

MACROECONOMIC ADVISERS'  
**MACRO FOCUS**



**FORECAST UPDATE:  
A DEEPER RECESSION AND LOWER INFLATION**

- The incoming economic data have been weaker than expected, and financial conditions have deteriorated dramatically since our last forecast. As a result, we have decided to update our forecast ahead of our next regularly scheduled forecast round at the beginning of November. The resulting forecast is considerably weaker than the one we produced in early October, with a deeper recession, a higher peak on the unemployment rate, and a lower path for inflation.
- The most important development bearing on the outlook is the substantial tightening of financial conditions—including a sharp decline in equity prices, a further deterioration of credit conditions, and an unexpected appreciation in the dollar. The adverse effects of these developments are only partly offset by the stimulus from lower energy prices.
- Absent a policy response, those changes would have raised the peak unemployment rate by about a percentage point relative to our October forecast. Of course, such a substantial revision calls for a policy response, which we assume takes place from both the monetary and fiscal authorities.
- Based on the weaker outlook for growth, we lowered the path of the federal funds rate. Instead of bottoming at 1%, as assumed in our last forecast, we now assume that the funds rate falls to ½% by the end of the year. In addition, we pushed back the beginning of the tightening cycle into 2010. Issues related to the zero bound on nominal interest rates are now very much on the minds of monetary policymakers. We also assume that there would be a sizable second fiscal stimulus package that will add meaningfully to growth in 2009. However, it is difficult to assess the effects of such a package, without knowing its specific structure.
- Even with these policy responses, we end up with three negative quarters of real GDP growth and a sluggish recovery that gets to above-trend growth only by 2010. This profile of GDP growth keeps the unemployment rate on its upward trajectory, with it reaching a peak of 7.4% by the end of 2009. This degree of slack qualifies the current period as a substantial recession by historical standards.
- The further increase in slack, the decline in energy prices, and the sharp deceleration of non-energy import prices that is underway will pull inflation significantly lower. We now expect core PCE inflation to decline to just above 1% by the end of 2010. Moreover, that moderation takes place under the assumption that longer-term inflation expectations remain anchored at 2%. If those expectations were to move lower, the economy could move to the edge of a deflationary episode.

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## **THE ECONOMIC DATA: WEAKENING AHEAD OF THE RECENT TURMOIL**

The incoming data has been weaker than anticipated, suggesting the economy was softer in the third quarter than we had estimated, even before the seizing up of credit markets in early October. Retail sales, for example, came in much weaker than expected in September and were revised lower for the previous two months. The data on retail inventories for August and industrial production in September pointed to less growth in inventory investment than previously expected.<sup>1</sup> And housing starts were a bit weaker than expected through September, though this has more effect on fourth-quarter growth than third-quarter growth given the lags involved. The cumulative effect of the weaker data was to lower our estimate of third-quarter growth by about  $\frac{3}{4}$  percentage point, from +0.1% in the last forecast to -0.7% in this forecast.

For the fourth quarter, there has been only a small decline in our *tracking estimate* of GDP growth, from -2.0% in our last forecast to -2.2% as of October 17. However, it is important to note that this estimate is driven principally by statistical momentum from the pattern of monthly data over the third quarter. It does not take account of changes in the underlying strength of demand that may come from other sources, such as broader financial conditions or credit availability. Those changes tend to be limited during most periods, but that is not the case today. Thus, it was important for us to update the forecast in a manner that can incorporate the changes in equity prices, credit spreads, the exchange rate, and energy prices, which all have a considerable impact on fourth-quarter growth. As explained fully below, our updated projection puts GDP growth in the fourth quarter at -2.8%.

## **FINANCIAL CONDITIONS: TIGHTENING DRAMATICALLY**

Financial conditions have deteriorated dramatically since about mid-September, with much of the deterioration coming since our last forecast in early October. Over the period since our forecast, the Wilshire 5000 index is down about 20%, implying a staggering \$2.8 trillion loss in household equity wealth in less than a month, on top of a \$4.4 trillion loss experienced over the prior year; the spread on the Baa corporate bond relative to the ten-year Treasury is more than 100 basis points wider, while high-yield bond spreads have widened nearly 400 basis points; and the real trade-weighted dollar index is up more than 7%.

