Twelfth Federal Reserve District

FedViews

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FedViews – July 9, 2009

Mary C. Daly, vice president and director of the Center for the Study of Innovation and Productivity at the Federal Reserve Bank of San Francisco, states her views on the current economy and the outlook:

- Financial markets are improving, and the crisis mode that has characterized the past year is subsiding. The adverse feedback loop, in which losses by banks and other lenders lead to tighter credit availability, which then leads to lower spending by households and businesses, has begun to slow. As such, investors' appetite for risk is returning, and some of the barriers to credit that have been constraining businesses and households are diminishing.

- The housing sector, which has been at the center of the economic and financial crisis, also looks to be stabilizing—albeit, at a very depressed level. The pace of house price declines is slowing, housing starts and new home sales have leveled off, and existing home sales have edged up in recent months. These positive developments suggest that the housing market may be reaching a bottom.

- Income from the federal fiscal stimulus, as well as some improvement in confidence, has helped stabilize consumer spending. Since consumer spending accounts for two-thirds of all economic activity, this is a key factor affecting our forecast of growth in the third quarter.

- Whether the adverse feedback loop will continue to slow and ultimately reverse depends in part on the labor markets, which continue to deteriorate. The economy lost 467,000 nonfarm jobs in June and the unemployment rate rose to 9.5 percent. Although recent monthly job losses remain sizable, the pace of declines, however, is lower than earlier this year.

- That said, ongoing weakness in the labor markets continues to push up foreclosures and pose risks to the fledgling recovery of housing.

- Although the economy continues to face many downside risks, we expect the easing of the financial crisis and the bottoming out of the housing market to allow a modest recovery to ensue in the third quarter. In our view, the recovery will be painfully gradual, with the economy expanding below potential for several quarters.

- The gradual nature of the recovery will put additional pressure on state and local budgets. Following a difficult 2009, especially in the West, most states began the 2010 fiscal year on July 1 with even larger budget gaps to solve.

The views expressed are those of the author, with input from the forecasting staff of the Federal Reserve Bank of San Francisco. They are not intended to represent the views of others within the Bank or within the Federal Reserve System. FedViews generally appears around the middle of the month. The next FedViews is scheduled to be released on or before September 14, 2009.

- While such gaps are typical in recessions, state governments face far larger problems than usual since all of their major sources of revenue (income, sales, and property taxes) have been disrupted. The federal fiscal stimulus payments to states should help stave off even worse difficulties, but the states likely will face constrained budgets for years to come.

- As the financial crisis has subsided and the economy has begun to stabilize, some worries about inflation have emerged. In the near-term, we expect the slow recovery and the persistent and considerable slack in product and labor markets to keep inflation below its preferred longer-run rate as reflected in the minutes of the Federal Open Market Committee meeting held in April.

- In manufacturing, capacity utilization is at an all time low. This excess capacity should continue to exert downward pressure on both input and final goods prices.

- There also is unprecedented slack in the labor markets. Considering the official unemployment rate plus the number of workers who are employed part-time involuntarily for economic reasons, the overall measured slack is in excess of the 1982 recession. Moreover, we foresee this measure rising even higher by the end of the year.

- This slack in the labor markets should continue to temper growth in wages and salaries, which has dropped off sharply over the course of the recession.

- Despite the considerable downward pressures on prices, concerns about deflation appear to have abated. Market participants now expect inflation over the next five years to be on average around 1%, roughly in line with our forecast.

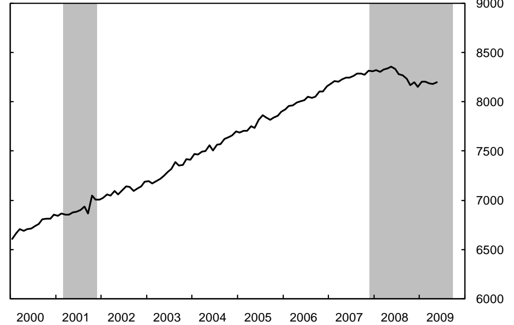
- Over the longer-run, inflation expectations are higher, hovering in a 2 to 3% range, and despite considerable media worries about future inflation risk, expectations remain well-anchored.

- Still, many remain worried that large fiscal deficits will eventually be inflationary. However, a look at the empirical link between fiscal deficits and inflation in the United States shows no correlation between the two. Indeed, during the 1980s, when the United States was running large deficits, inflation was coming down.

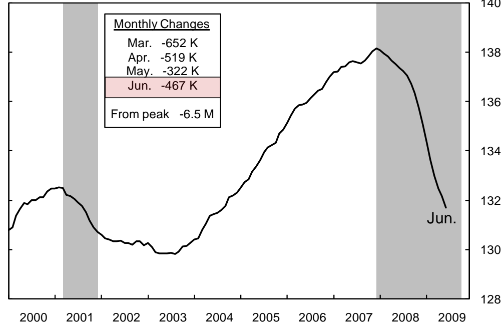
Three Issues

Economic Outlook	State budget gaps	Inflation worries
▪ Crisis subsides ▪ Fiscal/Fed actions ▪ Consumers hang on ▪ Labor market struggles	▪ Widespread problem ▪ Multiyear issue ▪ Usual pattern, unusual size	▪ Near-term: low inflation due to weak economy ▪ Longer-term: high inflation due to extraordinary monetary accommodation and fiscal deficits

