Twelfth Federal Reserve District

FedViews

Economic Research Department
Federal Reserve Bank of San Francisco
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San Francisco, CA 94105

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Eric Swanson, senior research advisor at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook:

- Financial market concerns about Europe reemerged over the past few weeks. In the spring, markets focused primarily on the unsustainable fiscal trajectory in Greece. Those concerns subsided in late spring when the European Union and the International Monetary Fund announced a special package of loans for Greece conditional on severe fiscal cutbacks, which the Greek parliament subsequently approved. Despite this package, market concerns about Greek debt remain, as evidenced by the large spreads between Greek bond yields and those of Germany and France. These bonds are all denominated in the same currency, so the 9% annual premium on Greek debt reflects a very substantial market fear of capital loss due to some kind of default or restructuring within the next 10 years.

- These past few weeks, market concerns have turned to Ireland. On October 1, Ireland announced that its banking problems were substantially worse than previously reported and would require the government to inject additional capital equal to about 20% of Ireland's GDP. Again, the EU and IMF provided an assistance package, and the Irish have imposed steep fiscal cuts. But the market-perceived probability of default or restructuring of Irish debt remains high.

- As the market's views about fiscal sustainability in Greece and Ireland have deteriorated, concerns have spilled over to other fiscally burdened euro area countries as well. Portugal has been particularly affected, but so too have Spain and Italy, and perhaps even to a small extent France and Germany, among the most fiscally sound euro-zone economies.

- The U.S. employment report for November showed payroll growth of only 40,000 workers and an increase in the unemployment rate to 9.8% from 9.6%. While these headline numbers were disappointing, the overall report was not quite as weak as they would suggest. For example, the September and October payroll numbers were each revised upward by roughly 20,000 workers. Moreover, private-sector nonfarm payrolls, which exclude all government employees, have averaged gains of over 115,000 per month since July. Similarly, the rise in unemployment was partly due to an increase in the labor force—that is, the number of people who started looking for work. Initial claims for unemployment insurance also seem to be trending down again after stalling during the spring and summer, although they remain at elevated levels comparable to the depths of the 2001 recession.

- Auto and light truck sales rose a bit more in November to a 12.2 million vehicle annual rate, continuing an upward trend that has lasted over a year. This represents a substantial sales gain of about 13% relative to a year ago. Nevertheless, auto sales remain very low by historical standards, comparable with 1984 and the depths of the 1991 recession, even though the U.S. population has increased by about 60-75 million people since then. Auto sales are also low relative to historical patterns of scrappage, which are computed from Federal Highway Administration data on total U.S.

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vehicle registrations. Low sales relative to scrappage suggest that the current sales pace may still be unsustainably low and substantial pent-up demand for autos may be accumulating.

- Manufacturing more broadly also continues to recover, although the rate of growth has been sluggish over the past few months. Reassuringly, data on new orders for November from the Institute for Supply Management continued to show solid growth. ISM's New Orders Index is a good leading indicator of future manufacturing production and of economic activity more generally.

- Housing is the one major sector of the economy where we still do not see signs of recovery. New and existing home sales remain near historic lows, and inventories of foreclosed homes remain very high. As a result, homebuilding and construction remain historically low and have shown little to no sign of improvement this year.

- Long-term interest rates have risen about half a percentage point over the past few weeks. Several factors probably explain this increase. First, markets are now expecting a stronger economic recovery, as the incoming data have been generally stronger than expected and the tax cut agreement between the President and Republican leaders in Congress was substantially larger than expected. A stronger economic outlook implies a higher path for monetary policy in the future and, hence, higher long-term interest rates.