In addition, banks and other financial institutions have remained under considerable pressure despite extraordinary government actions to help them. Even with the Fed continuing to expand its liquidity policies and the government guaranteeing certain bank liabilities, Libor spreads have remained very wide. Moreover, banks remain very concerned about their balance sheets and their capital positions, suggesting that they may continue to pull back on their supply of credit. We rely on the willingness of banks to lend to consumers, a variable measured by the Fed's Senior Loan Officer Survey, as an important measure of credit availability. Unfortunately, that data series is quarterly, and the most recent reading (for the beginning of October) will not be published until early November. Our current forecast run assumes that this reading will come in at -48, reflecting a notable deterioration from the -34 reading in July.

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<sup>1</sup> However, some of the weakness in industrial production was attributable to significant hurricane effects that will be mostly reversed.

**Table 1**  
**Changes in Financial Conditions over Various Periods**

	<b>Period of Fed Easing</b>	<b>Pause</b>	<b>Period Between Forecasts</b>
	8/10/2007 to 4/30/2008	4/30/08 to 10/3/2008	10/3/08 to 10/23/2008
<b>Equities (%)</b>			
Wilshire <sup>†</sup>	-4.6%	-20.4%	-20.8%
<b>Currencies (%)</b>			
Broad Nominal Index	-7.0%	7.0%	7.2%
<b>Yields (bp)</b>			
10-year Treasury Yield	-104	-14	0
<b>Spreads (bp)</b>			
BAA Corporate	122	125	113
High Yield Corporate	251	517	383
3-month Libor to OIS <sup>†</sup>	39	201	-31
Conforming Mortgages	48	52	-16
EMBI	65	180	398
<b>Bank Lending (index)</b>			
Willingness to Make Consumer Loans <sup>†</sup>	-15.1	-34.0	-48.0*
<b>Inflation Factors</b>			
WTI Spot (\$) <sup>†</sup>	42	-20	-31
Commodity Index (%) <sup>†</sup>	47.2%	-19.1%	-26.6%
5-year Breakeven Inflation (bp)	15	-134	-119

\*Federal Reserve Senior Loan Officer Survey; Diffusion Index - More Willing to make Consumer Installment Loans; Projected value based on change in credit spreads

<sup>†</sup>Updated through 10/24/2008

Table 1 shows the evolution of financial conditions since the middle of 2007, breaking that period up into several distinct phases—the period of aggressive Fed easing through April, the period of the Fed’s pause through our October forecast, and the period since our forecast (which of course includes the Fed’s intermeeting rate cut). During the period of Fed easing through April, the FOMC was actively trying to offset the tightening of financial conditions that was underway, and it managed to do so by lowering Treasury yields substantially. During the period of the Fed pause, financial conditions continued to tighten, but there was no offset coming from monetary policy.<sup>2</sup> Over the more recent period, the deterioration of financial conditions became much more dramatic, convincing the Fed to restart its easing cycle to offset some of the restrictive effects on GDP growth. But even with some policy response, the Fed has had no chance of fully offsetting these dramatic asset price changes. That has left us with much tighter financial conditions and a much weaker economic outlook.

With credit variables playing a more important role in our modeling, the forecast has become increasingly linked to the assumptions made about how credit conditions evolve over the forecast horizon. Here we have changed our approach to some degree. In the

<sup>2</sup> This point was the theme of the *Policy Focus* commentary “Missing in Action” that was circulated to MPI clients on October 7, the day before the Fed made its intermeeting rate cut.

previous forecast, we assumed that spreads remained unchanged for several quarters and then began to slowly improve as economic growth recovered. In this round, the jump-off point for spreads is so dramatically higher that we assume some of this widening reflects financial market disruptions that will quickly reverse. For example, for Baa corporate bonds, we assume about ½ the spread widening since our last forecast reverses by the end of the first quarter.

After this initial improvement, credit conditions are assumed to heal only slowly, as was the case in our previous forecast. Corporate and mortgage spreads gradually move lower, but remain well above their longer-run norms through the end of 2010. Banks instead continue to tighten up on their willingness to lend throughout 2009. These assumptions reflect our judgment that the credit sector is still in a process of deleveraging and improving capital positions. The equity market, in contrast, is not as weighed down by those considerations and can therefore react more quickly once the economic gloom begins to lift. In our view, equities are starting at very low prices even with a deep recession in our forecast. Thus, we assume a sharp bounce-back in equity prices over the next two years.