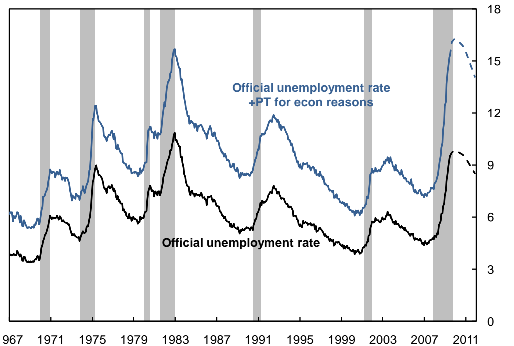
Consumers hanging on



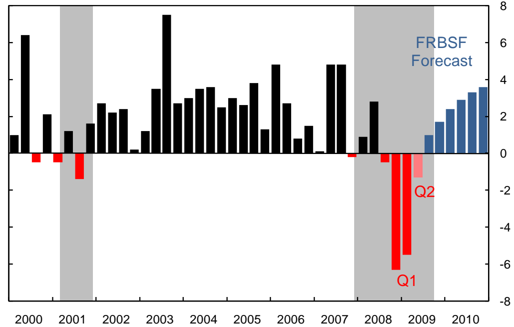
Job losses continue to mount…



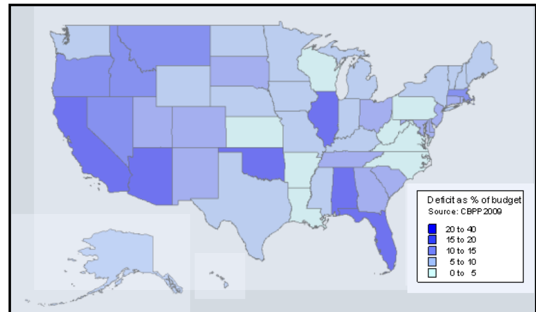
…pushing up unemployment.



Modest recovery to begin in Q3

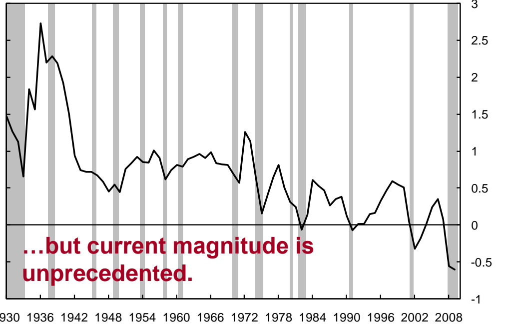


State budget gaps pervasive in 2009



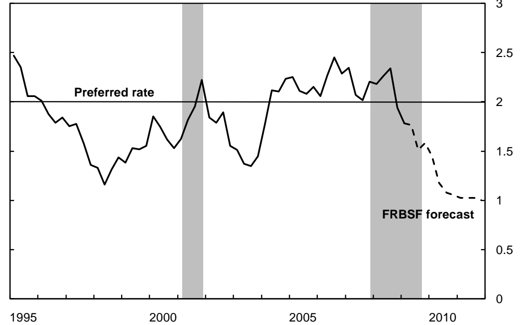
Gaps are typical in downturns…

State and Local Govt Receipts minus Expenditures
As percent of U.S. GDP



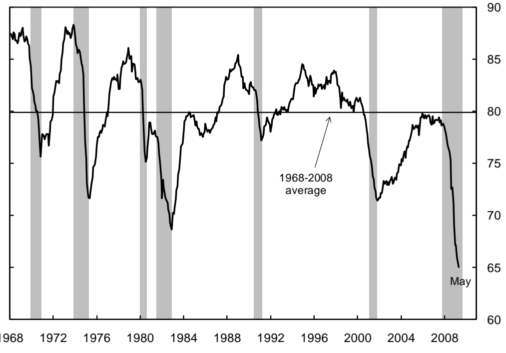
Near-term: expect inflation to fall

Core PCE Price Inflation
Percentage change from four quarters earlier



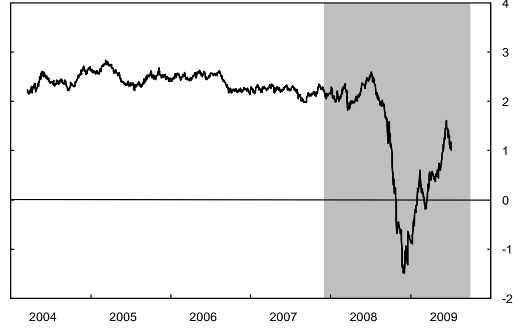
Capacity utilization at all time low

Manufacturing Capacity Utilization



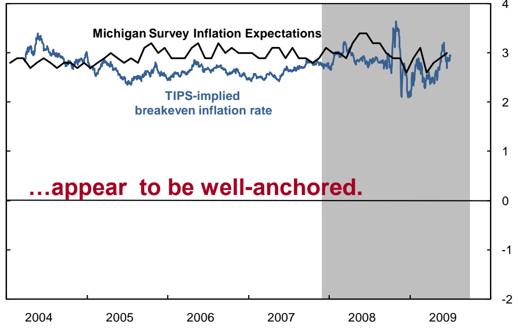
Near-term deflation fears abating

Inflation Expectations Next 5 years
based on breakeven inflation rates adjusted for an indexation lag



Long-run inflation expectations…

Inflation Expectations 5-10 years ahead
based on breakeven inflation rates adjusted for an indexation lag



No link between deficits and inflation

Fiscal deficits and core inflation