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  **President's Message: Some Perspectives on the Notorious Summer of 2008**

  In late 2008, the U.S. economy was suffering in the aftermath of a financial panic that was sparked by the collapse of Lehman Brothers and American International Group (AIG). The summer of 2008 has developed a notorious reputation because it preceded Lehman-AIG. In this column, I provide my perspective on some features of the macroeconomic situation during that period. [[1]](https://www.stlouisfed.org#endnotes)

  While many think that the financial crisis began in 2008, in fact conventional dating puts the beginning of the financial crisis in August 2007. Therefore, the crisis had been continuing for more than a year by the time of Lehman-AIG, and the Fed had been responding to the situation. In particular, the Federal Open Market Committee (FOMC) had lowered the federal funds rate target substantially between September 2007 and March 2008—from 5.25 percent to 2.25 percent. Because monetary policy operates with a lag, a widely held expectation during the first half of 2008 was that this aggressive easing would help the economy considerably throughout the rest of the year. This expectation turned out to be wrong, or at least naïve, in the fall of 2008.

  We now know that a recession started in December 2007 and ended in June 2009. During the summer of 2008, however, it was not readily apparent that the U.S. was actually in recession. According to initial estimates, real U.S. gross domestic product (GDP) growth was positive for the fourth quarter of 2007 and the first and second quarters of 2008. If one defines recession as two consecutive quarters of declining GDP, then the U.S. was not in recession

based on those figures. Also, in early July 2008, forecasts for the second half of the year were still for modest growth. Therefore, as of August 2008 there was a good case to be made that the U.S. economy would continue to muddle through the financial crisis, as it had seemingly been doing for many months. [2]

In reality, the economy contracted during the second half of 2008. Rather than preventing the financial panic, the Fed's substantial lowering of the policy rate may have had a counterproductive effect by feeding into another development during this period: the global commodity price boom during the second half of 2007 and the first half of 2008. The boom was especially pronounced in oil prices. The lower interest rates may have encouraged troubled financial firms to borrow cheaply and attempt to profit in commodities. This sort of "doubling down" behavior is common during financial panics. As of mid-June 2008, the price of crude oil had nearly doubled in the span of about 10 months (whereas the year-over-year increase was near zero as of August 2007). The commodity price shock slowed down auto sales and other parts of the economy that are sensitive to such prices. The slower economic growth, in turn, worsened the financial crisis and led to multiple financial firm failures during the fall of 2008.

While the Bear Stearns event occurred in March 2008, it had implications for events during the second half of the year. Bear Stearns was ranked 34th by revenue among financial firms in the U.S. during 2007. When JPMorgan Chase & Co. purchased the failing firm with assistance from the Fed, this suggested that the 33 financial firms that were even larger than Bear Stearns had some form of implicit insurance from the Fed. The Fed, however, was not in a position to give assistance to that many firms.

As of September 2008, investors had already known for a year that Lehman Brothers was in deep trouble. As such, the Lehman failure, while notable, was not particularly surprising, and the U.S. economy could have handled this single event. The fact that AIG, which was one of only a handful of triple-A-rated firms in the U.S., was also in deep trouble did come as a surprise. Moreover, the financial problems of AIG, especially because of its linkages with other firms as a provider of insurance, spilled over and worsened the financial situations of other firms. As a result, the Lehman-AIG event

brought all financial firms under vastly increased suspicion, driving the financial crisis from mid-September 2008 onward. [[3]](https://www.stlouisfed.org#endnotes)

Following the Lehman-AIG event, the FOMC changed the target policy rate to a range of 0 to 0.25 percent in December 2008, and the policy rate remains there more than five years later. In my view, the debate at the time of the decision did not take sufficient account of the experience in Japan. The Bank of Japan changed its policy rate to near zero in the 1990s, and short-term rates are still at zero today. The FOMC decision in December 2008 may have unwittingly committed the U.S. to an extremely long period of near-zero rates similar to the situation in Japan, with unknown consequences for the macroeconomy. [[4]](https://www.stlouisfed.org#endnotes)

The events of 2008 are likely to be studied for decades to come. The features of the macroeconomic situation that I have discussed here must be addressed in any comprehensive accounting of what happened during that period.

Endnotes

1. For more details, see my presentation on Nov. 21, 2013, "The Notorious Summer of 2008," at [http://research.stlouisfed.org/econ/bullard/pdf/Bullard_NWArkansas_](http://research.stlouisfed.org/econ/bullard/pdf/bullard_nwarkansas_2013november21_final.pdf). [ 2013November21_Final.pdf [back to text](https://www.stlouisfed.org#1##1)]
2. The current data instead show negative GDP growth in the first quarter of 2008. To see data revisions over time, visit the St. Louis Fed's real-time database, ALFRED (ArchivaL Federal Reserve Economic Data), at [http://alfred.stlouisfed.org/](http://alfred.stlouisfed.org/). [ [back to text](https://www.stlouisfed.org#2##2)]
3. For more discussion on the largest financial firms during this period, see my presentation on Nov. 18, 2009, "The First Phase of the U.S. Recovery," at [http://research.stlouisfed.org/econ/bullard/BullardCommerceFinal.pdf](http://research.stlouisfed.org/econ/bullard/bullardcommercefinal.pdf). [ [back to text](https://www.stlouisfed.org#3##3)]
4. See my 2010 Reviewarticle, "Seven Faces of 'The Peril,' " at