Twelfth Federal Reserve District

FedViews

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Fernanda Nechio, senior economist at the Federal Reserve Bank of San Francisco, states her views on the current economy and the outlook.

- Real GDP growth for the first quarter of 2015 was revised down to –0.7% on an annual basis. The weakness in the first quarter is attributable to a number of transitory factors, including a sharp drop in net exports, which pushed real GDP growth down by almost two full percentage points.

- We remain optimistic that the economy will rebound in the second quarter. The dollar appears to be stabilizing, the overall outlook for our trade partners is improving, and the West Coast port slowdown has been resolved, thus alleviating some of the conditions damping net exports.

- Several indicators suggest the economy is on better footing than GDP growth numbers indicate. Growth in employment and real incomes is solid, household wealth is improving, and the stock market is buoyant. In addition, monetary policy remains highly accommodative. In light of these conditions, we expect real GDP growth to move above its trend rate of 2% during the remainder of 2015. Absent other forces, and with employment and inflation at or near mandate levels, we expect the economy to settle around trend in the second half of 2016.

- Employment data show that 280,000 new jobs were created in May. This marks a significant rebound from March and April. In addition, the employment cost index shows signs that labor compensation is starting to pick up. These factors should provide a more solid foundation for household income, which in turn should boost consumer spending.

- Labor force participation also rose in May, outpacing job creation. Consequently, the unemployment rate ticked up to 5.5% in May. We expect the unemployment rate to slowly edge down as job market conditions continue to normalize.

- Several factors, including strong dollar appreciation and falling gasoline prices, continue to weigh down headline personal consumption expenditures (PCE) price inflation, which rose only 0.1% at an annual rate in the twelve months through April. Core PCE inflation, which removes volatile food and energy prices, proved more resilient, rising 1.2% percent over the past 12 months through April. As some of the downward forces on inflation dissipate and real GDP growth picks up, we expect core PCE price inflation to move gradually toward the Federal Open Market Committee’s 2% target.

- The continued anchoring of long-term inflation expectations is an important ingredient in our inflation outlook. When expectations for future inflation are well-anchored—that is, closely aligned with the Federal Reserve's long-run inflation objective of 2%—households and businesses tend to view deviations of actual inflation from the target as temporary and will base their wage and price decisions on the Fed's target. Thus, well-anchored expectations make it easier for the central bank to effectively hit its inflation objective.

- Surveys provide a direct measure of inflation expectations. One commonly used measure of U.S. inflation expectations is the Survey of Professional Forecasters (SPF). The median SPF forecast for PCE inflation over the 5 to 10 years ahead rose from near 2% in the first quarter of 2007 to 2.5% in mid-2009, before falling back to 2% by the end of 2014. The range of survey respondents' forecasts also widened between 2009 and 2011, but has recently narrowed.

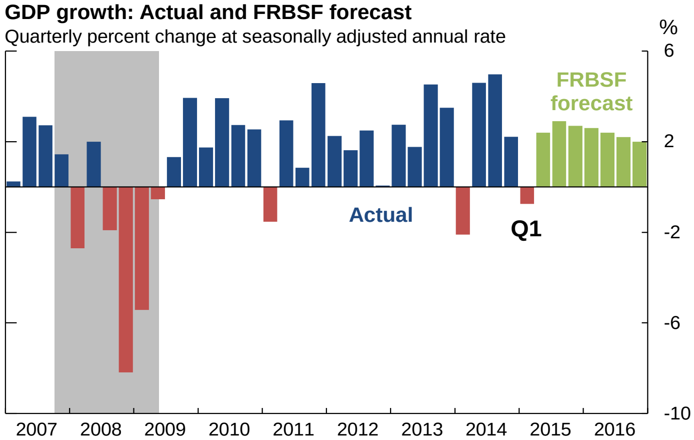
- The sample of forecasters can be split into two groups based on their accuracy in projecting short-term inflation. "Accurate" forecasters are defined as those with below-average forecast errors, while "inaccurate" forecasters make above-average forecast errors.

- Inaccurate forecasters explain most of the rise in the median long-term inflation forecast between 2009 and 2011. These forecasters disproportionately raised their long-term inflation forecasts as the Federal Reserve responded to the financial crisis with monetary accommodation, but later lowered them back closer to their pre-crisis median. This group also appears to have widened the range of forecasts between 2009 and 2011.

- Since the inaccurate group's projections have moved back down, the overall estimates from the survey suggest that long-term inflation expectations are currently in line with the Fed's 2% inflation goal.

Growth expected to rebound

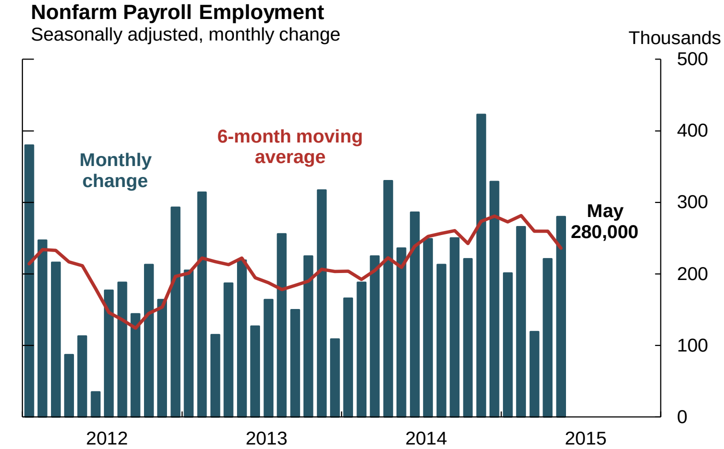
GDP growth: Actual and FRBSF forecast
Quarterly percent change at seasonally adjusted annual rate



