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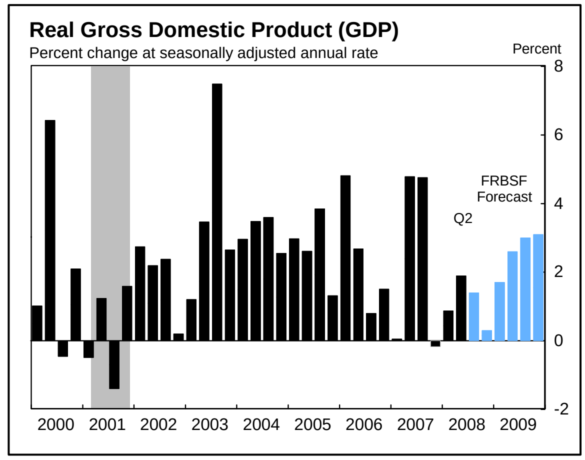
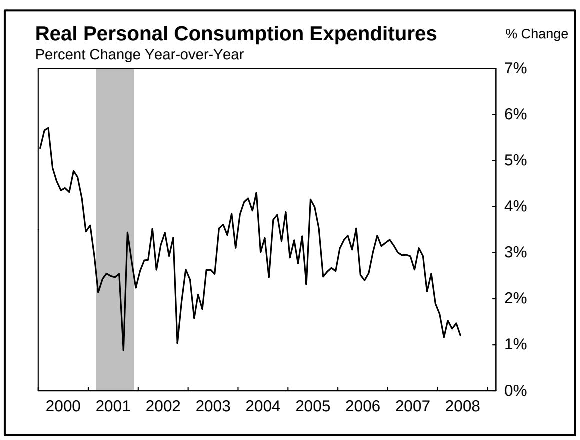
National Scene: Slow Growth, All Eyes on Inflation

In the last several months, many Federal Reserve officials as well as the Federal Reserve Bank of San Francisco's monthly *FedViews* forecast have cited three factors as contributing largely to current economic conditions: financial market turmoil, the ongoing housing correction, and surging food and energy prices. The *FedViews* forecast of July 2008 predicts that these factors will continue to weigh on the forecast for some time. However, fiscal and monetary stimulus should continue to provide an appreciable boost to GDP growth in the third quarter, followed by very slow growth in the fourth quarter, and a return to more stable growth in 2009.

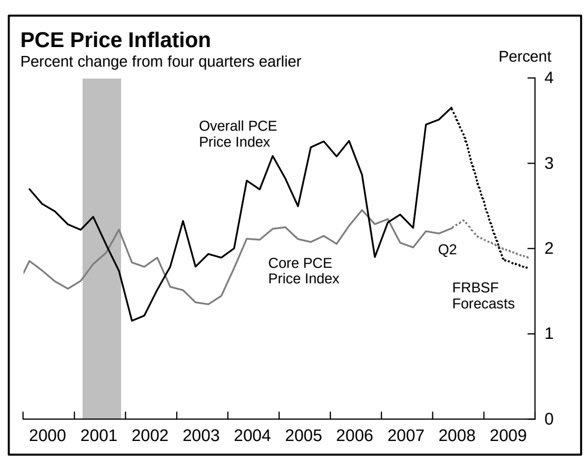


Consumer spending was weak through February but has picked up since March, boosted in part by the tax rebates that were mailed out from May through July (though there is considerable debate about the exact magnitude of the boost). This pick-up in consumption expenditures may unwind in the fourth quarter as the effect of the fiscal stimulus wanes.



Employment growth has continued its bleak performance since the beginning of 2008. Nonfarm payroll employment has fallen in every month of 2008, though on average by much less than during the 2001 recession. As employment has fallen, the unemployment rate is well above estimates of the "natural" rate and has, in fact, exceeded levels seen during the 2001 recession. These developments have come as the Federal Open Market Committee (FOMC) reintroduced language pointing to downside risks to growth into its policy statement in August (see Policy Pointers), after focusing more on inflation risks in June.

