Twelfth Federal Reserve District

FedViews

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Simon Kwan, vice president at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:

- The Federal Open Market Committee decided on November 3 to expand the Federal Reserve's holdings of securities to provide additional support for the economy. In addition to maintaining its existing policy of reinvesting principal payments from its securities holdings, the FOMC authorized purchases of a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011. The Open Market Trading Desk at the New York Fed estimated the principal payments from agency debt and agency mortgage-backed securities will be around $250 billion to $300 billion over the same period. Taken together, the Desk anticipated that it would purchase $850 billion to $900 billion in longer-term Treasuries through the end of the second quarter of 2011. The FOMC also decided to maintain its target for the federal funds rate at 0 to 0.25% and repeated its statement that "economic conditions…are likely to warrant exceptionally low levels for the federal funds rate for an extended period."

- Market participants had been expecting the Fed to engage in another round of large-scale asset purchases for quite some time. Both nominal and real Treasury rates had been declining, and implied inflation compensation of Treasury inflation-protected securities (TIPS) had been trending up. In addition, stock prices had advanced. The exchange value of the U.S. dollar had declined, but had mostly retraced the flight-to-quality appreciation that had taken place during the financial crisis.

- In its November 3 release, the FOMC stated that "the pace of recovery in output and employment continues to be slow." Real GDP grew at a 2% annual rate in the third quarter, about in line with expectations. We expect real GDP to grow at an annual rate of about 2.2% in the current quarter before picking up gradually to an average of about 3.5% in 2011.

- Household spending has been increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising. Core capital goods shipments rose again in September, the eighth consecutive monthly increase. However, core capital goods orders fell slightly in September. Investment in nonresidential structures remains weak.

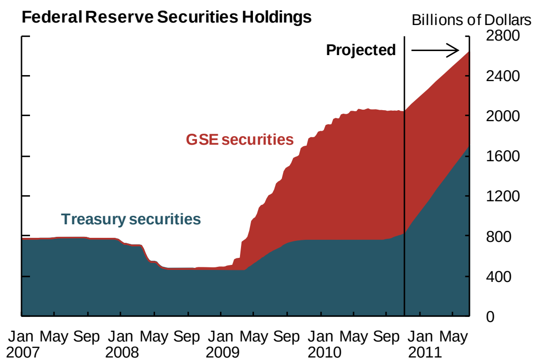
- The October employment report was better than expected. Private payrolls increased by 159,000 during the month. In addition, data for August and September were revised up and now show that private payrolls rose by an average of 135,000 over the past three months.

- The unemployment rate was unchanged at 9.6%. The below-potential economic growth of the past few quarters was too slow to make a dent in the very high unemployment rate. With subpar growth, the relatively steady unemployment rate reflected a decline in labor force participation, as workers without jobs for an extended period left the labor force. The unemployment rate might have risen if labor force participation had remained constant. Consistent with our GDP forecast, we expect the unemployment rate to decline only gradually over the next two years to about 8% by the end of 2012.

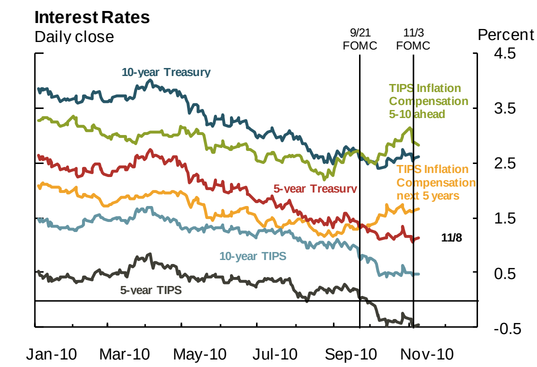
- Measures of longer-term inflation expectations remain stable. Both the market-based measure of TIPS implied inflation compensation five-to-ten years ahead and the projections of long-term inflation by Thomson Reuters/University of Michigan Surveys of Consumers and the Survey of Professional Forecasters have been within a fairly tight range. However, underlying inflation measures have trended lower in recent quarters. Despite recent increases in energy prices and the decline in the value of the dollar, the headline personal consumption expenditures price index (PCEPI) rose only 0.1% in September from the previous month. The core PCEPI, which excludes volatile food and energy prices, was unchanged in September and is up only 1.2% over the past 12 months. With considerable slack remaining in the economy, we expect core PCE inflation to be about 1% over the next 12 months. In the current environment, the uncertainty in our economic forecast is higher than usual. As such, there is a small probability that inflation could fall into negative territory over our forecast horizon.

