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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Mary C. Daly, vice president in the Economic Research Department of the Federal Reserve Bank of San Francisco, states her views on the current economy and the outlook.

- Recent economic news has been disappointing, confirming that the economy has been growing much less quickly than was expected earlier in the year. Although the slowdown is expected largely to be temporary, there are reasons to believe the underlying recovery has lost some momentum.

- Real personal consumption expenditures fell in May and are expected to be flat for the second quarter. In part, the weakness in consumer spending owes to temporary factors. These include the run-up in food and energy prices, which strained consumer pocketbooks, and supply chain disruptions related to the earthquake in Japan, which notably affected the auto industry, limiting inventories and boosting prices. With commodity prices stabilizing and supply chain disruptions easing, real personal consumption growth is expected to rebound in coming quarters.

- How willing and able consumers are to increase spending will depend a lot on their confidence, which lately has been waning. Ongoing negative news about labor markets has been a particular drag on confidence.

- The June employment report showed a gain of only 18,000 jobs. Private-sector payrolls rose by a scant 57,000, while government employment fell by 39,000. The unemployment rate increased to 9.2%, even though the labor force contracted. The slow growth of private-sector hiring is especially worrisome given expectations of additional cuts in government employment. These cuts are expected at all levels of government. At the federal level, a political consensus has emerged to reduce the budget deficit. At the same time, fiscal stimulus is waning. State and local governments are also shedding jobs as they work to bring expenditures in line with revenues.

- With job growth limited, workers are seeing little wage growth. Average hourly earnings have been rising by less than 2% for some time, little more than the rate of inflation. Thus, many workers have seen few gains in real wages.

- Weak job growth, high unemployment, and limited wage gains appear to have made households quite pessimistic about family income growth over the next year. The Thomson Reuters/University of Michigan Surveys of Consumers report that less than 45% of the households responding believe their family income will increase over the next 12 months—a remarkable drop from earlier decades. Although consumer finances are improving and the temporary drains on real disposable income are fading, these poor expectations about future family income pose a risk to consumption growth.

- On net, the easing of some of the economic headwinds combined with an apparent stabilization of the housing market should allow growth to pick up in coming quarters. We expect this pickup to push 2011 GDP growth to 2.6%, about a percentage point lower than we expected back in March. Although we expect the economy to gain additional momentum in 2012, evidence suggests that some of the recent weakness is persistent. Accordingly, we have reduced our forecast and now expect GDP to grow 3.3% in 2012.

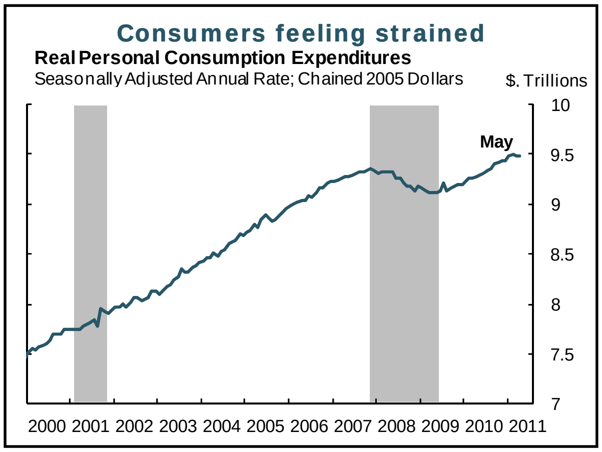
- Our forecast projects a gradual reduction in unemployment and a return to a low level of underlying inflation once the transitory increases associated with the run-up in food and energy prices are played out.

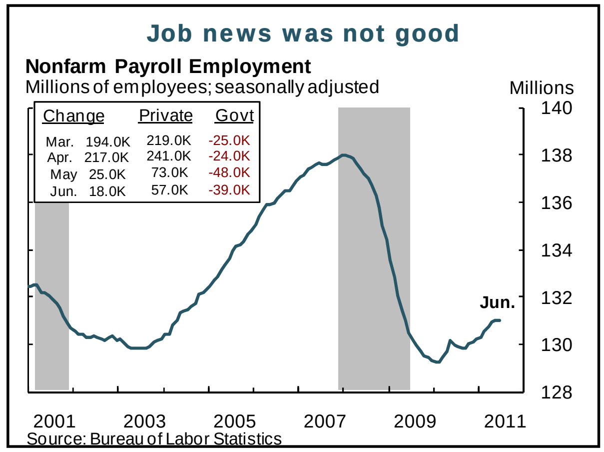
- The magnitude of the shocks to the labor market and the now stubbornly high unemployment rate have raised questions about the level of structural unemployment in the economy. Structural unemployment can be thought of as the result of frictions in the labor market. It is the level of unemployment consistent with maximum sustainable employment, one of the Federal Reserve's two mandated goals.

