Glenn Rudebusch, 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.

- Real GDP grew a disappointing 1.7% over the four quarters of 2012. Despite ongoing federal deficit reduction, which is expected to hold back the recovery significantly, we project 2013 growth of 2½% and 2014 growth of 3¼%. Improving financial conditions, increasing credit availability, accommodative monetary policy, and healthier labor and housing markets all support a faster pace of growth.

- Following most past recessions, a housing revival provided a significant boost to the early stages of recovery. But since the latest recession, housing has remained deeply depressed for several years. Over the past year, however, there are clear signs of improvement in home sales and residential construction, with housing starts up 25%. This new construction also has sizable spillovers to the rest of the economy through purchases of new appliances, furniture, and realtor and moving services. Furthermore, with house prices rebounding, more homeowners have sufficient home equity to refinance into lower monthly mortgage payments.

- Another positive development, especially over the medium term, is the boom in domestic oil and gas output as producers have begun to apply new drilling techniques. Natural gas prices are at historic lows relative to crude oil prices, and domestic crude oil is trading at a persistent discount relative to overseas oil. Lower energy prices ease household budgets and boost business bottom lines, and there are important salutary effects from the substitution away from imported oil.

- A strengthening labor market is a crucial underpinning for developing a strong, self-sustaining economic recovery. The March jobs report was a disappointment. Employment increased only 88,000 as job gains slowed across a range of industries. Of course, monthly employment changes are volatile and subject to significant revision. Averaging over the past six months suggests fairly solid gains in employment. Nevertheless, good jobs reports over the next few months will be crucial to avoid a repeat of last year’s summer slowdown.

- The long road ahead is apparent in our unemployment rate projection, which is little changed from a year ago. Our expectation of a slow acceleration in overall economic output is matched by a gradual decline in the unemployment rate.

- Personal consumption expenditures price inflation fell a bit faster than expected last year, as prices for a range of commodities eased. Currently, on a year-over-year basis, headline inflation is 1.4% and core inflation, excluding food and energy prices, is 1.3%. Going forward, we expect inflation will remain around 1½% this year and next.
• Ongoing fiscal austerity is a restraint on growth. Federal outlays are shrinking rapidly, in part as the economy is improving and because of the sequestration. Federal tax receipts are rising as the economy improves and a variety of tax cuts expire. One worry is that the recovery may not be able to withstand a too-rapid short-term federal deficit reduction. Also, so far, the spending cuts have fallen almost completely on discretionary spending, while little progress has been made toward restraining longer-term growth in entitlement spending.

• Entitlement spending is set to jump over the next two decades with the aging of the population. The growing share of older people in the total population will increase the burden on those of traditional working age to support these social expenditures.

• A key factor supporting further growth is continued improvement in financial conditions—owing in part to accommodative monetary policy. The Fed has reinforced low interest rates with two key actions. First, the Federal Open Market Committee (FOMC) has provided forward guidance about future short-term rates. Specifically, in December 2012, the FOMC stated its intention to keep the fed funds rate exceptionally low at least as long as the unemployment rate remains above 6½% and inflation and inflation expectations remain subdued. These economic thresholds help hold down short-term interest rate expectations and hence longer-term yields. Second, the FOMC has purchased Treasury bonds and government-sponsored enterprise mortgage-backed securities to directly bid up bond prices and push down longer-term yields.

• Although low rates have helped support the recovery, some commentators have worried about the potential for adverse unintended consequences of the Fed’s actions on financial stability. Namely, persistently low yields may induce some investors to take on too much leverage or risk in an unsafe “reach for yield.” One key concern is that a jump in interest rates could wrong-foot overextended investors and result in financial instability.

• Currently, private-sector forecasters anticipate that longer-term interest rates will rise gradually over the next few years to more normal levels. However, these forecasters, as well as financial market participants, recognize substantial uncertainty about the path of rates. These expectations do not appear unreasonable, but there are several ways the Fed can foster greater financial stability. First, to the extent that investors can avoid interest rate surprises, any financial fallout from higher rates should be reduced. Therefore, the Fed’s recent transparency about the likely path of policy should help reduce misperceptions that could lead to unnecessary interest rate volatility. Second, the Fed has increased its macroprudential oversight and use of regulatory and supervisory tools to help ensure that financial institutions are sufficiently resilient to weather losses and periods of market turmoil. Third, the Fed could use its balance sheet tools—including the timing and pace of asset sales—to mitigate the risk of a sharp rise in rates.

• It’s important to note that raising short-term rates prematurely could short-circuit the economic recovery and would almost certainly not increase the prospects for financial stability.

• Broad indexes of stock prices have posted substantial gains this year and reached new highs in nominal terms. However, the business profit share is quite high, and compared to Treasury rates, the Standard & Poor’s 500 earnings-to-price ratio appears to provide significant premium for the additional risk from holding equities.
We expect continued gradual recovery

GDP Growth: Actual and FRBSF Forecast
Quarterly obs; seasonally adjusted; annualized growth rate

Homebuilding is ramping up

Single-Family Housing Starts
Seasonally adjusted annual rate; three-month moving average

U.S. energy production restrains prices

Natural Gas and Oil Prices
Monthly average

Job growth has continued

Nonfarm Payroll Employment
Seasonally adjusted

Some improvement in labor market

Nonfarm Payroll Employment
Seasonally adjusted, monthly change

Long road to full employment

Unemployment Rate
Seasonally adjusted

Notes: Natural gas prices use energy equivalent of one barrel of oil. Dashed lines represent futures prices.

Source: Bureau of Economic Analysis and FRBSF staff

Source: Census Bureau

Source: Bureau of Labor Statistics

Source: Bureau of Labor Statistics and FRBSF staff
Inflation expected to remain below 2%

Underlying price pressures appear subdued

Federal fiscal headwinds are increasing

Older population share rising fast

Forecasters see slow adjustment of rates

Equity valuations have big risk premium