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Sylvain Leduc, research advisor at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- Incoming data have generally been better than expected over the past month, suggesting that the U.S. economy continues to grow at a moderate rate. Factors that held growth back in the first part of the year, such as the supply chain disruptions that followed the Japanese earthquake and tsunami in March, have largely dissipated. However, the rapidly evolving European debt crisis represents a significant downside risk to the U.S. growth outlook.

- The labor market is slowly improving. Nonfarm payroll employment expanded moderately in November, posting a gain of 120,000 jobs, according to the U.S. Bureau of Labor Statistics (BLS). In addition, the number of jobs added in September was revised up to 210,000 from 158,000, and in October to 100,000 from 80,000. In November, the private sector added 140,000 jobs, with employment rising in a number of service-providing industries. In contrast, public-sector employment continued to contract.

- The BLS survey of households also showed an improving labor market. The unemployment rate receded in November, falling 0.4 percentage points to 8.6%. The decline reflected both increased hiring and an exit of workers from the labor force. The civilian labor force participation rate fell 0.2 percentage point to 64%.

- Consumer spending has been relatively strong in recent months. Real personal consumption expenditures grew 2% in October from a year earlier, following a 2.2% increase in September. Sales of autos and light trucks continued to improve in October and November, averaging an annualized 13.4 million units per month. October retail sales were solid as well, up 0.5% from September.

- Consumer confidence rebounded from its recent trough at the end of the summer, which should help support future consumption growth. The Conference Board Consumer Confidence Index rose to 56 in November from 40 in October. The University of Michigan index of consumer sentiment increased in both November and December.

- However, downside risks to consumption growth are evident. Initial estimates of wages and salaries were revised down for the second and third quarters of 2011. Lower household income could restrain consumer spending in the near future.

- We expect the economy to grow moderately in the fourth quarter and over the following two years. In line with the relatively strong recent data, we anticipate the economy will expand at a 2.9% pace in the fourth quarter, before settling back to a pace of 2.4% in 2012 and 3.1% in 2013. In our projections, we assume that Congress will extend the payroll tax reduction through next year, but that it won't authorize extended unemployment benefits for 2012.

- We expect inflation to remain low over the next two years, reflecting high economic slack, subdued wage growth, and well-anchored inflation expectations. In addition, oil and other commodity prices have come down from their highs in the early part of the year. We expect overall prices to grow at an annual rate of 1.5% in both 2012 and 2013. That would be below the level most Federal Reserve policymakers consider to be most consistent with price stability.

- The European debt crisis poses a substantial downside risk to our forecast. Yields on 10-year euro-area government bonds rose dramatically in November after market participants were left unimpressed by European government proposals in October to stop the crisis. The Italian government's borrowing cost reached as high as 7.2% in November. Earlier in the year, it was less than 5%.

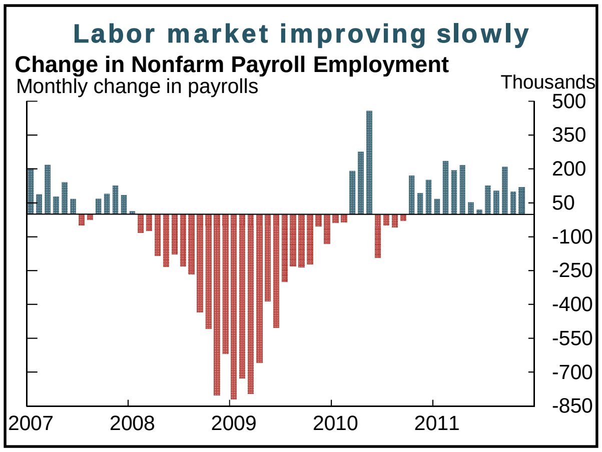
- Yields on European government bonds fell substantially at the beginning of December. This was partly in reaction to an announcement by the Federal Reserve and other central banks of a program to lower the cost of dollar funding abroad. The decline also reflected expectations that the European Central Bank would buy more government debt in the secondary market. However, European government bond yields have since jumped back up.

