Twelfth Federal Reserve District

FedViews

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Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, CA 94105

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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:

- Looking at the outlook from a year ago, our forecasts for economic growth and inflation proved to be reasonably on target, but the unemployment rate rose far more than we had expected. According to currently available data, real GDP growth was close to zero last year, with a sharp contraction in the first half of the year offsetting strong positive growth in the second half. Based on past experience, zero real GDP growth implies an increase in the unemployment rate of between 1 and 1-1/2 percentage points, consistent with our forecast from a year ago. In fact, the unemployment rate rose 3 percentage points from the fourth quarter of 2008 to the fourth quarter of 2009. The main factor driving this unusual rise in unemployment was very rapid productivity growth that allowed businesses to cut back sharply on labor while maintaining output levels.

- Both overall and core measures of inflation were a touch higher than we had forecast a year ago, reflecting the effects of unexpected increases in oil and other import prices. In addition, methodological changes in the definition of core inflation boosted this measure of inflation a bit, explaining part of the change in our forecast.

- Consumers relaxed their grips on their wallets during the holiday shopping season. Retail sales increased strongly over the final three months of 2009. Motor vehicle sales continued to trend upward, after dropping back following the expiration of the cash-for-clunkers program.

- The manufacturing sector has likewise started to rebound from last summer's depressed level. Leading indicators of business spending have moved up in recent months. The Institute for Supply Management's new orders index rose to a very high level in December, and orders and shipments of nondefense capital goods, excluding aircraft, recorded robust increases in November.

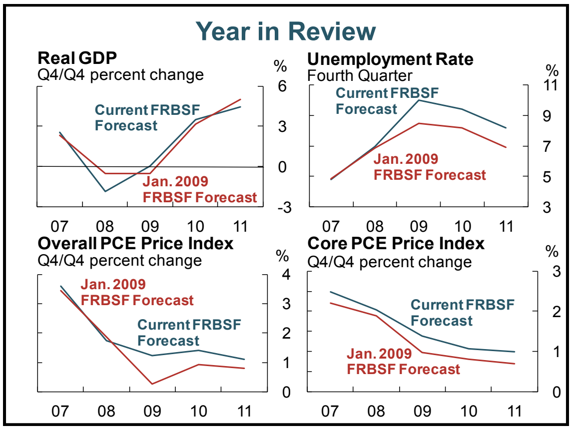
- Various signs indicate that the economic recovery is broad based. Increases in consumer spending, residential investment, and government purchases all contributed to real GDP growth in the third quarter of 2009. We expect that this pattern has continued in the fourth quarter and into this year. In addition, swings in inventory accumulation have added significantly to growth in the fourth quarter. Our forecast is for real GDP to increase by about 5-1/2 percent (annual rate) in the fourth quarter of 2009 and by about 3 percent in the first quarter of this year.

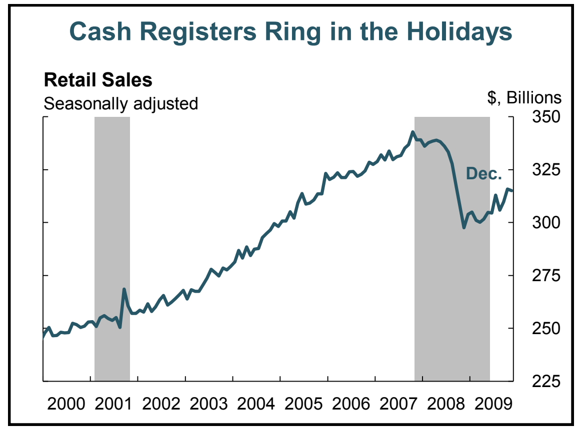
- Ebbing financial headwinds, greater consumer and business confidence, and substantial support from monetary and fiscal policy should propel the economy to grow about 3-1/2 percent this year and about 4-1/2 percent in 2011. A key risk to this forecast is whether household and business spending will improve sufficiently to offset waning fiscal stimulus over the next two years.

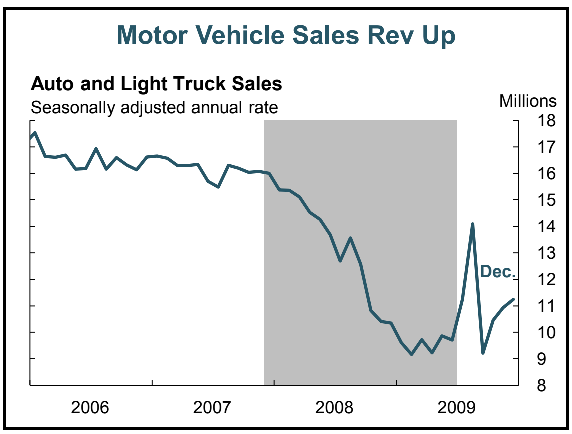
- Although the economy's output expanded during the second half of last year, the labor market has yet to turn upward. Nonfarm payrolls declined by 85,000 jobs in December. Other labor market indicators, such as the rates of hiring, job openings, and quits, were at very low levels in November. The labor market's lagged response to turning points in spending is typical of the early stages of recoveries from recessions. Given our forecast of solid output growth this year, the labor market soon should start to revive. However, in view of the depth of the recession, substantial labor market slack will likely persist for the next few years.