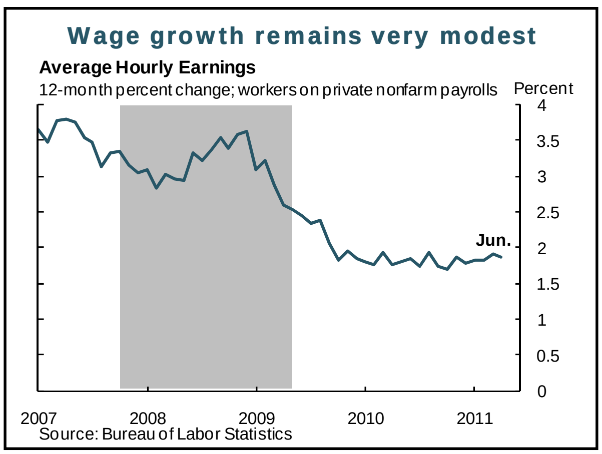
- Structural unemployment is not zero and is affected by such things as the age distribution of the population; the intensity with which the unemployed search for work and employers search for workers; and the match between the skills and geographic location of unemployed workers and employer vacancies. The question is whether structural unemployment has increased in the aftermath of the recession.

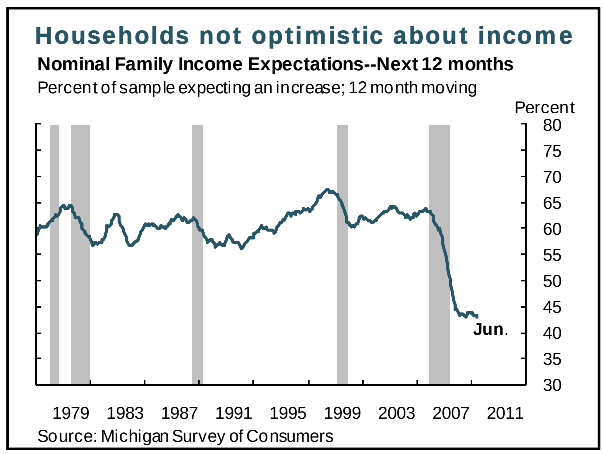
- Our analysis suggests that structural unemployment has increased over the past several years, boosted primarily by the extension of unemployment insurance benefits, but also by some unavoidable mismatches between the locations and skill needs of employers and the locations and skill sets of workers. We expect structural unemployment to come down somewhat as extended unemployment insurance benefits expire, but to remain above its prerecession levels for some time. Importantly, even with the increase in structural unemployment, measured unemployment remains far higher than the level associated with maximum sustainable employment, also known as full employment.

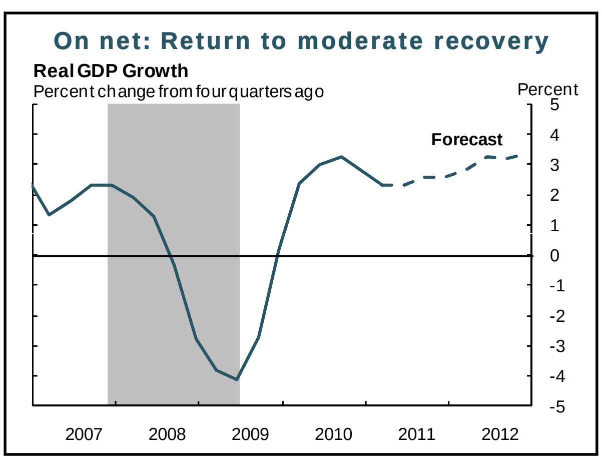
- The fact that so many potential workers have been unemployed for a long period represents an important challenge for the U.S. economy. The deterioration in skills among the long-term unemployed limits their future ability to find jobs and puts the economy at risk of relying on a far smaller number of workers to support living standards.

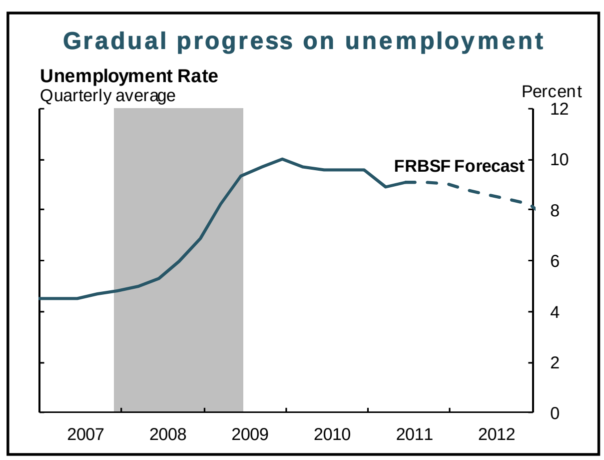

Consumers feeling strained
Real Personal Consumption Expenditures
Seasonally Adjusted Annual Rate; Chained 2005 Dollars
$. Trillions
May
10
9.5
9
8.5
8
7.5
7
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011