- Second, because the tax agreement is significantly larger than expected, the Treasury Department will have to issue substantially more debt than previously thought over the next two years to cover the cost of the program. That will partially offset the $600 billion of Treasury purchases the Federal Reserve announced in November. Third, the stronger economic outlook and stronger-than-expected criticism of the Fed's Treasury purchase program have led financial markets to scale back expectations regarding the ultimate size of the program, pushing up yields. Fourth, the debt crisis in Europe has increased market sensitivity to fiscal deficits and government debt burdens, so a small part of the rise in yields could reflect an increase in financial market concerns about the longer-term fiscal position of the United States and its implications for future U.S. interest rates. Finally, inflation-indexed Treasury yields have risen roughly in line with nominal Treasury yields, so changes in inflation expectations probably play only a minor role in this episode.

- We expect GDP growth in the current quarter to be somewhat sluggish, about 2.2%. However, the substantially larger-than-expected tax agreement led us to raise our estimates of 2011 GDP growth by about ½ percentage point in each quarter. We now forecast that GDP will grow about 3.1% in the first quarter and gradually increase to about 4.3% by the end of next year.

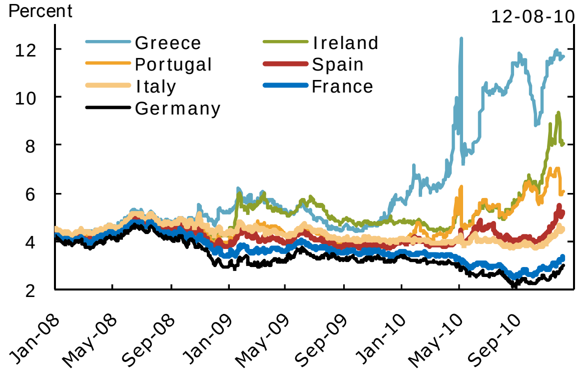
- The latest inflation data have been consistent with the view that inflation is low and drifting even lower. In October, overall personal consumption expenditures (PCE) inflation was 1.3% over the past 12 months, while core PCE inflation was 0.9%, the lowest 12-month change in the history of that series. We forecast inflation will remain at this low level or drift a bit lower for the next several quarters before slowly turning up.

- These low inflation readings sometimes contradict gut instincts, since we all see prices that have risen noticeably more than 1% over the past year. The table labeled "Despite Some Price Increases, Inflation Is Low" shows the 12-month change in the overall consumer price index and the price changes for some noteworthy goods and services over the same period. Although some items have risen in price over the past year, others have stayed the same or even fallen. Apparel prices are down about 1.3%. The prices of recreation goods, including televisions, are down about 1% overall. Despite a 5.7% increase in the meat, fish, and eggs category, the overall groceries or food-at-home category rose about 1.4%, very close to the overall change in the CPI. Rent is about unchanged over the past year, and this category makes up a large fraction of the typical household's expenses. Note that the rent category includes owner's equivalent rent, the imputed rental value of a dwelling, which the Bureau of Labor Statistics uses to measure homeowners' housing costs. If house prices and mortgage payments were used to measure housing costs instead of owner's equivalent rent, the cost of owner-occupied housing would have fallen over the past year.

- To avoid some of the volatility in the inflation data associated with food and energy prices, economists often emphasize "core" measures of inflation such as the core CPI and core PCE price index. But there are other ways to exclude some of the volatility in the monthly inflation data. For example, the median CPI, produced by the Cleveland Federal Reserve Bank, takes the CPI's underlying detail and reports the price increase of the middle component. The trimmed mean PCE price index, produced by the Dallas Federal Reserve Bank, takes the underlying detail of the PCE price index, drops the components that rose or fell most, and averages the price changes of the remaining components. All these methods of stripping out volatility from the inflation data tell essentially the same story over the past 10 years. When there was substantial slack in the economy in 2001–03, inflation fell. Inflation gradually rose again through 2008, and has since fallen sharply as a result of the severe 2008 recession and the continuing high level of economic slack. Currently, underlying inflation seems to be running at a rate of 0.5% to 1%. We forecast that this trend will continue a bit further before it levels out.