- With elevated unemployment and somewhat low inflation, progress towards the FOMC objectives of maximum employment and price stability has been disappointingly slow. The FOMC decision to expand its holdings of longer-term Treasury securities was intended "to promote a stronger pace of economic recovery and to help ensure that inflation is at levels consistent with its mandate."

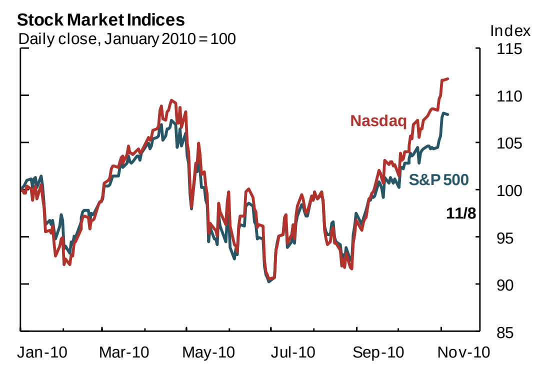
Monetary stimulus via LSAP



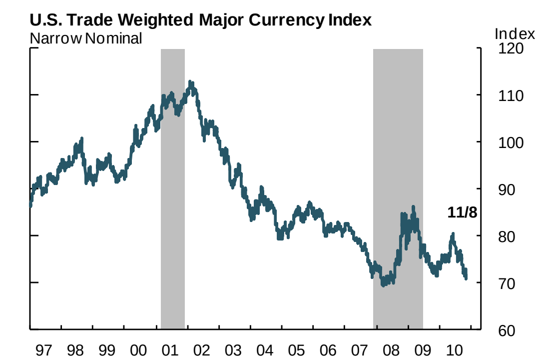
Financial conditions eased



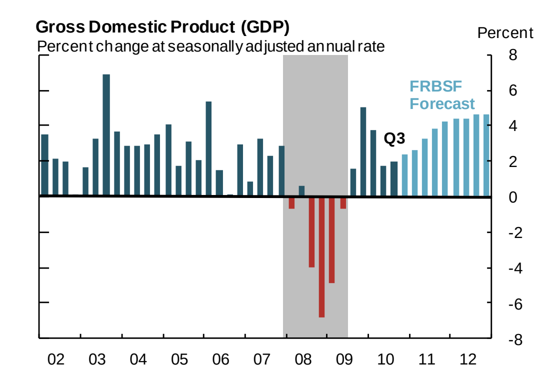
Stock prices advanced



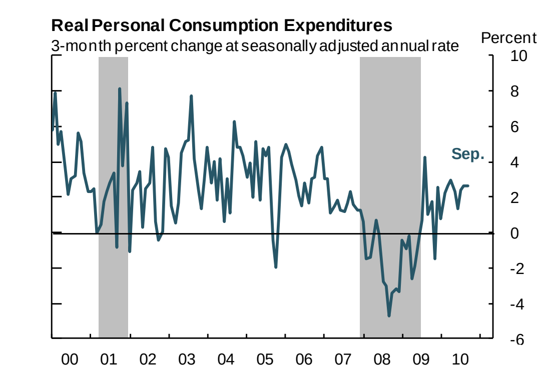
US dollar weakened

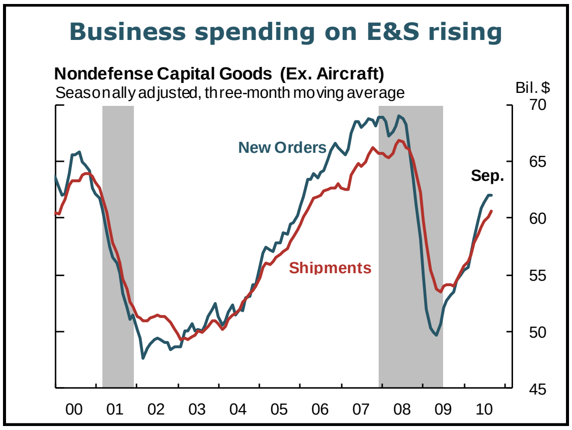


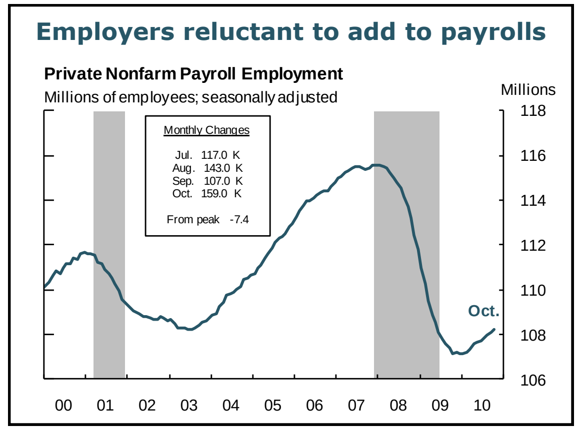
Pace of recovery continues to be slow

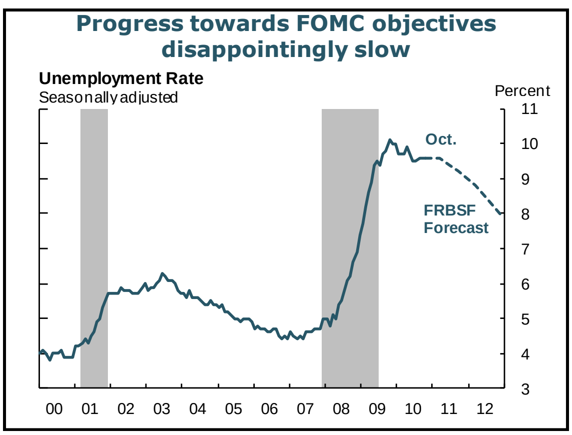


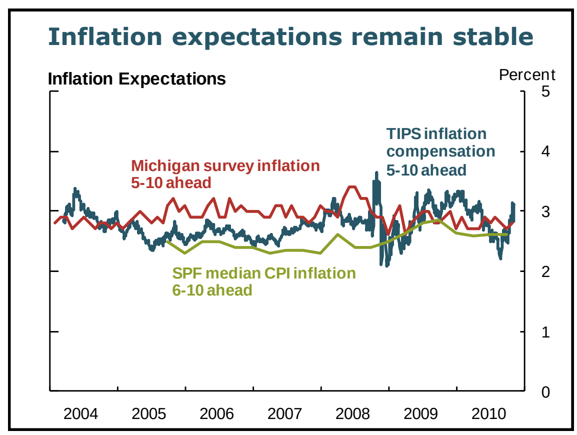
Household spending increasing gradually

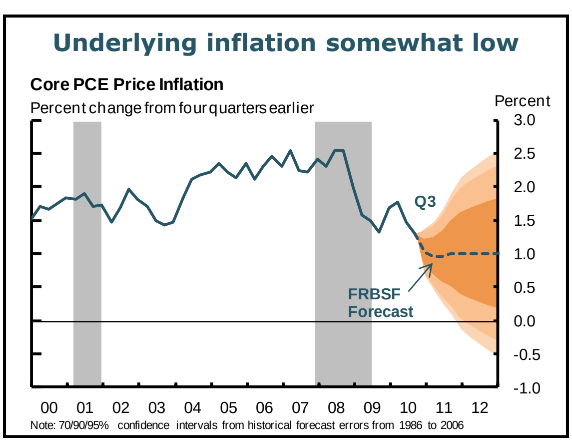



Business spending on E&S rising
Nondefense Capital Goods (Ex. Aircraft)
Seasonally adjusted, three-month moving average
Bil. $