One factor that is helping the outlook over the near term is the dramatic decline in energy prices. In the updated forecast, we adjusted down the assumed path of oil prices to reflect the roughly \$20/barrel decline in the spot price of Brent oil since our last forecast. The decline in energy prices from their peak in our July forecast (which assumed a forward price for Brent averaging \$142/barrel over the next couple of years) has been dramatic. It reduces nominal consumer outlays on gasoline and oil in the fourth quarter by roughly \$111 billion (at an annual rate), assuming real purchases remain unchanged, providing a boost to real disposable income that helps to keep consumer spending stronger (or less weak) than it otherwise would be.

### **THE POLICY RESPONSE: FISCAL AND MONETARY**

The sharpness of the downward revision to growth and the upward revision to the unemployment rate (discussed below) suggest that a policy response is prudent from both the monetary and fiscal authorities.

As discussed in detail below, we assume that the FOMC responds by easing policy 50 basis points at each of the next two meetings, bringing the federal funds rate to ½%. Moreover, we assume that the FOMC keeps the federal funds rate at this level into 2010, before starting a gradual process of moving it up to more normal levels. Of course, the FOMC only has limited room to operate given the zero bound on nominal interest rates. Given the threat of entering a deflationary period and of hitting this bound, it is appropriate for the government to pursue fiscal stimulus as well.

Unfortunately, it is difficult to fold a fiscal stimulus package into the forecast when we know so little about its structure and details. Both presidential candidates have proposed further fiscal stimulus measures, and Congress has been considering a new stimulus package. The range of possible outcomes is quite wide, including additional spending on infrastructure projects and other initiatives, another round of tax rebates, or immediate implementation of some of the permanent changes to taxes (particularly, an acceleration of the tax breaks in the proposed policies, while delaying any offsetting tax increases).

Moreover, even if we could figure out the structure of the fiscal package (or packages), we would face considerable uncertainty about its timing—whether some parts of any additional stimulus could be put in place before the next president comes to office and when it would be passed and become effective once the new president takes office.

We did not want to condition the forecast on the outcome of the presidential election. At the same time, however, we did not want to exclude a fiscal package since it seems highly likely at this point. Hence, we decided to make a fairly generic assumption about the fiscal package. First, we assume the bill that has been discussed in the House, which includes infrastructure spending, funds for extending unemployment benefits and for job training, a temporary increase in the Medicaid matching rate, and a temporary increase in food assistance, passes Congress in the first quarter of 2009. The bill that has been discussed amounts to \$31 billion of appropriations in 2009 and another \$15 billion in 2010, but we assume that the infrastructure spending component of the bill ends up being doubled (adding about another \$10 billion per year). Second, we assume a simple cut in the average personal tax rate that would lower personal tax payments at roughly a \$100 billion annual rate, effective in the second quarter of 2009.

The fiscal policy response alone raises real GDP growth over 2009 by about ½ percentage point. However, we reiterate that our assumptions about the structure of the fiscal stimulus, and its likely effects on GDP growth, will change as the details of any package become available.

#### **THE UPDATED FORECAST: CREDIT CRUNCHED**

The updated forecast is much weaker than our previous forecast run. Real GDP growth is expected to be negative for three straight quarters, including a sizable decline in the fourth quarter. Moreover, the recovery of growth over 2009 is slower than previously anticipated. Compared to our last forecast, we lowered GDP growth over the second half of 2008 by 0.8 percentage point, and growth over 2009 by 0.5 percentage point, even though the current forecast is based on 50 basis points of additional monetary policy easing and a sizable fiscal stimulus package. Without those initiatives, the downward revision to the growth forecast would have been even more severe.

The recent economic data suggest that the economy declined slightly in the third quarter. In this forecast, we show a 0.7% decline. The economy appears to have entered the fourth quarter with negative momentum, and spending in the fourth quarter (and through 2009) will also be restrained by the tightening of financial conditions discussed above. We also revised down our estimate of state and local government spending to reflect the weakening in state and locals tax receipts. The net effect of these developments is to steepen the decline in real GDP in the fourth quarter to -2.8%. For these same reasons, growth in the first quarter of 2009 was lowered from +0.4% in our last forecast to -1.4%.

