

April 12, 2012

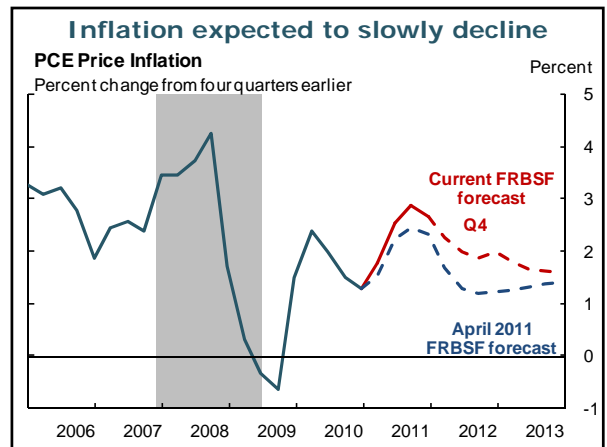
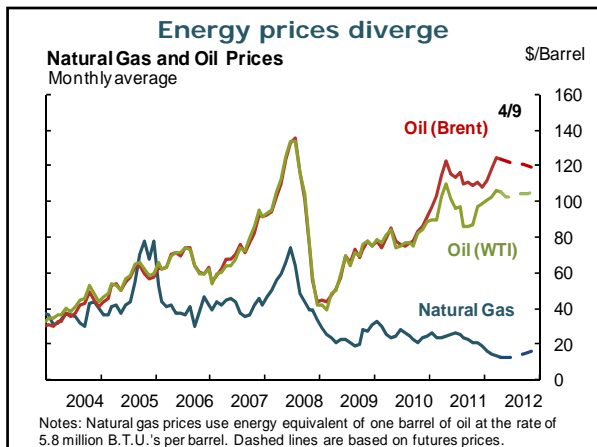
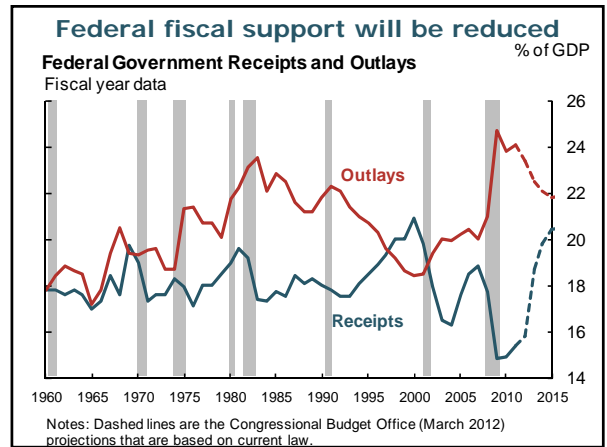
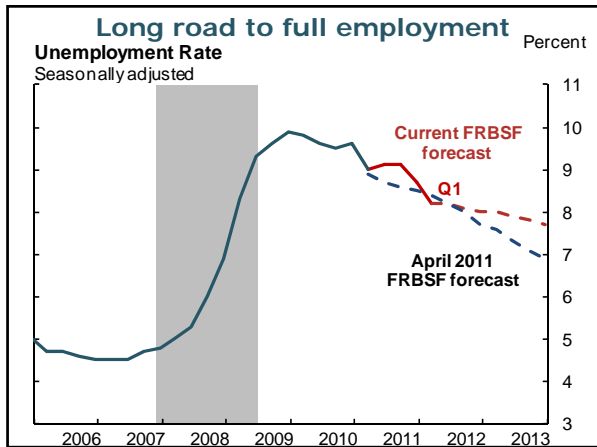
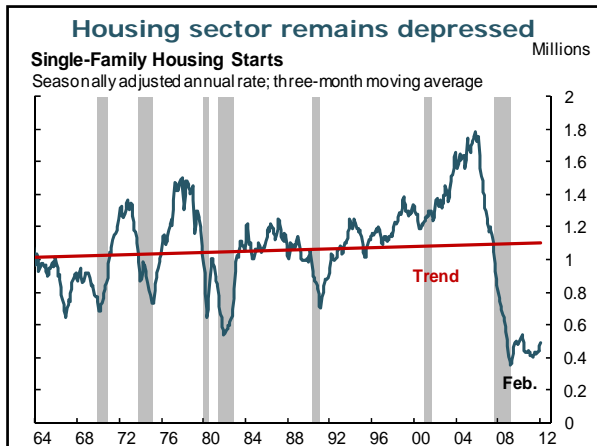
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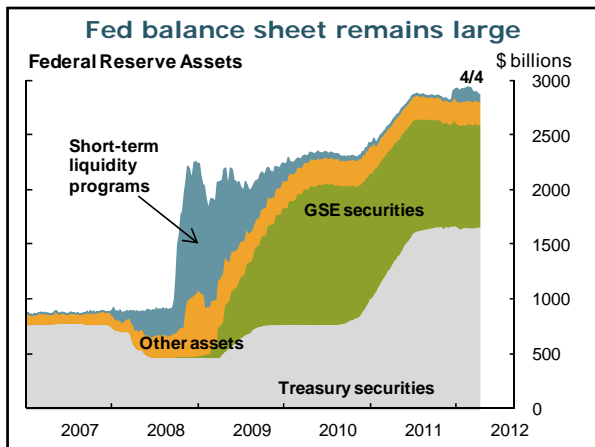
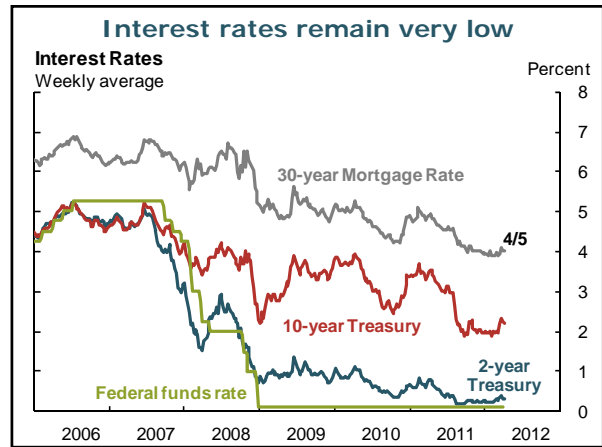
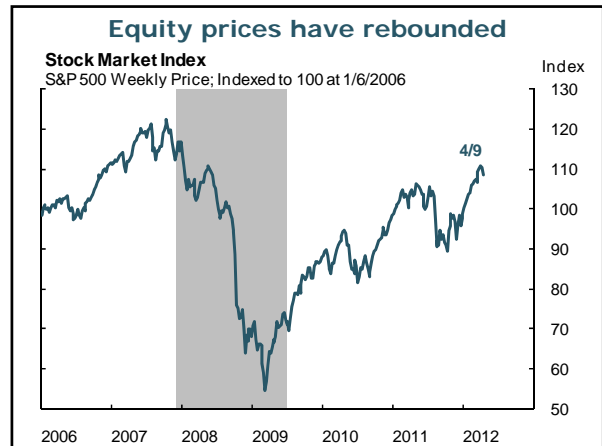
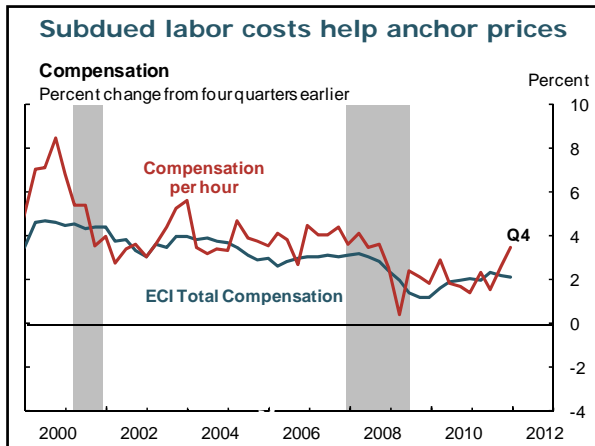
Glenn Rudebusch, executive vice president and director of research at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- Following past recessions, residential construction made significant contributions to the early stages of recovery. This time, several years after the Great Recession ended, housing remains deeply depressed. Recently, in some localities, there have been pockets of improvement. However, nationally, single-family housing starts are still moving sideways.
- Outside housing, the recent economic news has generally been a bit better than expected. An improving labor market is a crucial underpinning for our projection of moderate real GDP growth of around 2½% to 2¾% this year. The pace of net job growth has picked up over the past six months. We have recovered more than 40% of the 8.8 million jobs lost during the recession. Of course, the U.S. population has grown since the peak in jobs, so we are still a long way from full employment.
