

November 12, 2009

*John C. Williams, executive vice president and director of research at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:*

- The U.S. economy expanded at a 3.5% annual rate in the third quarter, ending a string of four straight quarters of negative growth. Consumer spending increased at a robust 3.4% annual rate in the third quarter, boosted by the cash-for-clunkers program. Not surprisingly, sales of motor vehicles fell sharply after the program ended. But the decline was somewhat less than expected, suggesting greater underlying strength in demand than previously thought. Residential construction and exports were also areas of strength in the third quarter.
- Improvements in consumer and foreign demand have helped the manufacturing sector to rebound from the worst recession in decades. Manufacturing production has increased in each of the three months through September. Capacity utilization in this sector rose to 67.5% in September, 2.4 percentage points above the all-time low reached in June. The most recent reading from the Institute for Supply Management manufacturing survey suggests further gains in output in October.
- In financial markets, risk spreads have come down since early this year. Spreads on corporate bonds are now at levels comparable to the previous recession. Although corporations have better access to capital, small businesses still find credit tight. Some banks have continued to tighten loan standards, but the percentage reporting such tightening has fallen significantly. The dollar has given up much of the gains it registered against other currencies during the worst of the crisis. In real terms, the dollar's exchange value is about where it was at the beginning of the recession.
- Although the National Bureau of Economic Research has yet to declare the recession over, there is increasingly compelling evidence that the economy has entered an expansion stage. The September reading of the Federal Reserve Bank of Chicago's National Activity Index rose slightly above the -0.7 level associated with recessions.
- Forecasters generally expect the pace of recovery in the United States and other major industrialized economies to be relatively modest compared to past recessions. In contrast, several emerging market economies are already growing rapidly. In China, for example, real GDP increased about 9% over the past year. And forecasters expect China's economy to continue growing rapidly for the next few years.
- We expect real GDP growth in the United States to slow to about 3-1/4% in the current quarter, but then to rise to 3-1/2% in 2010 and nearly 4-1/2% in 2011. In the near term, federal fiscal policy, monetary policy, and inventory building are principal sources of

growth. Looking further ahead, business spending, exports, and a return to normal levels of home building will increasingly drive growth. This forecast is subject to a great deal of uncertainty.

- Consistent with the pattern of the early stages of expansions in past business cycles, the labor market continues to be weak despite the return to positive GDP growth. Nonfarm payrolls fell by 190,000 jobs in October, on par with the previous two months, but well below the 560,000 jobs lost on average per month during the first half of the year. Since the recession began, 7.3 million jobs have been lost. The rates of job openings and hiring show little improvement so far. Businesses have continued to cut costs and have used productivity improvements to expand output without adding to payrolls.
- The unemployment rate rose 0.4 percentage point to 10.2% in October. Initial claims for unemployment insurance, however, have been on a downtrend in recent months. Given our forecast of solid real GDP growth over the next few years, the unemployment rate should gradually decline, falling to a little above 8% by the end of 2011.
- The high level of unemployment has put downward pressure on wage and price inflation. Over the past year, the employment cost index for private workers rose by about 1-1/4%, the smallest four-quarter percent increase since this measure started in 1980. Core price inflation has decreased markedly as well, reflecting the effects of economic slack and falling commodity prices. The core personal consumption expenditures price index rose a mere 1.3% over the past 12 months through September. Significant slack will continue to put downward pressure on inflation over the next few years, offset somewhat by the effects of import price increases.
- Inflation expectations remain stable. Longer-run inflation expectations have fluctuated in a relatively narrow band during the past several years, despite the sizable swings in commodity prices and the global financial crisis and recession.



