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:

- It is interesting to examine the recession and recovery of the economy through the prism of the stock market—particularly the broad Standard & Poor’s (S&P) 500-stock index, and the narrower S&P Homebuilders Industry and Dow Jones financial institution indexes. The first stage in the economic downturn was a housing bust, which was evident in steep declines in homebuilder stock prices in 2006 and 2007. Next, financial institutions suffered severe losses, and financial institution stocks posted steady price declines throughout 2007 and 2008. Finally, fallout from the housing bust and financial meltdown led to a deep recession, which was accompanied by a sharp decline in the overall stock market in 2008. More recently, as the financial crisis receded, the S&P 500 and financial institution indexes rebounded significantly. In contrast, the housing market and homebuilder stock valuations have not yet started to recover. Another measure of equity market investor sentiment is the VIX volatility index, which is based on the expected volatility over the next 30 days in the S&P 500 stock index. According to the VIX index, the market has returned from an expected level of volatility we can characterize as “terrified” at the height of the crisis to more normal levels.

- The gains in stock market wealth have put household balance sheets on a firmer footing, and recent growth in consumption has been solid. Consumer sentiment may also improve if the labor market recovers. The latest labor market readings have been encouraging. Nonfarm payrolls increased by 162,000 jobs in March, and most of that increase came from the private sector. Still, there is a long way to go to make up the more than 8 million jobs lost since the start of the recession. Furthermore, the unemployment rate remained unchanged at 9.7 percent in March, and a greater share of the jobless were classified as long-term unemployed. This enormous pool of unemployed workers represents a substantial shortfall from full employment.

- Federal Open Market Committee (FOMC) members appear to disagree about the extent of resource slack, which is subject to considerable measurement uncertainty. The output gap—which is the deviation of real output from its potential—is usually measured using gross domestic product (GDP) data. But an alternative measure uses data on gross domestic income (GDI). In theory, GDI should equal GDP. GDP measures total output by adding up all the spending in the economy, including consumption and investment. GDI measures total output by adding up all the income generated in the economy, including wages and profits. In practice, given imperfect data collection, GDP and GDI don’t quite match. Some economists argue that GDI provides the more reliable measure of U.S. output. By that measure, the recession was even deeper—and the current output gap even larger—than indicated by GDP.

- FOMC participants also disagree about the best way to measure the underlying trend in inflation. (See FRBSF Economic Letter 2010-11, “The Housing Drag on Core Inflation.”) An inflation measure

The views expressed are those of the author, with input from the forecasting staff of the Federal Reserve Bank of San Francisco. They are not intended to represent the views of others within the Bank or within the Federal Reserve System. FedViews generally appears around the middle of the month. The next FedViews is scheduled to be released on or before May 17, 2010.
that excludes volatile food and energy prices is often used to eliminate transitory movements in
prices. Researchers have also constructed trimmed mean and median measures of underlying
inflation, which exclude the most extreme price movements in each period rather than singling out
specific spending categories for permanent exclusion. All these measures are showing a steep
downtrend in rates of inflation over the past two years below levels reached in 2002 and 2003, when
deflation fears were widespread.

- Even more unsettling are the recent very low rates of increase in wages and compensation. In
  particular, the rate of compensation increases has been falling steadily since the start of the recession,
  and is now running two to three percentage points below levels posted in 2002 and 2003. This
  suggests that the probability of deflation is even higher now than during that earlier period.

- Going forward, we expect the economy to grow fairly rapidly—almost 3½ percent this year and over
  4 percent in 2011 and 2012. However, the level of economic activity is so depressed that, even with
  solid growth, it will take years to eliminate slack and return to full employment.

- There are risks to this forecast. On the upside, the last deep recession ending in 1982 was followed by
  very rapid growth as pent-up consumer and business demand was unleashed. However, it seems
  likely that the financial crisis will leave lasting scars, thereby slowing the growth rate of the
  economy. Furthermore, monetary policy has been constrained by the zero bound on nominal interest
  rates, that is, the inability to set a federal funds rate target below zero. In addition, fiscal policy
  stimulus, which has propped up recent economic growth, is waning. Therefore, few forecasters
  foresee a V-shaped recovery. Indeed, the average private-sector forecast is even more pessimistic
  than our forecast.

- Measures of the unemployment and output gaps indicate the presence of a lot of slack in the
  economy, which is pushing the inflation rate down. We anticipate that much of that pressure will be
  offset by well-anchored inflation expectations, which should keep inflation from falling much further.
  The early recovery period of 1983–84 provides a cautionary alternative. Even with fast economic
  growth, the high unemployment of the early 1980s caused steep disinflation.

- Surprisingly, many private-sector forecasters foresee a quick pickup in price inflation. This average
  forecast may be boosted by a few forecasters who put more emphasis on the size of the Federal
  Reserve’s balance sheet than on the extent of economic slack. However, although the Fed has
  enlarged its balance sheet and boosted the level of bank reserves and the monetary base, banks are
  not lending out those reserves. Broad measures of money in the economy are also growing very
  slowly.

- To combat the global financial crisis and the deep economic recession, the Fed took two
  extraordinary actions. First, when money markets were disrupted, the Fed supplied emergency short-
  term liquidity against good collateral to improve financial market functioning. Second, as the
  recession deepened, the Fed provided a lot of monetary policy stimulus to lower the cost of short- and
  long-term borrowing.

- The exit strategy for the first action is easy to describe because it is already completed. As financial
  conditions improved, demand for credit from the Fed fell and usage of the Fed’s lending facilities
  declined. Accordingly, the facilities were closed. The alphabet soup of Fed liquidity facilities did
  their job—helping to avoid an even worse financial collapse—and then closed up shop. No credit
  losses whatsoever were experienced. In contrast, a simple estimated monetary policy rule suggests
  that macroeconomic conditions still seem likely to warrant very accommodative monetary policy for
  a long time.
Recession and recovery in the stock market

Financial “Fear index” back to normal levels

Consumer spending moving up

Enormous pool of unemployed workers

Large output gap (may be even larger)

The recession has lowered inflation
Wages and benefits are barely growing

Labor Compensation
Percent change from four quarters earlier

Nonfarm Compensation per Hour

Employment Cost Index

Quarterly average Federal Funds Rate

Simple policy rule regression:
Fed's Target = 2.1 + 1.3 x Inflation - 2.0 x Unemp. gap
(Unemployment gap = Unemployment rate - CBO NAIRU)

Large output gap likely to persist

Real GDP
Seasonally adjusted chained 2005 dollars

Average GDP growth rate during 1983-84 recovery
FRBSF Potential Output
Private-sector consensus (Blue Chip)

Inflation likely to remain subdued

Core PCE Price Inflation
Percent change from four quarters earlier

Average disinflation during 83-84 recovery
FRBSF Forecast
Private-sector consensus (SPF)

Fed balance sheet is not inflating economy

Monetary Base, Money Supply, and Bank Loans
Seasonally adjusted; 1/3/2007 = 100

Extraordinary liquidity support has ended

Federal Reserve Short-Term Liquidity Facilities

Extraordinary liquidity support has ended

Monetary policy stimulus still needed

Fed’s Target Rate
Suggested target rate from simple rule using FRBSF forecasts

Simple policy rule regression:
Fed’s Target = 2.1 + 1.3 x Inflation - 2.0 x Unemp. gap
(Unemployment gap = Unemployment rate - CBO NAIRU)