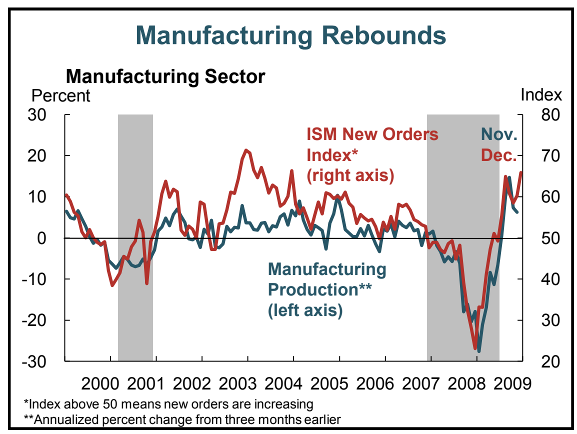
- The prolonged, deep recession has contributed to a decline in the inflation rate that is likely to continue for some time. Stable inflation expectations and rising prices of oil and other imports have partially offset the downward pressure on prices from slack in labor and goods markets.

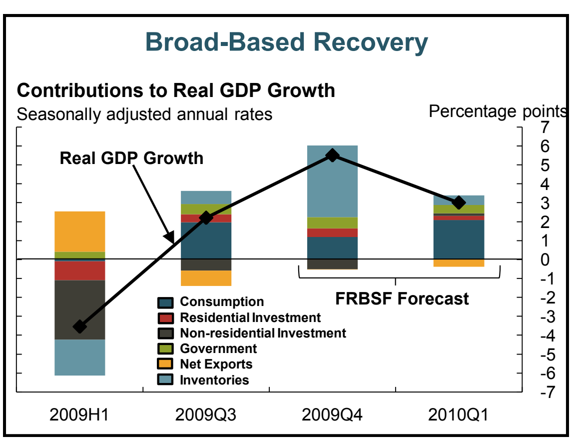
- Improvements in the economic outlook and an increased appetite for risk have pushed yields on Treasury securities higher. However, mortgage rates remain low. Yield spreads on corporate bonds relative to Treasury securities have continued to decline. Based on futures contracts, financial market participants expect the Federal Reserve and central banks in other major industrial economies to start raising short-term interest rates sometime later this year and to steadily increase rates in 2011.

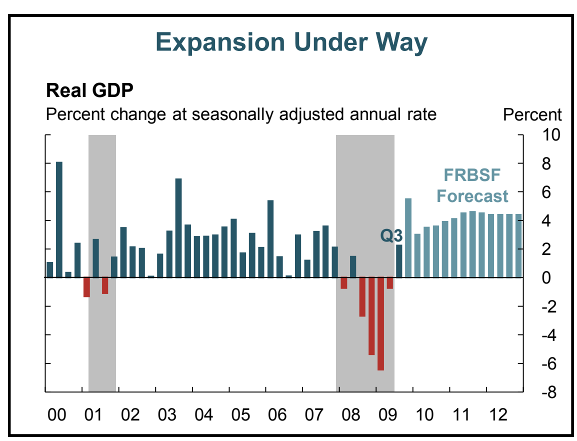

Year in Review
Real GDP
Q4/Q4 percent change
Current FRBSF Forecast
Jan. 2009 FRBSF Forecast
Unemployment Rate
Fourth Quarter
Current FRBSF Forecast
Jan. 2009 FRBSF Forecast
Overall PCE Price Index
Q4/Q4 percent change
Jan. 2009 FRBSF Forecast
Current FRBSF Forecast
Core PCE Price Index
Q4/Q4 percent change
Current FRBSF Forecast
Jan. 2009 FRBSF Forecast
%
07 08 09 10 11


Cash Registers Ring in the Holidays
Retail Sales
Seasonally adjusted
$, Billions
Dec.
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009

