to any of these factors. Instead, it is the blowback from a massive amount of bad lending (itself ignited by

loose money) mixed with overly harsh mark-to-market accounting rules.

The combination of bad loans and prevailing accounting practices has caused fear and panic in the financial system, in turn causing a huge decline in the velocity of money – how quickly money turns over in the economy. We believe the Federal Reserve will respond to the current situation by cutting rates by 100 basis points, back down to the 1% level that prevailed in 2003-04.

A slowdown in velocity will not only suppress real economic growth but also slow inflation. However, the credit crunch will not last forever. We expect the lack of confidence now permeating the financial system to dissipate in the next few months, leading to a return to healthy real GDP growth and rising inflation in the second half of 2009.

Brian S. Wesbury, Chief Economist
Robert Stein, Senior Economist

	Actual		Forecast					
	Q1.08	Q2.08	Q3.08	Q4.08	Q1.09	Q2.09	Q3.09	Q4.09
Real GDP Growth:								
Q/Q Annual Rate	0.9	2.8	0.0	-1.5	0.0	1.5	3.0	3.5
Year-to-Year Change	2.5	2.1	0.9	0.5	0.3	0.0	0.7	2.0
Unemployment Rate*	4.9	5.3	6.0	6.2	6.5	6.8	7.0	7.1
CPI**	4.2	4.3	5.3	4.7	4.2	3.6	2.6	2.7
GDP Deflator**	2.3	2.0	2.8	2.7	2.7	3.2	2.8	2.9
Rates (End-of-Quarter):								
Federal Funds Target	2.25	2.00	2.00	1.00	1.00	1.50	2.00	2.50
10-Year Treasury	3.45	3.99	3.85	4.05	4.30	4.50	4.75	4.95

*quarterly average ** year-to-year percentage change