Twelfth Federal Reserve District

FedViews

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Mary Daly, vice president at the Federal Reserve Bank of San Francisco, states her views on the current economy and the outlook:

- On September 20, the National Bureau of Economic Research’s Business Cycle Dating Committee officially called an end to the recession. It will go into the history books as the longest and deepest downturn since the Great Depression. The recession officially lasted 18 months from December 2007 to June 2009. Over that time, the U.S. economy shed 7.3 million jobs, GDP fell by 4.1%, and household net worth declined by 21%.

- Despite the official announcement, the public thinks the recession is ongoing. According to a CNN/Opinion Research Corporation Poll in September, more than 70% of those surveyed thought the U.S. economy was still in a recession.

- One reason for that view is that the economic recovery is proceeding at a very slow pace and has lost momentum since the spring. The effects of this downshift are visible in consumer confidence, which has fallen from earlier in the year.

- The September jobs report highlights one of the difficulties—the reluctance of businesses to add jobs. Payroll employment declined by 95,000 as large cuts in government staffing levels more than offset modest private job gains.

- Sluggish job growth left the unemployment rate for September unchanged at 9.6%. Data on initial claims for unemployment insurance also have remained elevated, suggesting that the pace of layoffs has yet to return to a level consistent with a solid recovery.

- With consumer confidence low, labor markets weak, and households still working to trim debt and boost savings, consumption growth remains modest. Federal Reserve Bank of San Francisco business contacts say retailers are working to keep inventories lean in anticipation of continued modest consumption growth going forward.

- Data on housing continues to disappoint. Despite low mortgage interest rates, housing markets have shown little ability to move forward now that the federal first-time homebuyer tax credit has expired. With continued weakness in home sales and prices, residential building remains virtually nonexistent.

- Business investment remains a bright spot, although the pace of expansion in this category appears to be slowing. The Institute for Supply Management purchasing managers index suggests that the manufacturing sector is expanding. That said, the index has been falling in recent months, indicating a less robust pace of expansion than earlier in the year.

- Consistent with the disappointing data, we have marked down our GDP forecast for the remainder of 2010 and 2011. We currently project that real GDP will expand around 2½% in 2010, below its potential of about 3% annually. We expect the recovery to gain momentum over the course of next year and that real GDP growth for 2011 will reach about 3½%.

- One reason for our more modest outlook is that no sector of the private economy stands ready to drive a robust recovery. As federal fiscal stimulus wanes and state and local government cutbacks accelerate, the private sector has failed to pick up the slack. With only modest gains in private economic activity, the overall pace of growth has slowed.

- The slow pace of growth projected over the forecast horizon suggests it will take a long time to return to normal. Based on our forecasts of real GDP growth and our estimates of potential GDP, we project that considerable economic slack, known technically as an output gap, will remain at least into 2013.

- With this sizeable output gap hanging over the economy, we expect both core and headline inflation to be restrained for some time. We project personal consumption expenditures (PCE) inflation to be around 1% in 2011 and 2012.

- The September 21, 2010, Federal Open Market Committee (FOMC) statement noted: "Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability." This was a stronger statement on the Federal Reserve's dual mandate than had previously been made.

- To understand what the Committee was referring to when it said it was failing to achieve its mandates—maximum sustainable employment and price stability—it is useful to look at the unemployment rate relative to its natural rate and core inflation relative to the preferred range cited by Committee members.

- The Survey of Professional Forecasters places the natural rate of unemployment—the lowest sustainable rate consistent with stable inflation—between 5% and 6.75%. The higher values and increased range of estimates for this rate, often called the non-accelerating inflation rate of unemployment (NAIRU), since the recession began reflect the view that there has been an increase in structural unemployment caused by skill or geographical mismatches between workers and available jobs. Even if structural unemployment has increased, the unemployment rate is still far above the highest survey estimate of the natural rate. This implies there is a way to go before achieving maximum employment.

- Relative to the preferred level of inflation among FOMC members, as reflected in their calculations from the June 2010 FOMC forecasts of the central tendency of the long-run level of inflation under appropriate monetary policy, core PCE inflation is running low. This low level of inflation, combined with the sluggish GDP forecast and large amount of slack in the economy, suggests that further disinflation is possible.

- Japan's experience beginning in the early 1990s underscores the risk of getting into a long period of sustained disinflation. Japan fell into deflation in the mid-1990s and has yet to recover.