Over these three quarters, all of the major components of domestic demand (consumer spending, nonresidential fixed investment, and residential investment) are expected to decline. In addition, the contribution from net exports is expected to diminish significantly, reflecting the effect of the slowdown abroad and the appreciation of the dollar.

Growth turns positive in the second quarter of 2009, reaching 2¼%. This pattern in part reflects that the most severe part of the drag from financial conditions begins to pass at that point. In addition, the fiscal stimulus package adds about 1 percentage point to growth that quarter. Over the balance of the year, the recovery gets on firmer footing, as the economy benefits from the end of the housing correction and the subsequent significant rebound in housing starts; from a steady improvement in credit conditions; from a sharp rebound in equity prices; by the easing in monetary policy; and from the continuing effects of the fiscal stimulus. Still, GDP growth barely achieves its trend rate over the second half of 2009.

The declines in GDP in coming quarters and the slower growth over 2009 leave the unemployment rate on a higher path than we had in the last forecast. We now project that the unemployment rate will peak at 7.4% in the second half of 2009— nearly ½ percentage point higher than in our last forecast. This reading represents a considerable amount of slack compared to our estimate of the NAIRU (4.8%). Based on this metric, this period would qualify as the most severe recession since the early 1980s.

The higher path for the unemployment rate, along with still lower energy prices and a sharp deceleration in non-energy import prices, results in additional downward pressure on inflation. Core PCE inflation moves down from 2.5% in 2008 to 1.8% in 2009 and 1.3% in 2010. Moreover, with considerable slack lingering, inflation is still falling at that point. Headline inflation will move below core inflation for a time and then converges to core inflation based on our neutral assumptions for food and energy prices.

This path for inflation is getting uncomfortably low, and there are downside risks to it. Among those risks is the possibility that inflation expectations could begin to move lower. The various measures of inflation expectations that the FOMC monitors (including the one that we use in our Phillips curve) showed some fragility earlier this year, moving higher in response to the elevated readings on inflation. Given our forecast that inflation falls to near 1% and that considerable slack persists through 2010, it is possible that those expectations could prove to be fragile to the downside. Indeed, it would be very reasonable for the FOMC to worry about deflation concerns developing in our forecast. In our forecast, we held long-term expectations for PCE inflation fixed at 2%, but if those expectations were to begin to decline, the path of inflation predicted in our model could move down notably.

#### **IMPLICATIONS FOR MONETARY POLICY**

We have argued that the deterioration in credit conditions and the tightening of financial conditions were the primary motivation for the aggressive monetary policy easing earlier in this cycle, as the FOMC was attempting to offset the economic restraint arising from those developments. However, the changes in financial conditions have been so sharp over recent weeks that it may now be impossible for the FOMC to fully offset them with conventional monetary policy. Nevertheless, monetary policy can still, at the margin, provide a partial offset, which is what we envision in the forecast.

We assume that the significant downward revision to the growth forecast will cause the FOMC to remain aggressive and cut the federal funds rate to very low levels. Specifically, we maintained our assumption of a 50-basis-point cut in the federal funds rate at the October meeting, and we have added a further 50-basis-point cut at the

December meeting. These actions will bring the federal funds rate to just 50 basis points—the lowest level on record (since the early 1950s).

While these policy actions seem extreme, they are not out of line with how the FOMC has reacted to changes in the macroeconomic outlook in the past. One point of departure that we use for thinking about monetary policy prospects is the prescription from estimated monetary policy rules, such as the Taylor rule. These rules imply that the federal funds rate should be reduced to zero (or even below zero) by early next year. Moreover, these rules do not make any allowance for a lower real equilibrium funds rate (from tighter credit conditions) or the need for insurance against downside growth risks or the prospect of deflation. In this sense, we are being somewhat cautious by assuming only another 100 basis points of rate cuts. Indeed, there are risks that the trough in the federal funds rate could be lower than we assume.

This further easing brings the zero bound on nominal interest rates into play, raising the possibility that the Fed will have to engage in unconventional policy measures. To some extent, such policies are already under way, as the Fed has injected a flood of liquidity (more than needed to hit the federal funds rate target) aimed at improving the functioning of short-term funding markets. Other steps could follow if the economic outlook continues to deteriorate.

