John Fernald, group vice president and associate director of research at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- Businesses are slowly hiring, consistent with an economy that is growing moderately. The economy has recovered about 3¾ million of the 8.8 million jobs lost during the downturn. In April, job gains were a somewhat disappointing 115,000. Still, upward revisions to jobs in February and March left the level of employment close to our expectations. The weaker apparent employment momentum may reflect warm winter weather in many parts of the country, which could have pulled some hiring forward.

- The unemployment rate was 8.1% in April. We expect the rate to remain near 8% at the end of this year and to decline to near 7½% by the end of next year. The unemployment rate is only slowly closing the gap towards its natural rate, which is the equilibrium rate consistent with neither upward nor downward pressure on wages and inflation. The natural rate appears to have risen markedly since the onset of the Great Recession, reflecting factors such as skills mismatch and extended unemployment insurance benefits. Most of these effects are likely to fade over time.

- Gross domestic product expanded at only a 2.2% pace in the first quarter. We expect growth to remain moderate, picking up only gradually to about a 2¼% pace in the second half of this year and in 2013. The moderate pace reflects continuing obstacles facing the economy. For example, the European debt situation continues to weigh on financial conditions. Credit availability remains constrained for many borrowers. All levels of government are trimming budgets. And lingering uncertainty about the economy and policy are constraining spending and investment.

- The gap between the actual and natural rate of unemployment is one measure of resource slack. A related measure is the gap between potential and actual output. Potential is what output would be if the workforce and productive capacity were fully utilized at sustainable, noninflationary levels. Our current estimate of potential output is markedly lower than it was before the financial crisis and recession. One reason is labor market disruption, as indicated by the increase in the natural rate of unemployment. Those disruptions reduce our estimate of total hours that would be worked if the economy were at full employment.

- Lower potential output also reflects slower productivity growth than we expected in 2007. Over the longer term, productivity growth is key to explaining growth in potential output. In retrospect, it appears that growth in inflation-adjusted output per hour worked has been growing significantly more slowly since the mid-2000s than before. The productivity acceleration of the mid- to late-1990s, fueled by information technology, appears to have run its course.

- Potential output has also been reduced because growth in productive capacity ground to a halt during the recession. Depressed investment was only sufficient to replace worn out capital. Businesses did
not add to the stock of stores, office buildings, computer servers, and other capital items. In the recovery, growth in equipment and software has resumed. But growth in structures remains lackluster.

- Other indicators also point to sizeable economic slack. In surveys, few households say that jobs are plentiful. And relatively few businesses report they have a hard-to-fill vacancy, although the percentage has been rising somewhat. Anecdotal reports suggest that businesses find most positions easy to fill, except for those that require specialized engineering or technology skills.

- Labor costs have been growing only modestly, another indicator of slack. This is true for both wages and overall compensation, including benefits. Modest compensation growth anchors costs for businesses and is a key factor in our forecast of subdued inflation.

- Business profit margins are a link in the chain running from labor costs to prices. These margins look extraordinarily strong now. According to the national-accounts data used to compute GDP, the pretax corporate profit rate is the highest in decades and the after-tax corporate profit rate is the highest on record. We do not forecast that the profit rate will rise further.

- Underlying inflation remains subdued. Overall inflation has run up, reflecting gasoline prices. However, gasoline prices are off their highs as crude oil has fallen from its peak. With low growth in labor costs, we expect inflation to average about 1¾% this year and next.

- With substantial resource slack, moderate growth, and subdued inflation, interest rates are low. Indeed, in its statement following its April meeting, the Federal Open Market Committee pointed to “economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run” as factors that led it to anticipate “exceptionally low levels for the federal funds rate at least through late 2014.”
Businesses are slowly hiring

Change in Nonfarm Payroll Employment
January +275
February +259
March +154
April +115

8.8 million jobs lost

But unemployment remains elevated

Seasonally adjusted Unemployment Rate

FRBSF estimate for natural rate

Large gap remains

FRBSF forecast

Unemployment rate

Unemployment

FRBSF estimate

Economy growing at a moderate pace

Gross Domestic Product (GDP)

Percent change at seasonally adjusted annual rate

Economy is still a long way from normal

Potential and Actual Real GDP

2007Q4 real GDP = 100

Actual real GDP

Current FRBSF potential

2007Q4 FRBSF potential

FRBSF forecast

Note: 2007Q4 FRBSF potential line holds output gaps for 2005-07 at their 2007Q4 estimated values.

Underlying productivity growth is slower

Business Sector Labor Productivity
Cumulative growth rate since 1987:1

Capacity growth halted during recession

Capital Input Growth
Annualized quarterly growth rate

Forecast

Equip. & software

Structures
Other indicators suggest sizeable slack

Survey Measures of Job Market Slack

- Percent of firms with "hard to fill" positions
- Percent of households who say "jobs are plentiful"

Source: Conference Board survey of households, NFIB survey of businesses

Modest wage growth anchors costs, prices

Employment Cost Index

- Percent change from same period one-year earlier
- Overall compensation
- Wages & salaries

Underlying inflation remains subdued

PCE Inflation

- Percent change from four quarters earlier
- Overall PCE price index
- Core PCE price index
- FRBSF forecast

Corporate profit rate is high

Corporate Profit Rate

- Pretax profits as a share of gross value added
- Overall
- Nonfinancial

Interest rates remain low

Interest Rates

- Low-grade bond
- AAA bond
- BAA bond
- 10-yr. Treasury
- Fed funds target
- 2-yr. Treasury

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