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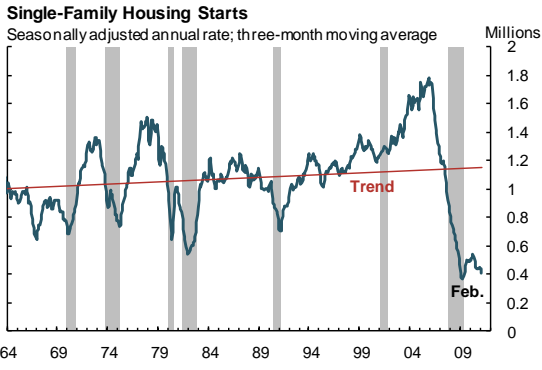
*Glenn Rudebusch, senior vice president and acting director of research at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:*

- Much of the recent economic news has been disappointing, with notably weaker data for consumer spending, business investment, and government purchases. Over the past two months, our forecast for first-quarter real GDP growth has been revised down by over a percentage point to an annual rate of less than 2%. In addition, the list of headwinds that could potentially hold back the economic recovery has grown.
- In particular, higher gasoline prices will sap household income. Crude oil prices have jumped because of heightened geopolitical risk in North Africa and the Middle East and greater projected demand for fossil fuels in the wake of the nuclear catastrophe in Japan. Prospects for residential construction have also dimmed, with home sales languishing despite bloated inventories of unsold homes. In addition, greater cutbacks in federal spending are in train. Finally, the disaster in Japan may push down growth directly a bit as supply problems disrupt production.
- However, much of the first-quarter weakness appears to reflect transitory factors, including harsh winter weather at the start of the year. The underlying pace of economic recovery appears intact. Based on the underlying economic momentum, growth should rebound in the current quarter to above 3%.
- Perhaps the key factor supporting further growth is the continuing improvement in financial conditions. With greater investor confidence and improved profits, broad indexes of stock prices are up about 12% over the past year. So even with stagnant home prices, household net worth has been climbing. The falling dollar and some easing of credit conditions are also helping make financial conditions more accommodative.
- A revival of the labor market is a crucial underpinning of a strengthening, self-sustaining economic recovery. The pace of private-sector hiring has picked up recently. During the past two months, private employment has risen by almost a half million jobs. That's a solid down payment on the 8.7 million jobs lost during the recession, but obviously there is a long way to go to return to full employment.
- This long road ahead is also apparent in the unemployment statistics. Over the past year, the unemployment rate has fallen by about a percentage point to 8.8% in March, which matches our April 2010 forecast. Going forward, the new headwinds suggest an even slower improvement in the labor market than what was expected a year ago.
- Real GDP growth over the past year was disappointing, but the underlying economic recovery appears on track. Real GDP is expected to increase 3½–4% over the next year. Improving financial

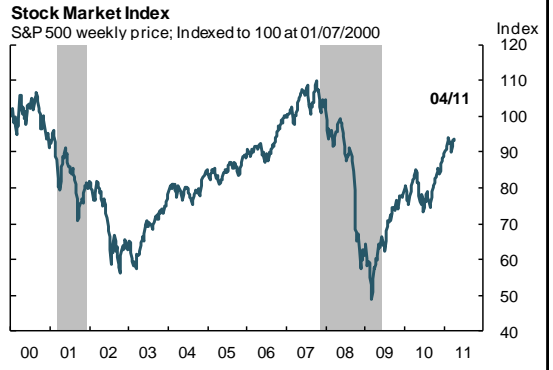
conditions, increasing credit availability, accommodative monetary policy, healthier labor markets, and rising household and business confidence should all support a faster pace of growth.

