US Federal Reserve downgrades economic growth forecast for 2008

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The US Federal Reserve Board last week cut its US economic growth forecast for 2008 and upped its estimate of inflation.

The Fed revised its projection for growth to between 1.3 and 2 percent, down half a percentage point from its October forecast. It also raised its core inflation forecast to between 2 and 2.2 percent, up 0.3 percent from its earlier estimate.

The Fed's growth estimate was widely seen as optimistic. The International Monetary Fund estimates that the US economy will grow by only 0.8 percent over the same period.

Inflation statistics for January also painted a grim picture, with consumer prices up 4.3 percent over a year earlier. Prices rose 3.7 percent for the whole of 2007.

The core inflation rate, which excludes food and energy prices, crept up to 2.5 percent, significantly higher than the Fed's target of about 1.7 percent. The US central bank does not expect the US economy to normalize until 2011, according to the projections it released last Wednesday.

The European Commission also cut its 2008 Eurozone growth forecast, from 2.2 to 1.8 percent, and revised its 2008 inflation estimate up by half a percentage point, to 2.6 percent. The Commission's projection for Eurozone core inflation was revised upwards drastically from 2.1 percent to 2.8 percent.

"Given the evolution of leading indicators, this still looks very optimistic," Ken Wattret, economist at BNP Paribas bank, told the *Financial Times*. Eurozone inflation reached a 14-year high of 3.2 percent in January.

The parallel movement of economic variables in the US and the Eurozone refutes claims that Europe had been "decoupled" from US economic problems. It is becoming increasingly clear that no part of the world is immune from a deepening financial crisis that first erupted in the US last August.

The US is the world's largest importer, and a collapse in US demand would create an overcapacity crisis in the rest of the world. Moreover, by some estimates, over half of US subprime-backed debt was exported.

Germany is showing trends similar to the US. The country's gross domestic product (GDP) growth slowed from 2.5 percent in the third quarter to 1.8 percent in the fourth. Fears of a significant growth slowdown were strengthened by lower-than-expected retail sales and consumer spending in December.

Despite steadily rising inflation, the Fed has been reducing interest rates aggressively, slashing .75 percentage points on January 21 and .50 points a week later. Fed Chairman Ben Bernanke has continued to stress that the Federal Reserve Board is primarily focused on preventing a recession.

The US central bank is pumping liquidity into financial markets, despite the dangerous implications for inflation and the position of the US dollar on world currency markets, in an attempt to prevent a potentially catastrophic banking crisis. In a recent article, NYU economist Nouriel Roubini wrote: "Why did the Fed ease the Fed Funds rate by a whopping 125 bps [1.25 percent] in eight days this past January? It is true that most macro indicators are heading south and suggesting a deep and severe recession that has already started. But the flow of bad macro news in mid-January did not justify, by itself, such a radical inter-meeting emergency Fed action followed by another cut at the formal FOMC [Federal Open Market Committee] meeting.

"To understand the Fed actions one has to realize that there is now a rising probability of a ‘catastrophic’ financial and economic outcome, i.e., a vicious circle where a deep recession makes the financial losses more severe and where, in turn, large and growing financial losses and a financial meltdown make the recession even more severe. The Fed is seriously worried about this vicious circle and about the risks of a systemic financial meltdown.”

Meanwhile, US housing and credit markets and consumer spending show no signs of improvement. Higher inflation risks are pushing up the price of long-term credit, making it difficult for home owners to take out loans or refinance their homes. Mortgages are generally based on the interest rates on long-term bonds. The higher costs of credit will tend to further depreciate housing prices while driving more households into foreclosure.

Last week saw another bout of turbulence in the credit markets as the cost of insuring US and European corporate credit hit a new high. The cost of debt insurance for companies listed on the benchmark iTraxx Europe index skyrocketed by 20 percent last Wednesday to 1.37 percent, up from .5 percent at the start of the year. In the US, debt insurance costs hit double their level at the start of the year.

The decreased availability of credit has made it difficult for many companies to finance their daily operations. Last week, Sharper Image, an upscale consumer goods retailer, filed for Chapter 11 bankruptcy, citing decreasing consumer demand and difficulty obtaining credit.

There have been 13 bankruptcies of publicly traded companies this year, with combined assets of over $7.7 billion. By way of comparison, there were only 11 such bankruptcies for the whole of last year, and the combined assets of the bankrupt companies amounted to $700 million.