Reuven Glick, group vice president in the Economic Research Department of the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:

- The economy has shown more signs that recovery is proceeding at a moderate pace.

- Real consumer spending rose solidly in the last three months of 2010, although it dipped slightly in January due partly to weather. Vehicles sales have been increasing steadily over the past year and rose strongly in February, up 27% from the year before. Escalating gasoline prices represent a headwind on consumption by draining purchasing power and undermining consumer confidence.

- Industrial production, which includes utilities and mining, declined in January, but this was attributable to a large drop in utilities output as temperatures in some parts of the country returned to more normal seasonal levels. Manufacturing production is experiencing solid growth. The Institute for Supply Management indicated that new orders for manufacturers and nonmanufacturers were very strong in February.

- The housing sector continues to perform poorly. Single-family housing starts were unchanged in January from the month before, while building permits fell substantially. House prices as measured by the Case-Shiller index fell in December for the third month in a row and were down 2½% from the year before and 31% from the July 2006 peak.

- February’s payroll employment report provided evidence that hiring was improving following unexpected weakness in January due to weather. The number of nonfarm workers employed in February rose 192,000. In the past three months, job gains have averaged 136,000 per month while private-sector job gains have averaged 152,000 per month. The unemployment rate in February fell by a tenth of a percentage point. Over the past three months, it has declined from 10% to 8.9%, although some of this decline is associated with discouraged workers leaving the workforce. Another encouraging sign regarding labor markets is the continuing downtrend in new claims for unemployment insurance.

- Oil prices have been firming since the global recovery began in 2009, but in recent weeks they have spiked further because of developments in the Middle East and supply uncertainty. Prices of non-energy commodities, including metals, foodstuffs, and textiles, have also risen sharply. However, natural gas prices have remained low as increased production has outpaced demand.

- Global commodity prices have followed global economic activity as measured by world industrial production. Commodity prices fell during the recent recession and rose with the recovery, which increased demand for raw materials, particularly from developing countries such as China. In fact, increased demand from developing countries accounts for most of the increased world demand for
commodities such as oil, wheat, and corn over the past decade. In the case of corn, a substantial amount of increased demand also reflects its use in ethanol production.

- Commodity price swings have a direct impact on headline inflation through higher costs of energy and food, which account for 14% of overall consumer spending. However, commodity price swings—even double-digit changes—historically have had only a small effect on underlying inflation, which excludes spending on volatile energy and food components. To some extent, this reflects decisions by businesses to adjust profit margins rather than pass through higher costs to customers, particularly when demand is weak. A more important reason is that for many consumption goods, commodities and raw materials account for only a small part of the overall cost of production, particularly compared with the costs of labor, distribution, and retailing. Moreover, roughly three-fourths of consumer spending is on services such as housing and medical care that do not involve many commodities in production.

- The data continue to suggest that the economy is gradually improving, albeit with a bit less momentum than previously projected. As a result of weaker data, higher oil prices, and slightly more fiscal stringency, we have lowered our real GDP growth forecast slightly to about 3½% this year and 4¼% in 2012 on a fourth-quarter-to-fourth-quarter basis. Unemployment is projected to decline slowly to about 8½% at the end of this year and 7½% at the end of 2012, with the economy still operating below potential. Higher oil prices pose a particular risk to this outlook by acting as a form of tax on household income. However, most estimates indicate that another similar jump in oil prices likely will shave only a few tenths of a percentage point off GDP growth this year.

- Over the past 12 months, overall headline inflation as measured by the personal consumption expenditures price index has risen 1.2%, while core PCEPI has risen 0.8%. We expect recent commodity and energy price surges to raise headline inflation temporarily. We foresee relatively little pass-through to core inflation in 2011 and 2012. The slowly recuperating economy, excess capacity, and well-anchored long-term inflation expectations will keep labor costs low. In fact, with labor productivity continuing to rise, unit labor costs have actually been falling recently.
Consumption on an upward trend

Real Personal Consumption Expenditure

- Percent change from 12 months earlier

Source: Bureau of Economic Analysis

Car sales picking up

Auto and Light Truck Sales

- Seasonally adjusted annual rate

Manufacturing expanding

Manufacturing Sector

- ISM New Orders Index*
- Manufacturing production**

* Index above 50 means new orders are increasing
** Annualized percent change from three months earlier

Housing sector is still weak

Single-Family Housing Starts and Permits

- Seasonally adjusted annual rate

Oil prices rising; natural gas prices falling

Oil and Natural Gas Prices

- Average monthly spot price

Source: Bureau of Labor Statistics
Commodity prices track world demand

World Industrial Production and Commodity Prices

Index (2000=100)

Dec.

Feb.

Non-energy commodity prices

(CRB, left scale)

World demand reflects developing country growth

Oil Demand Increase from 2001 to 2009

Million barrels per day

Source: US Energy Information Administration

Pass-through from fuel and materials prices to core inflation is low

Material Prices and Core PCE Price Index

Core PCE price index

Fuel & crude materials

12-month % change

Source: Bureau of Labor Statistics

Most consumption spending is on services

Composition of Personal Consumption Expenditures 2010

Housing excl. energy 16%

Food 8%

Fuel & energy 6%

Apparel 3%

Other nondurables 8%

Motor vehicles 3%

Household durables 3%

Other durables 5%

Medical care 16%

Other services 18%

Financial services 8%

Other nondurables 8%

Other 18%

Restaurants 6%

Note: Noncore consumption= Food+Fuel&Energy= 14% of spending; red=nondurables, blue=durables, green=services. Source: BEA

Gradual expansion is on track

Real GDP Percent change at seasonally adjusted annual rate

FRBSF Q4 Forecast

Percent

00 01 02 03 04 05 06 07 08 09 10 11 12

Underlying inflation remains low

PCE Price Inflation Percent change from four quarters earlier

Overall PCE price index

Core PCE price index

FRBSF forecasts Q4

Percent

00 01 02 03 04 05 06 07 08 09 10 11 12

-1 0 1 2 3 4 5

-10 -5 0 5 10