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MA Forecast Update (October 24): 2008.3 - 2010.4

Major Economic Indicators

	2008.1	2008.2	2008.3	2008.4	2009.1	2009.2	2009.3	2009.4	2010.1	2010.2	2010.3	2010.4	Q4/Q4 % change or annual avg.			
													2007	2008	2009	2010
<b>Key Indicators of Real Activity</b>																
Real gross domestic product*	0.9	2.8	-0.7	-2.8	-1.4	2.3	3.1	2.4	3.0	3.5	3.6	3.9	2.3	0.0	1.6	3.5
Contributions to growth:																
Final sales	0.9	4.3	-2.1	-2.4	-1.0	2.3	2.1	2.1	3.0	3.0	3.1	3.5	2.6	0.2	1.4	3.2
To domestic purchasers	0.1	1.4	-3.1	-2.8	-1.2	2.6	2.9	2.6	3.2	3.3	3.4	3.8	1.7	-1.1	1.7	3.4
Net exp. of goods & services	0.8	2.9	1.0	0.4	0.2	-0.3	-0.7	-0.5	-0.3	-0.3	-0.3	-0.3	0.9	1.3	-0.3	-0.3
Change in private inventories	-0.0	-1.5	1.4	-0.3	-0.4	-0.0	0.9	0.3	0.0	0.5	0.5	0.3	-0.2	-0.1	0.2	0.3
<b>Major components of real GDP:</b>																
Personal consumption expend.*	0.9	1.2	-3.4	-3.1	-0.9	3.2	2.4	2.0	2.6	2.6	2.9	3.3	2.2	-1.1	1.7	2.8
Nonres. fixed investment*	2.4	2.5	-5.2	-3.9	-7.0	-3.6	-0.4	1.6	4.1	6.3	7.5	8.6	6.4	-1.1	-2.4	6.6
Residential investment*	-25.1	-13.3	-17.3	-18.9	-8.8	11.8	29.7	24.7	25.1	18.7	13.6	11.6	-19.0	-18.8	13.3	17.1
Change in private inventories**	-10.2	-50.6	-15.2	-23.8	-33.4	-34.6	-10.0	-2.3	-1.1	11.3	24.3	33.3	-2.5	-25.0	-20.1	16.9
Exports of goods & services*	5.1	12.3	12.3	-2.3	1.7	3.9	4.9	5.6	6.3	7.1	7.6	8.0	8.9	6.7	4.0	7.3
Imports of goods & services*	-0.8	-7.3	3.4	-3.7	0.3	4.9	8.5	7.4	6.6	7.1	7.7	7.7	1.1	-2.2	5.2	7.3
Gov't consump. & gross invest.*	1.9	3.9	3.2	2.3	2.4	2.0	1.7	1.1	1.0	1.0	0.8	0.9	2.4	2.8	1.8	0.9
Pvt. housing starts (thous. units)	1053	1025	870	843	823	978	1074	1144	1257	1273	1341	1357	1341	948	1005	1307
Light vehicle sales (mil. units)	15.2	14.1	12.8	12.1	11.6	12.0	12.3	12.6	12.9	13.2	13.5	13.8	16.1	13.6	12.1	13.4
Industrial production, total*	0.4	-3.1	-5.0	-2.8	-3.9	-1.6	1.2	1.7	1.9	3.1	4.0	4.8	2.1	-2.6	-0.7	3.5
Industrial production, mfg*	-1.0	-3.6	-5.0	-3.6	-5.2	-2.5	1.0	1.9	2.1	3.5	4.5	5.3	2.3	-3.3	-1.3	3.8
Capacity utilization (mfg, %)	78.7	77.6	76.1	75.1	73.9	73.3	73.4	73.7	74.1	74.8	75.6	76.5	79.4	76.9	73.6	75.2
Nonfarm payroll employ. (mil.)	137.9	137.7	137.4	136.8	136.1	135.8	135.9	136.1	136.4	136.9	137.3	137.9	137.6	137.4	136.0	137.1
Average monthly chg. (thous.)	-38	-73	-112	-202	-209	-108	16	73	118	149	152	196	104	-106	-57	154