Source: Bureau of Economic Analysis and FRBSF staff

Continued strength in job creation

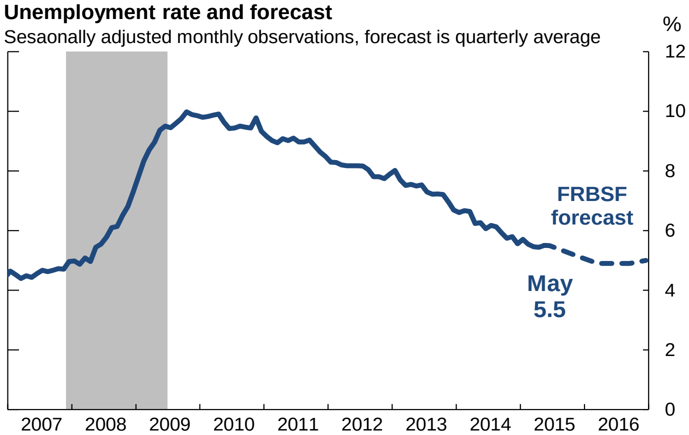
Nonfarm Payroll Employment
Seasonally adjusted, monthly change



Source: Bureau of Labor Statistics

Unemployment expected to edge down

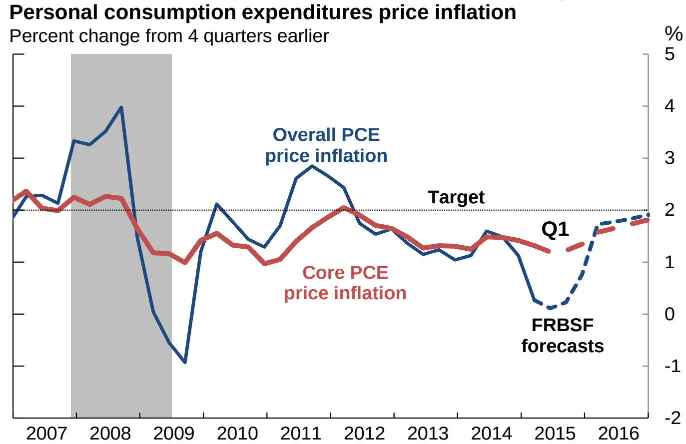
Unemployment rate and forecast
Sesaonally adjusted monthly observations, forecast is quarterly average



Source: Bureau of Labor Statistics and FRBSF staff

Inflation expected to return to target

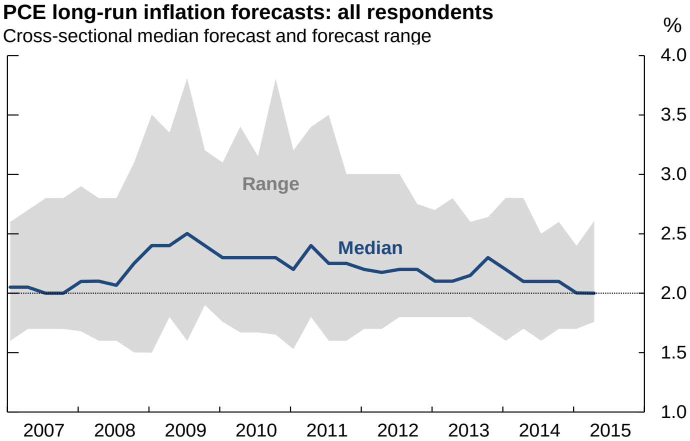
Personal consumption expenditures price inflation
Percent change from 4 quarters earlier



Source: Bureau of Economic Analysis and FRBSF staff

Professional forecasts in line with target

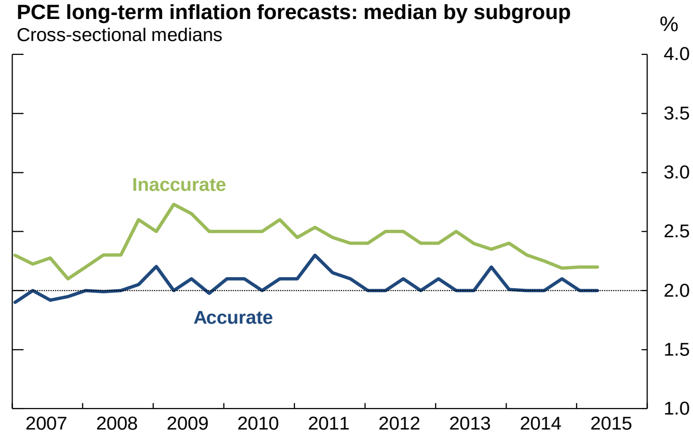
PCE long-run inflation forecasts: all respondents
Cross-sectional median forecast and forecast range



Source: Survey of Professional Forecasters
Shaded area shows range of forecasts between the 10th and 90th percentiles.

Poor forecasters driving most changes

PCE long-term inflation forecasts: median by subgroup
Cross-sectional medians



Source: Survey of Professional Forecasters. Accurate forecasters have a better record of 1-year ahead inflation forecasts (below average forecast error)