Job news was not good
Nonfarm Payroll Employment
Millions of employees; seasonally adjusted
Millions
Change Private Govt
Mar. 194.0K 219.0K -25.0K
Apr. 217.0K 241.0K -24.0K
May 25.0K 73.0K -48.0K
Jun. 18.0K 57.0K -39.0K
Jun.
140
138
136
134
132
130
128
2001 2003 2005 2007 2009 2011
Source: Bureau of Labor Statistics

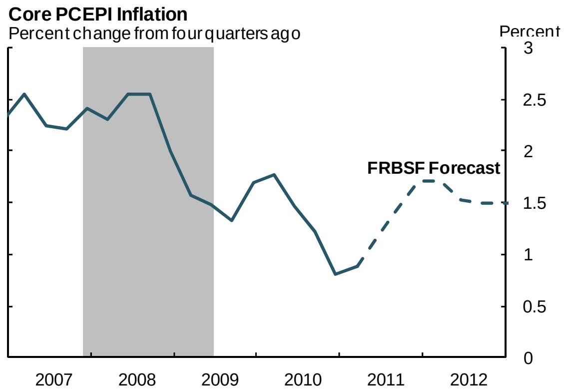

Wage growth remains very modest
Average Hourly Earnings
12-month percent change; workers on private nonfarm payrolls
Percent
Jun.
4
3.5
3
2.5
2
1.5
1
0.5
0
2007 2008 2009 2010 2011
Source: Bureau of Labor Statistics


Households not optimistic about income
Nominal Family Income Expectations--Next 12 months
Percent of sample expecting an increase; 12 month moving
Percent
Jun.
80
75
70
65
60
55
50
45
40
35
30
1979 1983 1987 1991 1995 1999 2003 2007 2011
Source: Michigan Survey of Consumers


On net: Return to moderate recovery
Real GDP Growth
Percent change from four quarters ago
Percent
Forecast
5
4
3
2
1
0
-1
-2
-3
-4
-5
2007 2008 2009 2010 2011 2012


Gradual progress on unemployment
Unemployment Rate
Quarterly average
Percent
FRBSF Forecast
12
10
8
6
4
2
0
2007 2008 2009 2010 2011 2012

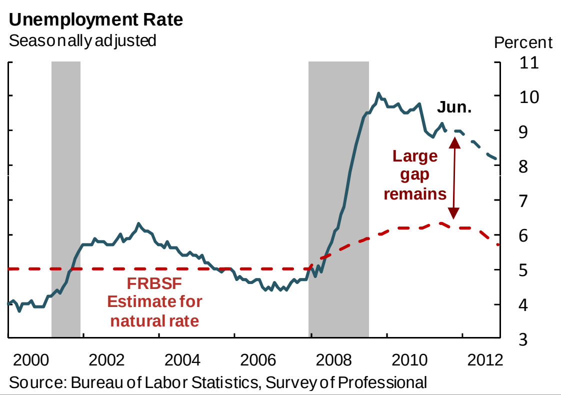
Inflation first up, then down



Structural unemployment

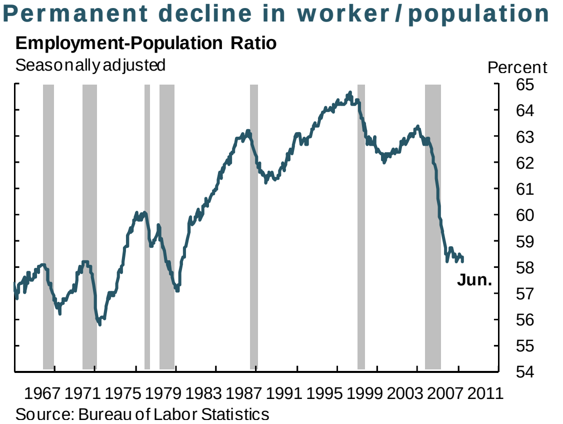
- The level of unemployment consistent with maximum sustainable employment—not zero
- Affected by:
  - Demographics (age of population)
  - Job search intensity among candidates (unemployment insurance)
  - Candidate search/screening intensity among firms (hiring costs)
  - Match (mismatch) in worker skills and offered jobs
  - Match (mismatch) in worker geographic location and offered jobs
- Good reasons to think it has risen since the recession

But a large gap remains



Long-term unemployed exit

Permanent decline in worker/population



Large gap consistent with other indicators