Recession is officially over

U.S. Business Cycle Peak and Trough Dates

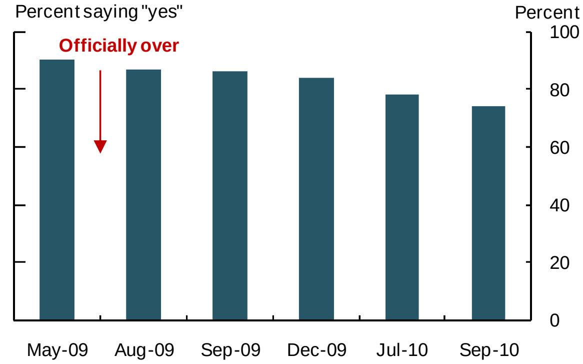
Final Tally	Peak	Trough
	Nov 48	Oct 49
18 months	Jul 53	May 54
	Aug 57	Apr 58
7.3 million jobs lost	Apr 60	Feb 61
	Dec 69	Nov 70
4.1% decline in GDP	Nov 73	Mar 75
	Jan 80	Jul 80
21% decline in net worth	Jul 81	Nov 82
	Jul 90	Mar 91
	Mar 01	Nov 01
	Dec 07	Jun 09

Source: NBER Business Cycle Expansions and Contractions.

Public is not convinced

Do you think the economy is in a recession or not?

Percent saying "yes"

