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:

• As the Greek debt crisis intensified and panic began spreading to other parts of the European periphery, the European Union (EU), the International Monetary Fund (IMF), and the European Central Bank (ECB) took aggressive steps to provide support for Greece and to protect against contagion to other countries. These actions included $140 billion of loans to Greece and the establishment of a nearly $1 trillion fund to support Greece and other EU countries as necessary. Moreover, the ECB has started to purchase private and public debt in dysfunctional markets. As a result of these bold actions, interest rates on government debt of the affected countries fell dramatically.

• The crisis in Europe spilled over to stock markets across the globe. Stock prices tumbled on May 6 and 7, but recovered somewhat after the policy announcements on the following weekend. Over the past month, broad measures of U.S. stock prices have declined by about 2 percent, while measures of European stock prices fell by about 7 percent. Over the same period, the value of the euro fell by 7 percent against the dollar.

• The European debt crisis also led to the emergence of stress in dollar-denominated term funding markets in Europe. The spread between the three-month Libor rate and overnight rates rose to about 20 basis points. Note that stress in this market pales in comparison to the financial crisis of 2007 and 2008. In response to signs of strain in short-term funding markets in Europe, the Federal Open Market Committee (FOMC) announced on May 9 that it had authorized reestablishing temporary U.S. dollar swap arrangements with the Bank of Canada, the Bank of England, the European Central Bank, and the Swiss National Bank. On the next day, reestablishment of temporary swap lines with the Bank of Japan was also announced. These swap lines, which take the same form as those that expired in February, are authorized through January 2011.

• Despite the turmoil afflicting Europe, interest rates in the United States remain very low. Indeed, concerns about fiscal imbalances in some European countries led to a flight to safety into U.S. Treasuries and other high-quality dollar-denominated securities. Longer-term Treasury yields have declined by about 30 basis points over the past month, and rates on higher-quality corporate bonds and mortgages have also moved down, but by lesser amounts.
The Federal Reserve’s Senior Loan Officer Opinion Survey showed that U.S. banks eased standards a bit in April following severe tightening of standards in 2008 and 2009. These improved credit conditions should help support consumer and business spending during the recovery.

Our forecast for economic growth hasn’t changed much in the past month. Real GDP increased at a 3.2 percent annual rate in the first quarter of this year, generally in line with our expectations. Consumer spending and business purchases of equipment and software were big contributors to first-quarter growth, while the construction sector was a drag on growth. Looking ahead, we expect real GDP growth of about 3¾ percent this year for 2010 as a whole and about 4¼ percent next year. Improvements in financial conditions, increased consumer and business confidence levels, and solid growth in the global economy, especially in Asia, should foster moderate growth this year and next.

The labor market is turning around. Nonfarm payrolls have increased by over 570,000 jobs over the first four months of this year, with broad-based job gains in April. Nonetheless, the labor market still has a long way to go to get back to full strength. About 8.4 million jobs were lost over 2007–2009. The unemployment rate stood at 9.9 percent in April. Given our forecast for economic growth, we expect the unemployment rate to end the year at around 9¼ percent and to end next year at about 8¼ percent, well above most estimates of “full employment.”

The weak labor market has restrained growth in labor compensation, which has helped reduce inflation pressures. Broad measures of labor compensation rose by between 1¼ and 2¼ percent over the past year, but remained well below levels seen just prior to the recession. Core measures of price inflation have been subdued as well, with the price index for personal consumption expenditures (PCE) excluding food and energy rising 1.3 percent in the past year.

Our forecast is for core and total measures of PCE price inflation to dip to about 1 percent this year and remain at about that level for the next two years owing to continued slack in labor markets. However, this inflation forecast is fraught with uncertainty. The chart shows forecast confidence regions corresponding to 1 and 2 standard deviation forecast errors based on the historical accuracy of forecasts. The dashed lines illustrate two possible paths for core inflation based on alternative assumptions about the behavior of inflation expectations. In the case of “well-anchored expectations,” the core inflation rate would rise to its average level of about 2 percent over recent history by the end of next year. In the case of “unanchored expectations,” the very low inflation rate of the past year would cause inflation expectations to drop lower. The combination of high unemployment and lower inflation expectations would result in deflation by 2012.
Manufacturing Sector Soars

Other Sectors Right Behind

Labor Market Turning Around

But, Unemployment Stubbornly High

Compensation Growth Muted

Inflation Subdued, but Highly Uncertain