Market Concerns about Europe

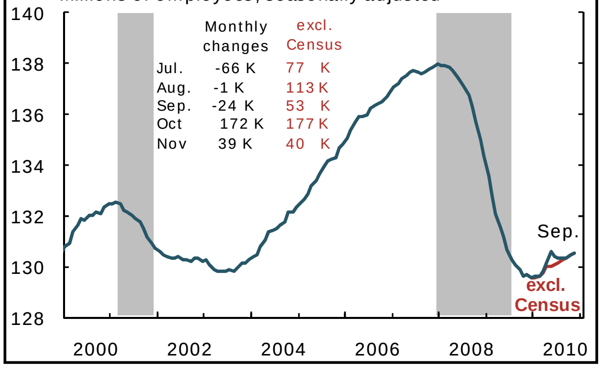
Ten-Year Government Bond Yields



Employment Improving Modestly

Nonfarm Payroll Employment

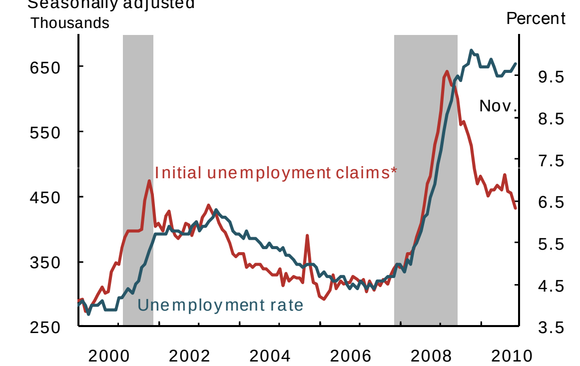
Millions of employees; seasonally adjusted



Unemployment Remains High

Unemployment Indicators

Seasonally adjusted

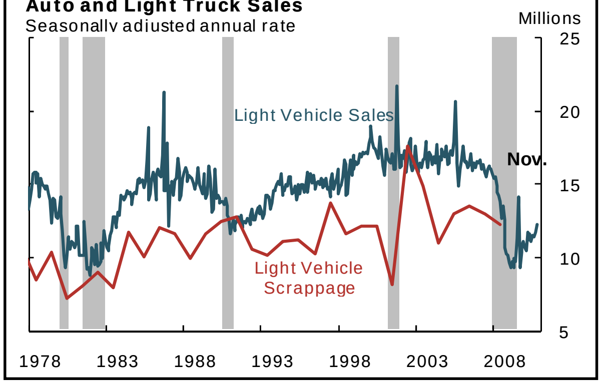


*Four week average

Auto Sales Rising from Very Low Levels

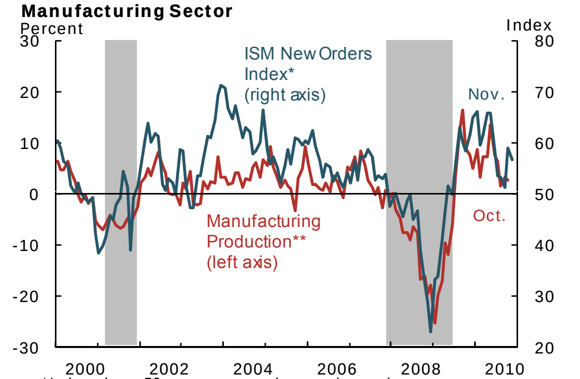
Auto and Light Truck Sales

Seasonally adjusted annual rate



Manufacturing Still Recovering

Manufacturing Sector



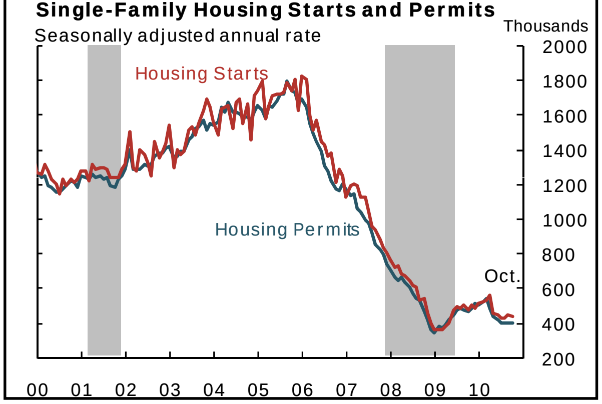
*Index above 50 means new orders are increasing