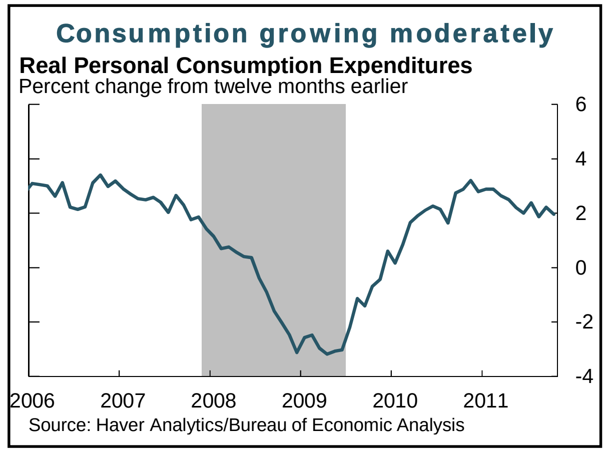
- Financial conditions for large European banks remain precarious. Mimicking movements in European government bond yields, premiums on European bank credit default swaps are up again. This suggests that market participants perceive European banks as risky investments.

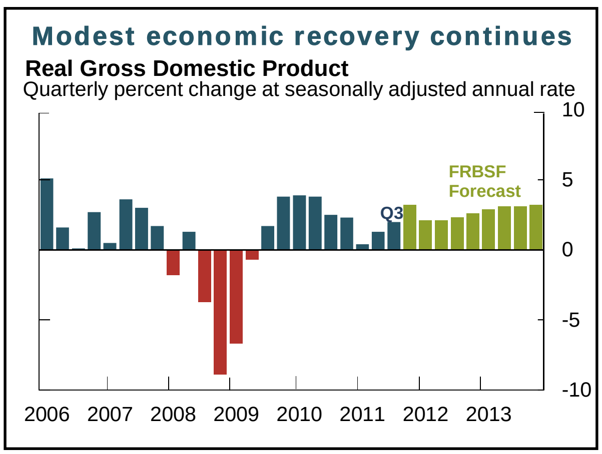
- If European economic contraction only leads to lower U.S. exports, the effect on U.S. growth should be relatively modest. Europe is an important U.S. trading partner, receiving 22% of U.S. exports. However, total exports account for only 15% percent of U.S. GDP.

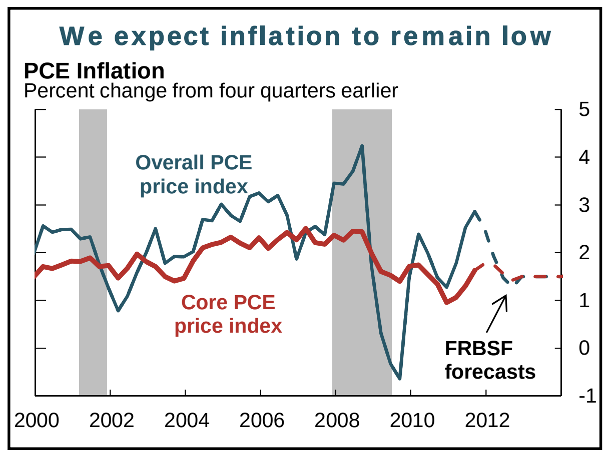
- The effects of the European debt crisis could be more severe if financial contagion were to occur. For instance, credit default swap premiums for some U.S. banks have risen substantially as the European debt crisis has intensified. For certain U.S. banks, credit default swap premiums are reminiscent of those observed during the financial crisis in 2008–09. U.S. banks have mostly shed their direct exposure to European sovereign debt. But they remain subject to the risk that European trading counterparties might not be able to meet their obligations.

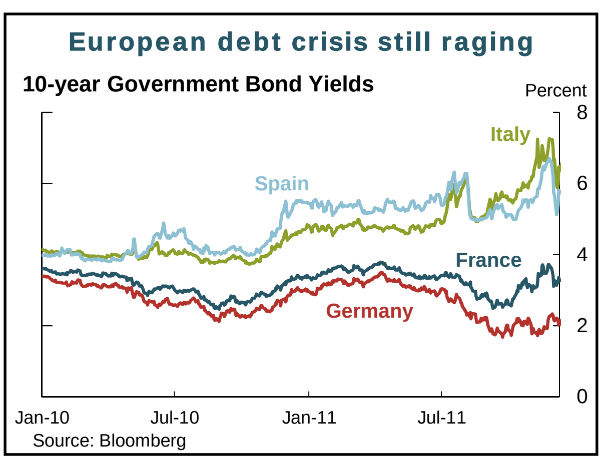
- The European bank crisis has increased interbank lending stress, as indicated by the spread between three-month LIBOR and the three-month overnight index swap rate. However, the spread is still much lower than it was at the height of the 2008–09 crisis. The fear is that a disorderly outcome to the European debt crisis could push this spread higher. Such acute financial distress could derail the ongoing U.S. recovery.