- While industrial production in the United States and other advanced economies remains well below pre-recession levels, production in many emerging-market economies has been growing fast and reaching new peaks. This strong growth has pushed up demand for many agricultural and industrial commodities. The latest jump in oil and commodity prices is projected to push year-over-year inflation in the personal consumption expenditures price index to 2½% by the middle of this year. Still, as in the past, it does not appear likely that the run-up in commodity prices will have a long-lasting impact on underlying inflation trends. Commodity prices are not generally expected to rise as rapidly over the next two years as they have over the past few months, so the impetus to headline inflation will diminish. In addition, with unemployment still high, there has been little upward pressure on labor costs, which account for about 60% of total production costs.
- One measure of underlying inflation strips out the transitory noise due to food and energy prices. This measure is likely to move somewhat higher as commodity price increases pass through to some extent to a variety of final consumer goods. Still, underlying inflation appears likely to remain subdued.
- A simple rule of thumb that summarizes the Fed's policy response over the past two decades recommends lowering the federal 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. Either headline inflation or core inflation can be used with this rule to construct policy recommendations. Relative to a core inflation formulation, a policy rule using headline inflation would have called for a higher fed funds rate in 2005–2006 before the recession and in 2008 in the midst of a deepening recession. Currently, both formulations call for substantial monetary accommodation.
- The simple rule can also contrast the policy situation in Europe and the United States. During the financial crisis, the European Central Bank, like the Fed, also lowered its policy rate essentially to zero. Recently, unlike the Fed, the ECB raised its policy rate by ¼ percentage point. Such an increase is broadly consistent with the policy rule recommendation for Europe. The higher policy rate recommendation reflects the fact that the economic downturn was much milder in the euro area's core countries than in the United States. For example, the euro-area unemployment rates rose on average about half as much as in the United States.

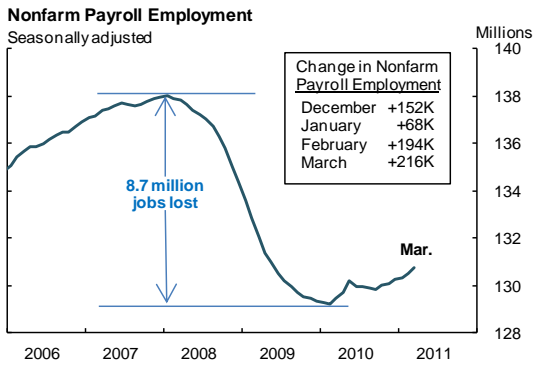
### Housing: A faint pulse, no recovery yet



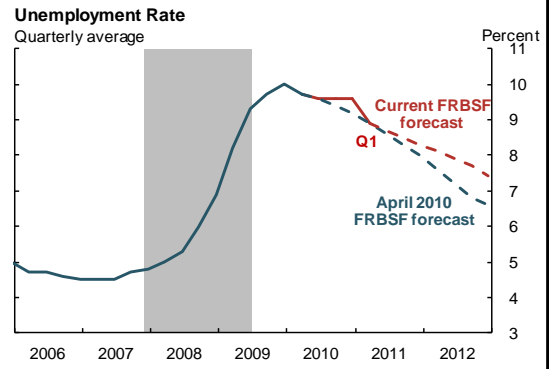
### Better financial conditions support growth



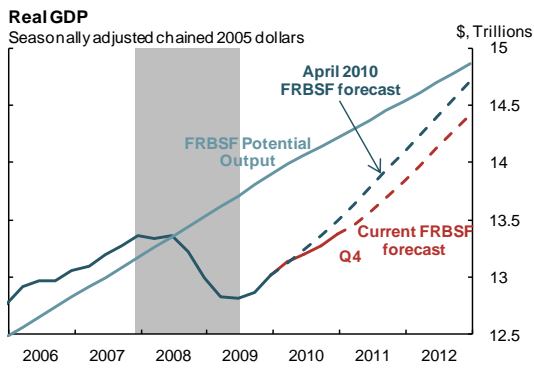
### Businesses are slowly starting to hire



