

February 10, 2011

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Glenn Rudebusch, senior vice president and associate director of research at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:

- The economic recovery has strengthened, with a self-sustaining private-sector dynamic taking hold in which increased spending leads to greater production and income and vice versa. Greater confidence is apparent in stock prices, which have posted steady gains since the middle of last year. However, financial institution valuations are less than 60% and homebuilder valuations are about 20% of their early 2006 levels.
- Gains in stock market wealth have helped put household balance sheets on a firmer footing. In response to rising wealth, improved sentiment, and some easing in access to credit, consumers are spending more. Auto and light truck sales in January were about 17% higher than a year ago.
- Factory output has posted solid gains since the end of the recession, in part because of increasing exports. Recent orders data suggest the expansion will continue. However, although firms have added little new capacity since 2007, current and prospective levels of utilization indicate manufacturers appear likely to retain considerable amounts of unused capacity for some time.
- Recent employment data have been a mixed bag. Nonfarm payroll employment rose only 36,000 in January, well below expectations of a 150,000 job increase. Some of the disappointing growth was likely due to severe winter weather. However, the January benchmark revision of the payroll data, based on more complete unemployment insurance records, showed an overall decline in employment of 8.7 million jobs from the end of 2007 to the business cycle trough, about 400,000 jobs greater than previously reported. So far in the recovery, only about 1 million of those jobs have been recovered. Relative to population, there has been no progress in adding jobs. The employment-to-population ratio has remained around 58.5% for more than a year.
- In contrast to the lackluster payroll employment data, the unemployment rate has improved remarkably. In January, the unemployment rate fell to 9.0%, after falling from 9.8% in November to 9.4% in December. Altogether, this 0.8 percentage point drop was one of the steepest two-month declines on record. The unemployment rate is based on a survey of households, while the payroll figures come from a separate survey of employers. Given the severe winter storms during January and statistical problems in seasonally adjusting data around the year-end holiday period, it is difficult to say which survey is currently the more reliable labor market indicator. We have taken a substantial signal from the recent unemployment data and, relative to our forecast last October, we now anticipate a much lower path for the unemployment rate over the next several years. Still, the sizable

pool of remaining unemployed workers represents a persistent and substantial shortfall from full employment.

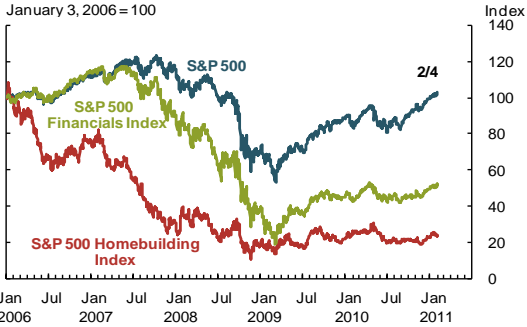
- The sizable amount of slack in the economy is also evident in the large output gap, the deviation of real output from its potential. Given the recent greater momentum in final sales, we have boosted our real GDP growth forecast to 4% this year and 4½% in 2012 (on a Q4-over-Q4 basis). However, with the economy operating far below potential, even two years of robust economic growth are not enough to attain full utilization of the nation’s productive resources.
- Slack in the economy has damped overall U.S. consumer inflation despite recent jumps in commodity prices. Commodity prices are generally determined by global supply and demand. Adverse weather conditions have reduced harvests in a number of countries, which has helped boost grain prices. Furthermore, while industrial production in the U.S. and other advanced economies remains well below pre-recession levels, production in many emerging-market economies has reached new peaks. The leap in overall global demand for industrial commodities, especially metals and crude oil, has outstripped the ability of suppliers to immediately expand. In contrast, the price of natural gas in the United States, which is relatively insulated from foreign demand, has remained relatively low.
- Oil price increases tend to create two distinct risks. First, higher prices are a kind of tax that saps household income, and some of the strength of the current recovery will be drained away by higher gasoline prices. Second, higher prices can sometimes pass through into final consumer prices and eventually into wages. In the past few decades, such pass-through has not been evident in the United States, in part because the acquisition costs of energy and industrial commodities account for a small share of the overall cost of producing core consumer goods and services. The run-up in commodity prices in 2008 left no lasting imprint on underlying consumer inflation, and calls for tighter monetary policy at that time now appear to be misguided.
- By the end of next year, we expect overall and core inflation to settle at about 1%, held down in part by moderate labor costs. The rate of increase in compensation has fallen steadily since the start of the recession and is now running below 2%. With rising labor productivity, unit labor costs have actually been falling recently.
- A rule of thumb that summarizes the Fed’s policy response over the past two decades can be obtained by a statistical regression of the funds rate on core consumer price inflation and on the gap between the unemployment rate and the Congressional Budget Office’s estimate of the natural, or normal, rate of unemployment. The resulting policy guideline recommends lowering the funds rate by 1.4 percentage points if inflation falls by 1 percentage point and by 1.8 percentage points if the unemployment rate rises by 1 percentage point. This rule of thumb captures the broad contour of the actual target funds rate during late 2007 and 2008 when the Fed lowered its target by over 5 percentage points to essentially zero. In 2009 and 2010, as unemployment rose and inflation slowed, this rule of thumb indicates that—if it had been possible—another 5 percentage point reduction in the funds rate would have been consistent with the Fed’s historical policy response. Interest rates can’t fall below zero, so the Fed started to purchase longer-term debt securities to lower longer-term interest rates and provide additional monetary stimulus. (See *FRBSF Economic Letter* 2010-18, “The Fed’s Exit Strategy for Monetary Policy.”
<http://www.frbsf.org/publications/economics/letter/2010/el2010-18.html>)