- The long road ahead is also apparent in our unemployment rate projection. The unemployment rate edged up a bit last summer and then fell rapidly during the winter to 8.2% in March. Some of this improvement reflected more hiring and fewer job layoffs. But a portion was because some of the unemployed ended their job searches and dropped out of the labor force. Going forward, we expect fewer people to leave the labor force and little further decline in the labor force participation rate. Accordingly, we anticipate a very gradual decline in the unemployment rate over the next two years.
- During the recession, federal spending jumped and tax receipts fell. These changes reflected discretionary tax cuts and spending increases, as well as automatic fiscal stabilizers, such as the unemployment insurance safety net. Under current law, outlays are scheduled to start shrinking rapidly next year with the start of congressionally mandated sequestration spending reductions. In addition, federal tax receipts are scheduled to jump as a variety of tax cuts expire. These scheduled reductions in federal fiscal support may give the economy an abrupt downside shock.
- Energy prices have diverged recently in two key ways. This is due in large part to a ramp-up in the domestic production of crude oil and natural gas as new horizontal and hydraulic fracturing drilling techniques are applied to shale rock formations. First, North Sea Brent crude oil has moved about \$20 a barrel higher than West Texas Intermediate crude. For a long time, the two traded within a few dollars of each other. They have diverged because the infrastructure is not yet in place to get all of the additional U.S. oil production to international markets. Second, a remarkable gap has developed between the prices of crude oil and natural gas. On an energy-equivalent basis, Brent crude oil is