70
65
60
55
50
45
New Orders
Shipments
Sep.
00 01 02 03 04 05 06 07 08 09 10


Employers reluctant to add to payrolls
Private Nonfarm Payroll Employment
Millions of employees; seasonally adjusted
Millions
118
116
114
112
110
108
106
Monthly Changes
Jul. 117.0 K
Aug. 143.0 K
Sep. 107.0 K
Oct. 159.0 K
From peak -7.4
Oct.
00 01 02 03 04 05 06 07 08 09 10


Progress towards FOMC objectives disappointingly slow
Unemployment Rate
Seasonally adjusted
Percent
11
10
9
8
7
6
5
4
3
Oct.
FRBSF Forecast
00 01 02 03 04 05 06 07 08 09 10 11 12


Inflation expectations remain stable
Inflation Expectations
Percent
5
4
3
2
1
0
Michigan survey inflation 5-10 ahead
TIPS inflation compensation 5-10 ahead
SPF median CPI inflation 6-10 ahead
2004 2005 2006 2007 2008 2009 2010


Underlying inflation somewhat low
Core PCE Price Inflation
Percent change from four quarters earlier
Percent
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
Q3
FRBSF Forecast
00 01 02 03 04 05 06 07 08 09 10 11 12
Note: 70/90/95% confidence intervals from historical forecast errors from 1986 to 2006