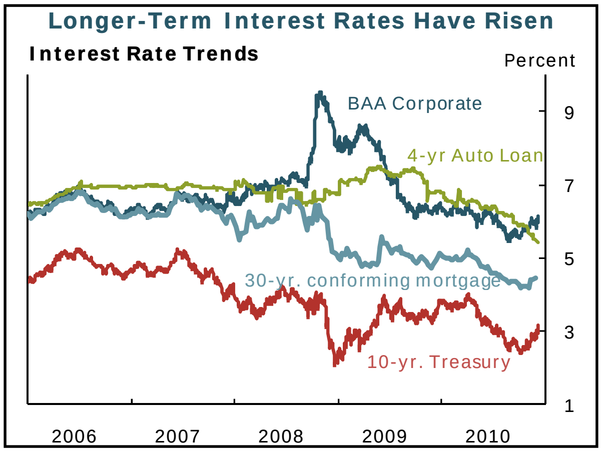
**Annualized percent change from three months earlier

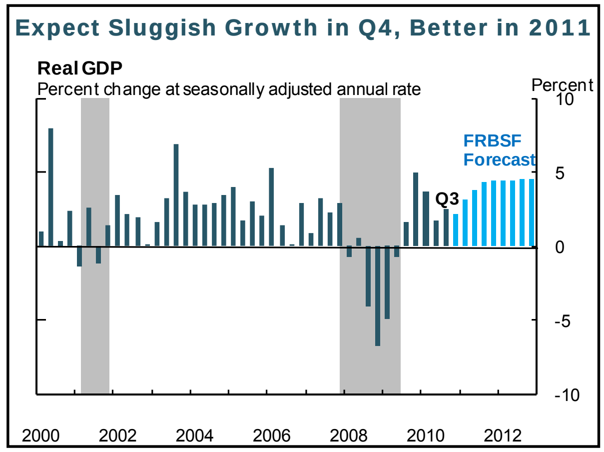
Homebuilding Remains Extremely Weak

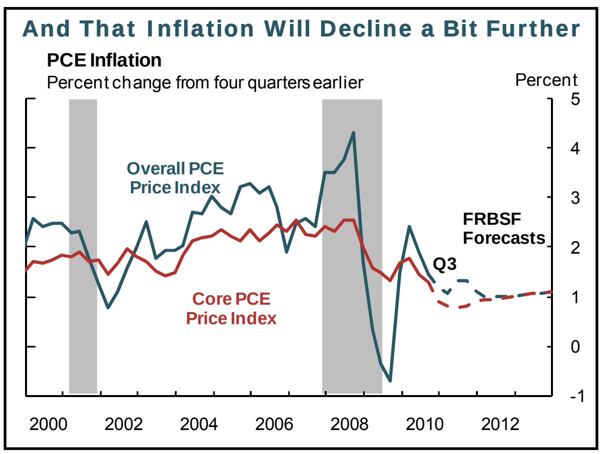
Single-Family Housing Starts and Permits

Seasonally adjusted annual rate









Despite Price Increases, Inflation Is Low

	12-mo. Change	(weighted in CPI)
Consumer Price Index	1.2%	
Gasoline	9.5%	(4.4%)
Meat, Fish & Eggs	5.7%	(1.7%)
Airfare	4.4%	(0.8%)
Tuition	3.7%	(2.8%)
Medical Care	3.4%	(6.5%)
Rent (incl. OER)	0.0%	(31.2%)
Apparel	-1.3%	(3.7%)
Recreation (incl.TVs)	-1.0%	(6.4%)
Communication	-0.6%	(3.4%)
Food at home overall	1.4%	(13.7%)