about 10 times more expensive than natural gas. The very low natural gas prices will blunt some of the effect of higher gasoline prices on consumer energy budgets. In addition, the recent jump in crude oil prices has not been mirrored by higher prices for most other industrial and agricultural commodities.

- Energy price swings have been pushing consumer price inflation up and down since the recession began. The surge in crude oil prices last year resulted in a bulge in consumer inflation. However, as crude oil prices stabilize, inflation should slowly fall to below 2% next year.
- One anchor for price inflation has been restrained labor costs. With unemployment still high, there has been little upward pressure on these costs, which account for about 60% of total production costs.
- A key factor supporting further growth is continuing improvement in financial conditions, owing in part to accommodative monetary policy. With greater investor confidence and strong profits, broad indexes of stock prices have rebounded almost to pre-recession levels. One measure of improving financial market sentiment comes from low levels of equity market volatility.
- Low interest rates are also supporting the recovery. For example, reduced auto financing rates have helped boost motor vehicle sales and production. The Fed has taken three key actions to promote low interest rates. First, it has held the benchmark federal funds rate at essentially zero since late 2008. Second, the Fed has provided forward guidance about future policy rates. According to its March 13 statement, the Federal Open Market Committee anticipates that “economic conditions—including low rates of resource utilization and a subdued outlook for inflation over the medium run—are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.” Finally, the Fed has purchased about \$2 trillion of longer-term U.S. Treasury and government-backed debt securities. This additional demand for securities has pushed bond prices higher and yields lower.
- One concern associated with the Fed’s larger balance sheet is interest rate risk (see [“The Fed’s Interest Rate Risk” FRBSF Economic Letter 2011-11, April 11, 2011](#)). However, the Fed remains in a very strong financial position. The Fed paid the Treasury \$75 billion in excess income last year and had \$220 billion in unrealized capital gains from its securities portfolio.





Fed's income statement is strong

Federal Reserve income statement
(Billions of dollars, Jan. 1 through Dec. 31, 2011)

Interest income	88.0
- Interest expense	4.1
- Operating expenses	5.4
- Realized capital losses	0.0
= Net income (comprehensive)	77.4
- Additions to capital (surplus)	0.4
- Dividends paid to banks	1.6
= Remittances to Treasury	75.4
Memo: Unrealized capital gains (as of December 31, 2011)	220.0

Note: Numbers may not total due to rounding.