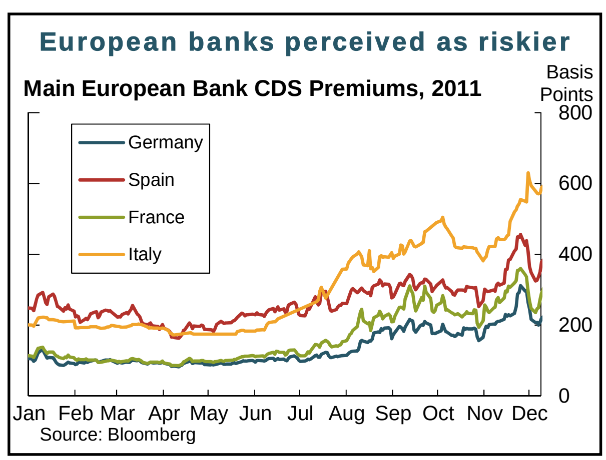

Labor market improving slowly
Change in Nonfarm Payroll Employment
Monthly change in payrolls
Thousands
500
350
200
50
-100
-250
-400
-550
-700
-850
2007
2008
2009
2010
2011


Consumption growing moderately
Real Personal Consumption Expenditures
Percent change from twelve months earlier
6
4
2
0
-2
-4
2006
2007
2008
2009
2010
2011
Source: Haver Analytics/Bureau of Economic Analysis

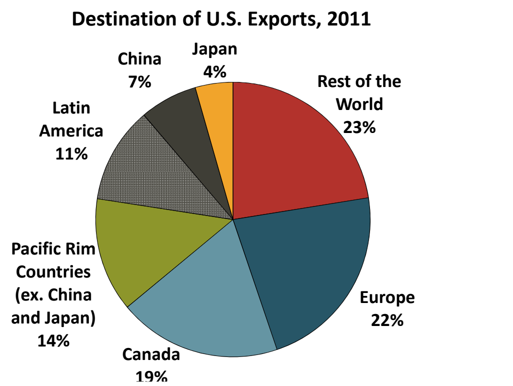

Modest economic recovery continues
Real Gross Domestic Product
Quarterly percent change at seasonally adjusted annual rate
10
5
0
-5
-10
FRBSF
Forecast
Q3
2006
2007
2008
2009
2010
2011
2012
2013


We expect inflation to remain low
PCE Inflation
Percent change from four quarters earlier
5
4
3
2
1
0
-1
Overall PCE
price index
Core PCE
price index
FRBSF
forecasts
2000
2002
2004
2006
2008
2010
2012

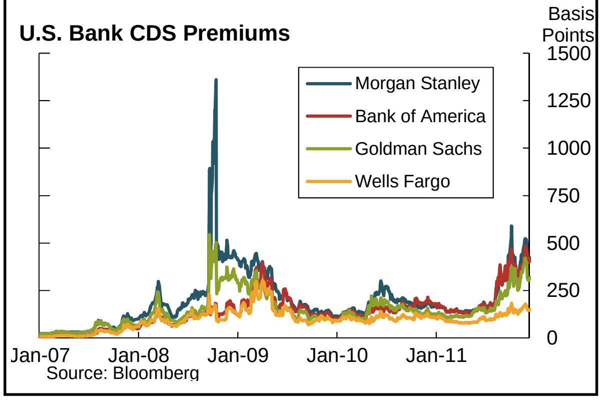

European debt crisis still raging
10-year Government Bond Yields
Percent
8
6
4
2
0
Italy
Spain
France
Germany
Jan-10
Jul-10
Jan-11
Jul-11
Source: Bloomberg


European banks perceived as riskier
Main European Bank CDS Premiums, 2011
Basis
Points
800
600
400
200
0
Germany
Spain
France
Italy
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Source: Bloomberg

From Europe to the U.S. via trade



Contagion to U.S. banks



Interbank lending stress rising some