- Given the extended nature of the expected recovery to levels of unemployment and inflation consistent with the Fed's mandate for full employment and price stability, the policy rule also suggests little need to raise the funds rate target anytime soon. Of course, this projection of future policy will change as economic forecasts are revised. Such conditionality is consistent with the FOMC's forward-looking policy guidance from its January 26 meeting, that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period." In the simple rule, the length of the "extended period" depends on the expected paths for unemployment and core inflation. Therefore, the downward revision over the past few months to the projected path of the unemployment rate translates into a higher path for the funds rate and an earlier liftoff from a zero funds rate. However, according to the simple policy rule of thumb, the positive unemployment news since last October appears to have shortened the duration of the "extended period" of near-zero interest rates by only about three months. Substantial monetary policy accommodation appears warranted for some time.

Broad equity markets have surged

Stock Prices

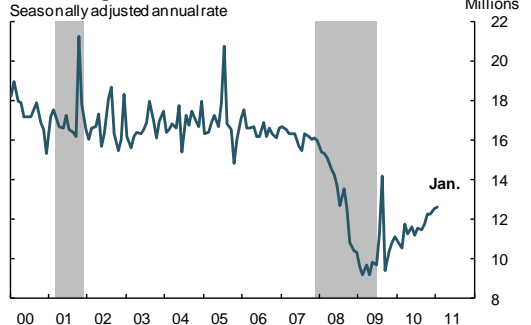
January 3, 2006 = 100



Consumers are returning to showrooms

Auto and Light Truck Sales

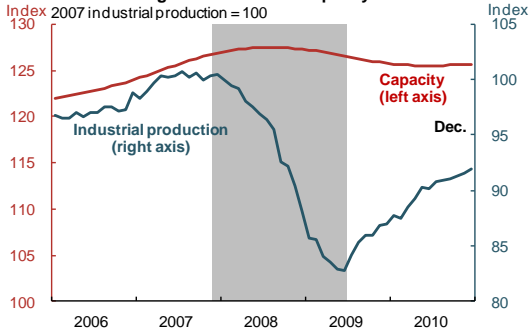
Seasonally adjusted annual rate



Factory production is rebounding

Manufacturing Production and Capacity

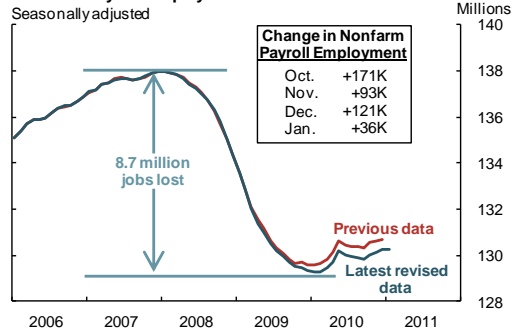
2007 industrial production = 100



Firms remain reluctant to hire

Nonfarm Payroll Employment

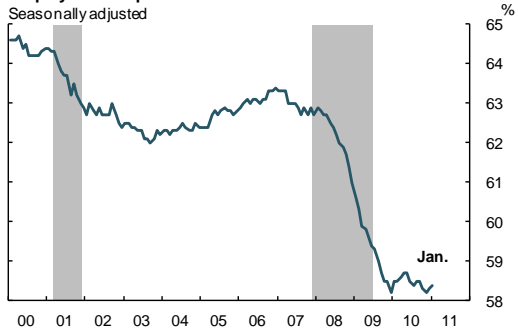
Seasonally adjusted



No job growth relative to population

Employment-Population Ratio

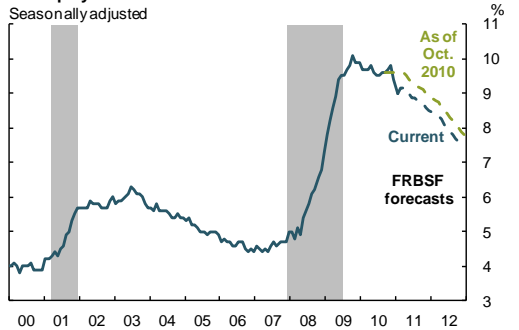
Seasonally adjusted



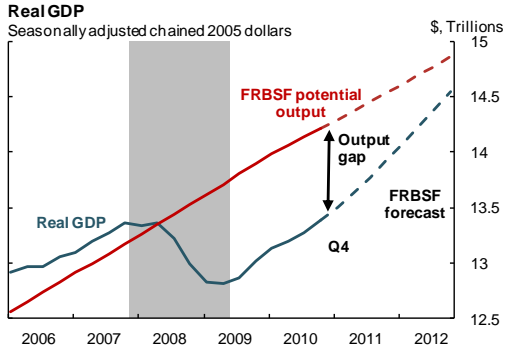
Progress in reducing unemployment

Unemployment Rate

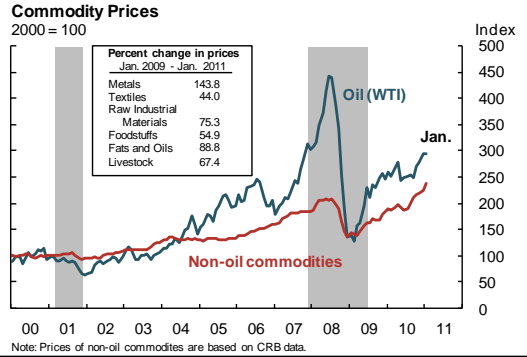
Seasonally adjusted



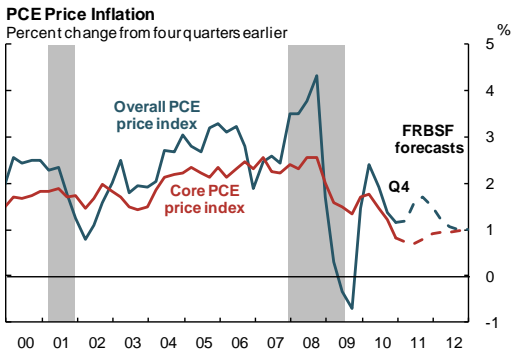
Large output gap will slowly diminish



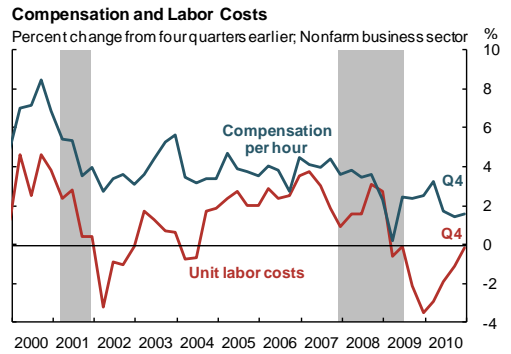
Industrial and agricultural prices jump



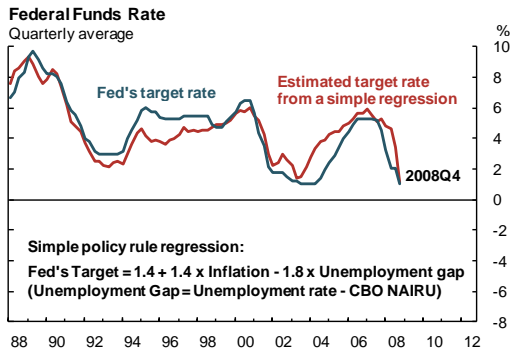
Underlying inflation remains very low



Little pressure from labor costs



Simple rule of thumb for monetary policy



Extended period only slightly curtailed