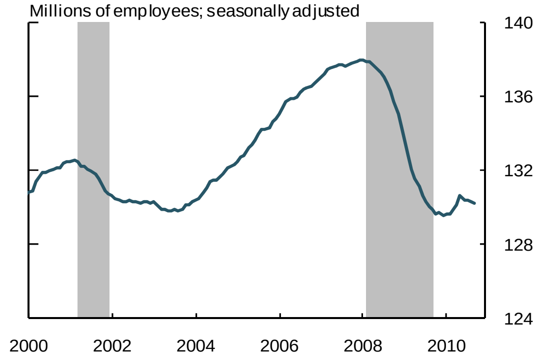


Source: CNN/Opinion Research Corporation

Job growth still constrained

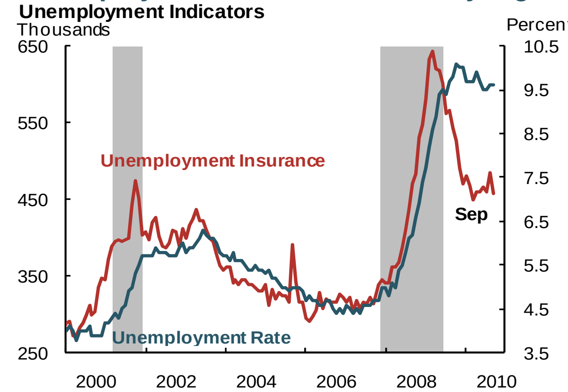
Nonfarm Payroll Employment

Millions of employees; seasonally adjusted



Unemployment remains stubbornly high

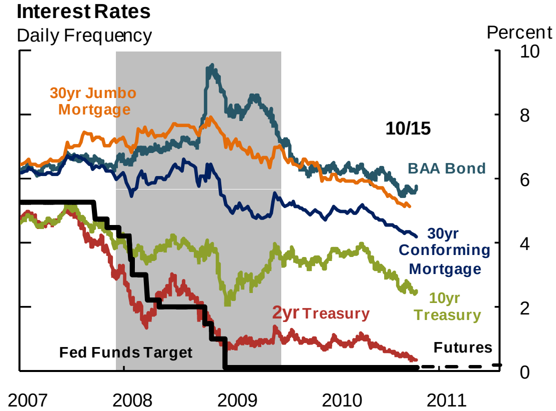
Unemployment Indicators



Interest rates remain low

Interest Rates

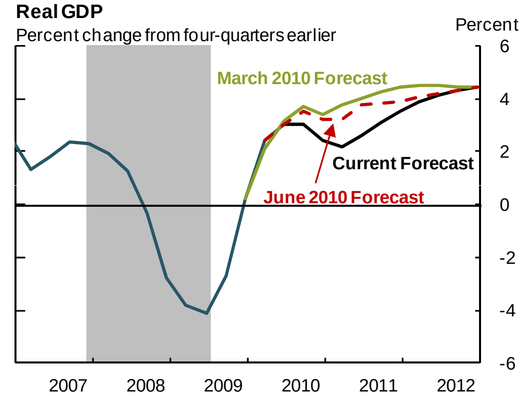
Daily Frequency



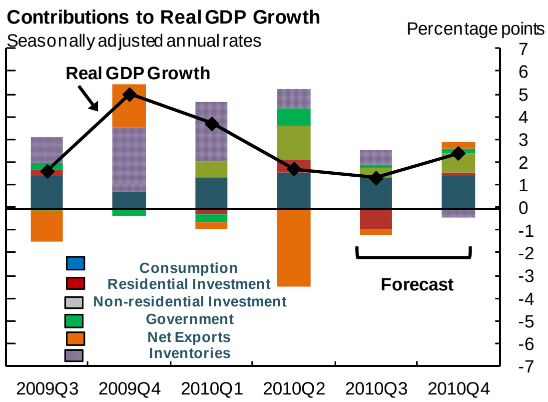
Marked down our forecast

Real GDP

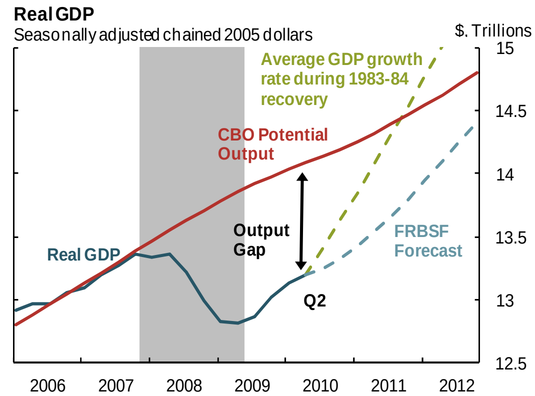
Percent change from four-quarters earlier



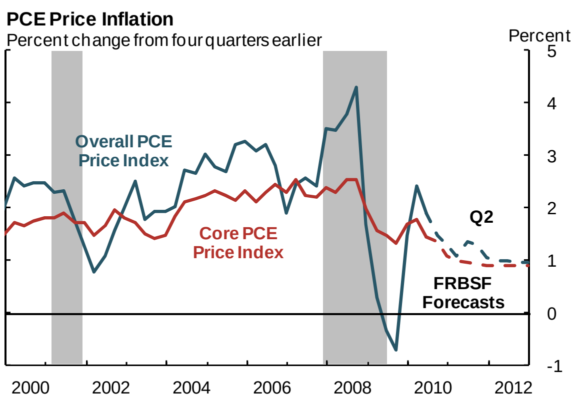
Modest growth across the board



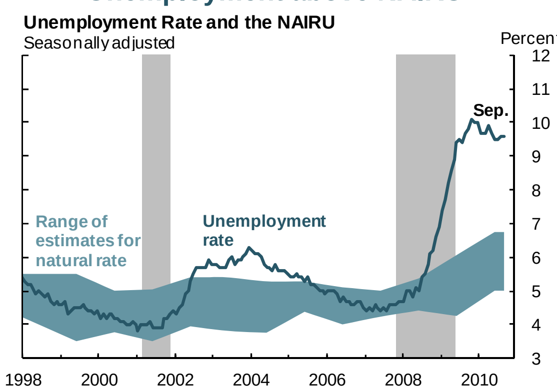
A long time to return to normal



Inflation remains subdued

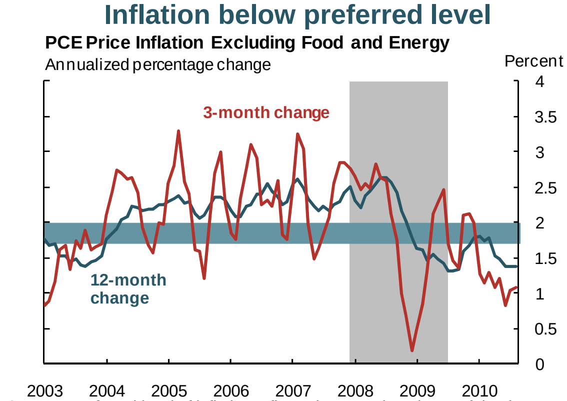


Unemployment above NAIRU



Source: Range of estimates for natural rate: Survey of Professional Forecasters.

Inflation below preferred level



Source: Preferred level of inflation reflects the central tendency of the long-run level of inflation among FOMC members as of June 2010.

History suggests this is a risk