Private nonfarm hours*	-1.7	-0.8	-1.7	-3.3	-3.3	-1.3	0.2	0.5	1.0	1.4	1.4	1.9	-0.3	-1.9	-1.0	1.4
Civilian unemployment rate (%)	4.9	5.3	6.0	6.5	7.0	7.3	7.4	7.4	7.4	7.4	7.4	7.3	4.6	5.7	7.3	7.4
<b>Prices, Productivity, &amp; Costs</b>																
GDP chain-type price index*	2.6	1.1	5.3	1.0	3.9	1.4	1.6	1.4	1.8	1.4	1.2	0.9	2.6	2.5	2.1	1.3
CPI, all items (all urban)*	4.3	5.0	6.7	-4.0	2.8	2.0	2.2	1.9	1.9	1.9	1.5	1.1	4.0	2.9	2.2	1.6
CPI excl food & energy (all urb)*	2.5	1.9	3.2	2.5	2.3	2.2	2.1	1.9	1.9	1.8	1.6	1.0	2.3	2.5	2.1	1.6
PCE price index*	3.6	4.3	5.6	-2.9	2.1	1.7	1.9	1.7	1.7	1.6	1.3	1.1	3.5	2.6	1.8	1.4
PCE price excl food & energy*	2.3	2.2	3.2	2.4	2.2	1.7	1.8	1.6	1.4	1.3	1.2	1.1	2.2	2.5	1.8	1.3
PPI (finished goods)*	9.2	10.6	10.2	4.1	1.0	0.6	1.0	0.7	0.7	0.7	0.4	0.2	6.7	8.5	0.8	0.5
Compensation per hour*	3.8	3.7	4.9	4.1	3.7	3.7	3.7	3.6	3.5	3.4	3.5	3.5	3.6	4.1	3.7	3.5
Output per hour*	2.6	3.7	0.2	-0.8	1.1	3.9	3.4	2.2	2.5	2.7	2.8	2.7	2.7	1.4	2.6	2.6
Unit labor cost*	1.2	0.0	4.7	5.0	2.6	-0.1	0.3	1.4	1.0	0.7	0.7	0.9	0.9	2.7	1.0	0.8
Refiners' cost of imported oil (\$/b)	89.8	115.9	113.2	77.3	74.6	76.5	77.8	78.9	79.9	80.7	81.4	82.3	67.1	99.0	77.0	81.1
<b>Selected Financial Variables</b>																
Federal funds rate	3.18	2.09	2.00	1.08	0.50	0.50	0.50	0.50	0.67	0.94	1.69	2.21	5.02	2.09	0.50	1.38
10-year Treasury note yield	3.66	3.89	3.86	3.49	3.10	3.00	3.00	3.15	3.50	3.80	3.95	4.00	4.63	3.73	3.06	3.81
Aaa corporate bond yield	5.46	5.60	5.65	5.96	5.45	5.40	5.40	5.35	5.57	5.73	5.68	5.69	5.56	5.67	5.40	5.67
Broad trade-weighted US\$	97.3	95.8	97.5	107.7	107.2	106.9	106.3	105.8	105.0	104.5	104.1	104.0	103.4	99.6	106.5	104.4
Value of corp. equities (eop)***	-9.9	-1.7	-9.0	-21.1	11.8	6.4	5.7	8.2	5.4	4.5	4.6	3.3	1.9	-36.4	36.1	19.1
<b>Incomes &amp; Related Measures</b>																
Corporate profits w/ IVA & CCAAdj*	-4.3	-14.3	22.3	-23.0	4.6	10.0	11.8	3.1	6.1	6.9	5.9	5.0	-2.0	-6.3	7.3	6.0
Real disposable personal income*	-0.7	11.9	-8.1	3.8	2.5	5.4	1.4	2.5	3.1	3.1	3.4	3.8	1.8	1.5	2.9	3.4
Personal saving rate (%)	0.2	2.7	1.6	3.2	4.0	4.5	4.2	4.3	4.5	4.6	4.7	4.9	0.6	1.9	4.3	4.7
Fed. surplus (unified, FY, bil. \$)	-824	176	-477	-590	-815	-455	-590	-689	-891	-356	-599	-704	-162	-388	-613	-634

\* Percent change at annual rate  
 \*\* Billions of chained (2000) dollars  
 \*\*\* Quarterly percent change not annualized