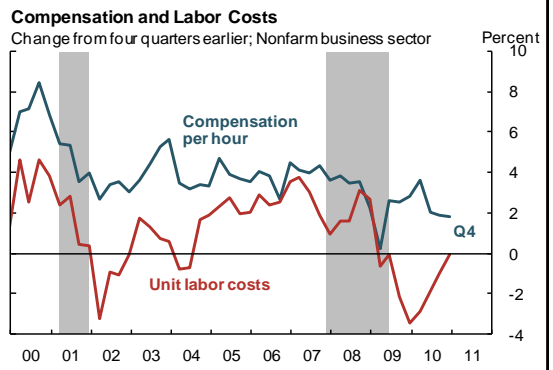
### Long slow path to full employment



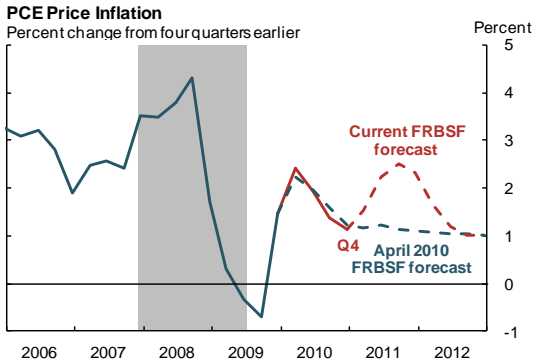
### Large output gap likely to persist



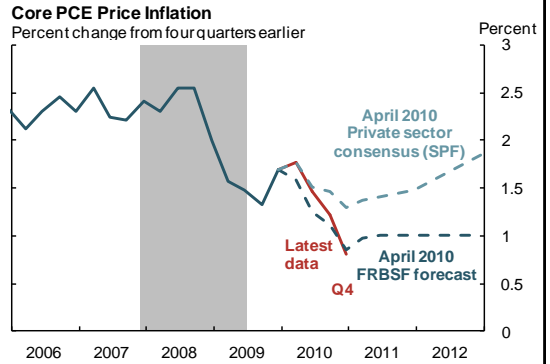
### Steady labor costs anchor prices



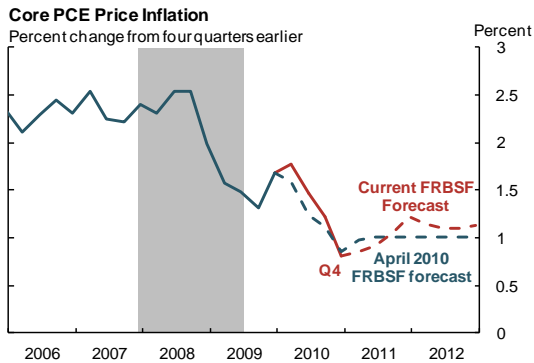
### Headline inflation bulge expected this year



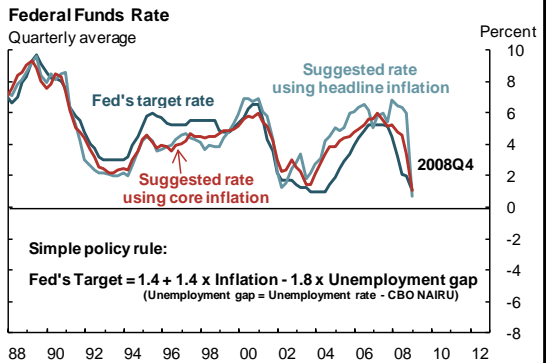
### Core inflation did fall last year



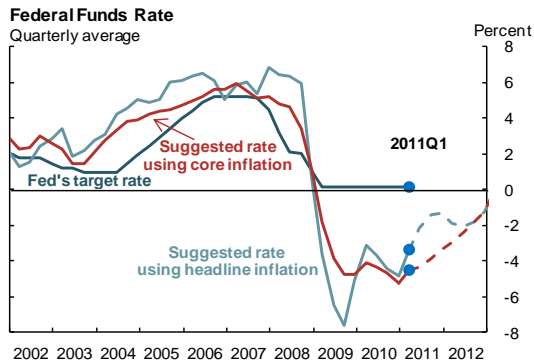
### Underlying inflation likely subdued



### Simple policy rule of thumb



### Monetary policy stimulus still needed



### Contrasting policy in the US and Europe