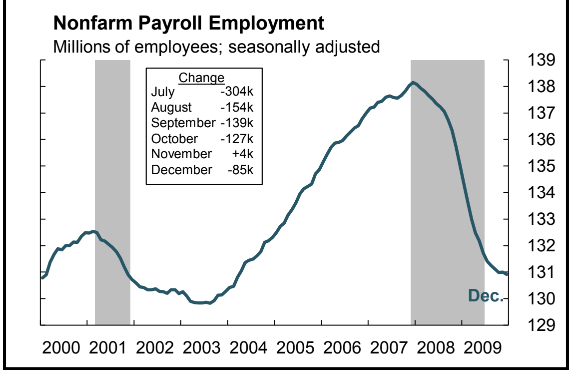

Motor Vehicle Sales Rev Up
Auto and Light Truck Sales
Seasonally adjusted annual rate
Millions
Dec.
2006 2007 2008 2009


Manufacturing Rebounds
Manufacturing Sector
Percent
Index
ISM New Orders Index* (right axis)
Nov.
Dec.
Manufacturing Production** (left axis)
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009
*Index above 50 means new orders are increasing
**Annualized percent change from three months earlier

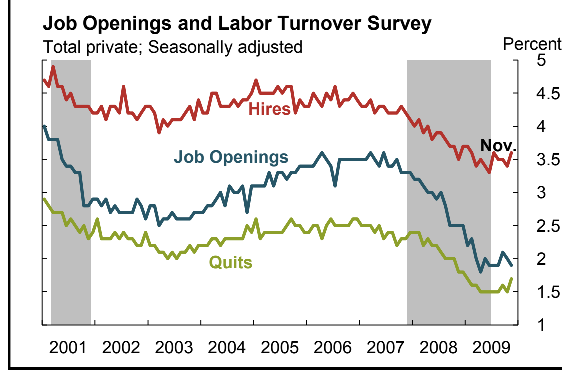

Broad-Based Recovery
Contributions to Real GDP Growth
Seasonally adjusted annual rates
Percentage points
Real GDP Growth
FRBSF Forecast
Consumption
Residential Investment
Non-residential Investment
Government
Net Exports
Inventories
2009H1 2009Q3 2009Q4 2010Q1


Expansion Under Way
Real GDP
Percent change at seasonally adjusted annual rate
Percent
FRBSF Forecast
Q3
00 01 02 03 04 05 06 07 08 09 10 11 12

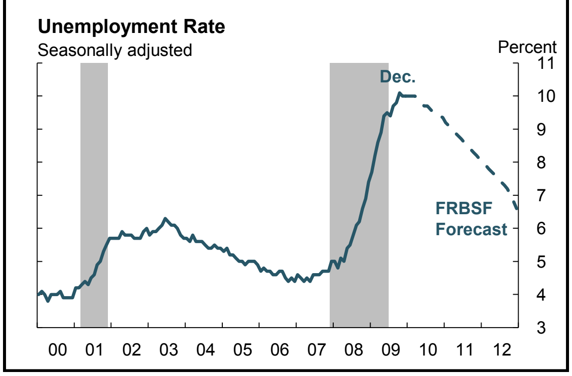
Labor Market Nears Trough…



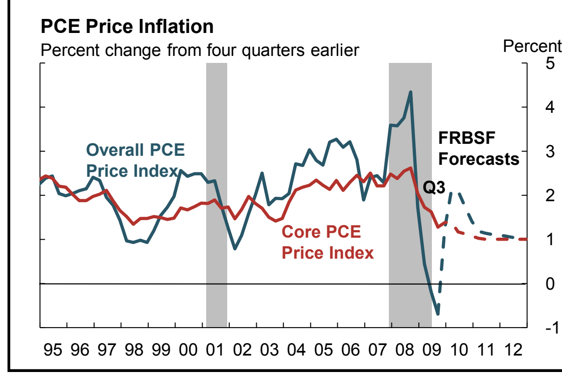
And Should Soon Start to Recover



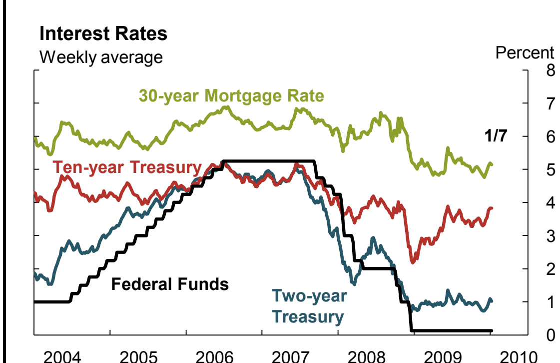
Still, Sustained Slack to Persist



Inflation Subdued



Longer-term Interest Rates Edge Up



Markets Expect Rate Hikes in 2010