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Mark Spiegel, vice president in the Economic Research Department of the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- GDP growth in the first quarter of 2011 came in at a disappointing 1.8% annualized pace, down from 3.1% in the fourth quarter of 2010. However, there is reason to believe that this slowdown is transitory. Our forecast projects moderate growth of around 3% in the current quarter and close to 4% in the second half of this year.
- A number of the factors contributing to the first-quarter slowdown in growth are expected to be either one-off declines that won't be repeated or shifts in spending that should lead to paybacks going forward. Among the latter is a temporary drop in federal defense spending, which took about 1% from growth. We expect this decline will be made up in the next few quarters. In addition, severe winter weather acted as a drag on both household consumption and investment in structures.
- There have also been pockets of strength. Manufacturing remains strong, with the Institute for Supply Management index for April coming in at 60.4, down slightly from 61.2 in March, but still indicating expansion and slightly above expectations. An ISM index figure over 50 indicates growth.
- Consumption also remains relatively solid. Real personal consumption expenditures (PCE) grew at a healthy 2.7% annualized pace in the first quarter of 2011, coming off a very strong 4% pace in the fourth quarter of 2010. There are some concerns that consumption growth might be slowed by declining household confidence. The University of Michigan index of consumer sentiment fell sharply in March by 10 points, primarily on concerns about energy prices. The index registered a slight rebound of 2.3 points in April.
- Auto sales have continued to recover in the first four months of the year. In April, sales ticked up a bit to an annual pace of 13.2 million units, after averaging 13.0 million units in the first quarter and 12.3 million units in the fourth quarter of 2010. Analysts believe that the trend indicates continued firming in the U.S. auto market. Japan's earthquake may disrupt production of autos and some key auto parts this quarter. As inventories are drawn down, auto sales might also be affected.
- Investment represented a particular bright spot in the first quarter. For the quarter as a whole, investment in equipment and software rose at a robust annual rate of 11.6%. New orders and shipments for core capital goods remained strong through March.
- The labor market is showing welcome signs of firming. Total nonfarm payroll employment grew by 244,000 jobs in April, according to the Bureau of Labor Statistics. The private sector fared even better, adding 268,000 jobs. These results were far above expectations, especially given that releases

earlier in the week were softer. The ADP National Employment Report indicated that private payrolls grew by only 179,000 in April, well below expectations of about a 200,000 increase. And initial claims for unemployment had been rising in recent weeks.

- Still, the level of unemployment remains high. The unemployment rate actually rose in April from 8.8% to 9.0%. The unemployment rate is calculated based on a survey of households that is distinct from and smaller than the payroll survey. The household survey showed employment falling in April. Given the deep reservoir of unemployed workers, it will likely take years for labor markets to recover from the recent recession.
- Oil prices, though still elevated, have been falling precipitously and are now down more than 15% from recent highs. Prices of precious metals and other commodity prices have also fallen recently.
- Going forward, the decline in oil and other commodity prices will narrow the gap between overall inflation and measures of underlying inflation. The overall or headline price index for personal consumption expenditures rose 0.4% in March from the previous month, driven primarily by increases in oil and other commodity prices. However, core inflation, which strips out energy and food prices, only increased 0.1%. Core inflation is one of a number of measures of underlying inflation used at the Federal Reserve and elsewhere to gauge medium-term inflation trends. We project headline PCE inflation will average 2.25% for 2011 and core PCE inflation will average 1.25%.
- The euro has fallen this week, largely on news suggesting a pause in the European Central Bank's (ECB) moves to raise its policy interest rate and concerns about the sovereign debt difficulties of countries on the European periphery. The ECB's recent rate hike was broadly consistent with a simple rule of thumb, commonly known as a Taylor rule, that predicts policy interest rates based upon inflation levels and the gap between actual and potential output. Under such a rule of thumb, the euro area's relatively milder recession was broadly consistent with an initiation of rate increases earlier than in the United States.
- However, the fact that the policy was appropriate for the euro area as a whole does not imply that it was proper for all countries in the monetary union. The attached figure titled "ECB policy rate edges up" compares the ECB policy rate with predictions of such a rule for the euro-area "core" countries of Germany, France, the Netherlands, Belgium, and Austria, and the highly indebted "periphery" countries of Portugal, Greece, Spain, and Ireland. The policy rate is much closer to levels predicted by a Taylor Rule for the core of the euro area. Indeed, such a rule applied to the peripheral countries would continue to predict policy rates below zero.
- Given the relative size of these economic regions, it is unsurprising that ECB policy more closely matches conditions in the euro-area core. However, increases in interest rates may magnify the difficulties the peripheral countries are experiencing servicing their sovereign debt obligations.