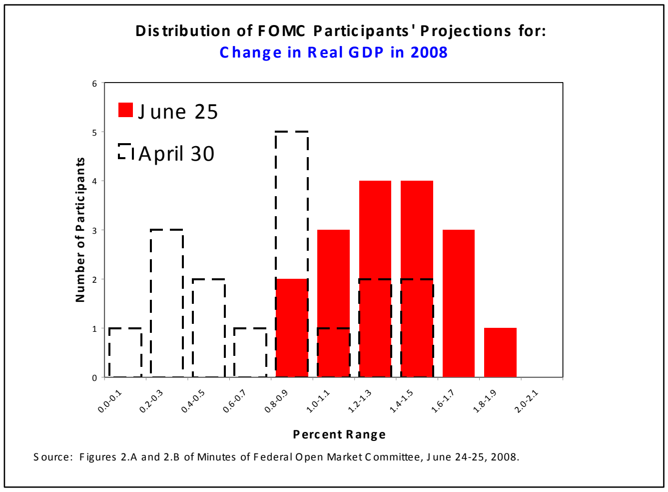
Concerns about inflation have been a dominant theme in the economic outlook in 2008, caused largely by surging food and energy prices. However, the magnitude of this risk remains very uncertain. Oil prices reached a record high in July 2008, but within a month had fallen by $30 per barrel. *FedViews* forecasts overall inflation to decline gradually going forward as food and energy prices stabilize. Overall inflation is expected to return to around 2% by the end of 2009. Likewise, *Fedviews* is forecasting core inflation, which excludes food and energy prices, to level off in the near term, as the effects of previous run-ups in commodity prices subside, and then to gradually decline toward 2% over the course of 2009.

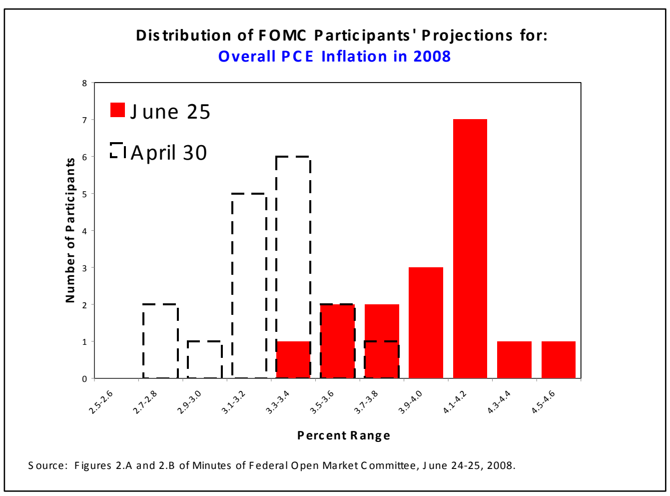


Policy Pointers: FOMC Shifts Concerns

On August 5, the FOMC left the target overnight federal funds rate unchanged at 2%. While the Committee members have held this target rate constant since the April meeting, their assessments of the risks facing the economy have fluctuated considerably.

The summary of economic projections of FOMC participants, published in the recently released minutes of the June 24–25 meeting, provides a window into how the Committee's outlook has changed. In terms of projections for 2008 real GDP growth, the central tendency of participants has shifted up from just under 1% to around 1.3–1.4%. Moreover, the range of projections has narrowed, with all participants at the June meeting expecting at least 0.8% growth. While participants became much more optimistic over this period in their views on real GDP growth for the year, they became much more pessimistic regarding headline inflation. The central tendency for their projections of 2008 personal consumption expenditures (PCE) price inflation moved from just over 3% to just over 4%, though there remained a wide range of projections. It should be pointed out that participants' projections regarding core inflation shifted only slightly higher relative to April.





These changes in FOMC projections between the April 30 and June 24-25 meetings were reflected in the changes in the wording of the FOMC policy statements from those meetings. The June 25 policy statement noted that "downside risks to growth…appear to have diminished somewhat," while "upside risks to inflation and inflation expectations have increased." Since then, data on real economic growth have been lackluster while inflation readings have been high. Reflecting these developments, the August 5 meeting statement indicated a shift in the FOMC's outlook back toward the more balanced assessment of risks that prevailed in late April. Futures markets appear to have taken this latest change in wording as indicating a reduced probability of an increase in the federal funds target rate prior to late 2008.

Around the District: State Budget Woes

Collectively, states around the nation are taking in far less tax revenues than they require to balance their budgets. This is particularly true in the Twelfth District, where California, Arizona, and Nevada all have state budget gaps above 8% (according to the National Conference of State Legislators). The decline in revenues in these and other states is a direct result of the current slowdown in the overall economy: reduced home sales mean lower real estate transfer tax revenues; lower property values mean lower property tax collections; job losses and reductions in personal income lead to declines in revenues from sales and personal income taxes; and reduced business activity cuts into corporate income tax revenues. While budget shortfalls are a result of weakness to date in the overall economy, they could cause further weakness in the future through cuts in state and local government employment and spending. State and local government employment is a large share of the economy, accounting for 12% of nonagricultural employment, compared to 10% for manufacturing employment.

FedViews, Beige Book, and *FRBSF Economic Letter* are available at http://www.frbsf.org/economics/index.html#pubs
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