

November 10, 2011

Also available upon release at  
[www.frbsf.org/publications/economics/fedviews/index.php](http://www.frbsf.org/publications/economics/fedviews/index.php)

*John Fernald, group vice president and associate director of research at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.*

- The economic recovery is proceeding at a subdued pace, with substantial and persistent resource slack and low underlying inflationary pressures.
- Businesses have been slowly but steadily hiring since early 2010. The economy has recovered about 2¼ million of the 8¾ million jobs lost in the recession. Private businesses have increased employment by about 2¾ million jobs, while federal, state, and local governments have reduced employment.
- Household net worth fell sharply during the recession, reflecting declines in home and equity prices. These balance sheet changes have prompted households to save more rather than spend. During the recession, the personal saving rate rose to its highest levels since the early 1990s and has largely moved sideways during the recovery. In the third quarter of 2011, the saving rate ticked down to 4%, the lowest rate since before the recession. Spending during the quarter rose only modestly, but real disposable personal income fell.
- Consumers lack confidence. Sentiment never fully recovered after the recession. In July and August, the two principal consumer surveys showed that attitudes clearly soured again and are now at levels comparable to the lows of the financial crisis. A risk to the outlook is that households may put their money where their mouths are—and reduce spending.
- Housing has been a persistent factor weighing on the recovery. Construction of new homes has been flat since 2009. The long-term fundamentals of population growth should support much higher levels of home construction. One factor suppressing new construction is competition with homes that have already been built. These include not only the large inventory of existing homes currently for sale, but also the shadow inventory of homes in foreclosure or on which the mortgage payer is seriously delinquent, properties that could come on the market soon.
- Over time, one factor that should help support the housing market is that home prices now are more in line with fundamentals. The precipitous slide in home prices after 2006 weighed on household finances and discouraged potential buyers worried that prices would keep falling. One measure of fundamentals is home prices relative to what it would cost to rent those homes. This price-rent ratio is analogous to a price-earnings ratio for a stock. During the housing boom, this ratio ran up sharply. By

some measures, the price-rent ratio is now close to its average value in the two decades prior to 2002, before the housing bubble. Based on expectations for median home prices from a survey of professional housing market watchers, this price-rent ratio should remain relatively stable over the next few years.

- We expect the subdued pace of economic recovery to continue. Consumers are reluctant to spend, firms remain cautious about hiring and investing, and government purchases are contracting. Growth in the fourth quarter of 2011 is likely to be around 2½%, roughly on par with the third quarter. Over the next year, we expect growth to run a bit below that pace.
- In addition to lackluster demand, a key factor contributing to the subdued pace of activity is restrained growth in underlying potential output. Potential is what output would be if the workforce and the productive capacity of the economy were fully employed at sustainable, noninflationary levels. We estimate that potential output is growing at only about a 1¾% pace, which we expect to continue in 2012. That compares with an annual rate of about 2½% in the years before the recession and almost 3½% in the late 1990s.
- During and since the recession, business investment in productive capacity has been restrained, and labor markets have experienced notable disruption. But, over the longer term, the slower pace of underlying productivity growth is the key factor explaining slower growth in potential output. Since 2003 or 2004, productivity growth—output per hour worked—has been growing significantly more slowly than in the years before. The productivity acceleration of the mid- to late-1990s appears to have ended.
- Although potential output growth has been slow in recent years, actual output growth has been even weaker. Reflecting the shortfall of aggregate demand, there is a large cyclical gap in labor markets between the unemployment rate and most estimates of the natural rate of unemployment, that is, the equilibrium rate of unemployment that would cause inflation neither to rise nor fall. This natural rate rose during the recession and has stayed elevated, reflecting some degree of mismatch between the skills of the unemployed and the jobs that are available, plus the effects of extended unemployment insurance benefits. Nevertheless, any reasonable estimate of these effects still leaves a sizeable and persistent gap between unemployment and its natural rate.
- In recent months, there has been a general flight from risky to safe assets. For example, 10-year Treasury securities were yielding near 3% early in the summer. A weaker and more uncertain outlook for U.S. and global growth, as well as monetary policy actions, have pushed 10-year rates down to around 2%. With the worsening outlook, low-grade bond yields have risen since the summer, though they have retraced most of their spike of late September and early October.
- A major source of economic and financial risk arises from the sovereign debt crisis in Europe. Debt yields for peripheral European economies are very high, indicating persistent credit-market concerns. European authorities have been seeking to contain the crisis. Nevertheless, Greek and Italian yields have generally risen further in recent weeks.

- Wage pressures have generally remained modest, helping to anchor production costs and price pressures. Measures of compensation are rising more slowly than their pre-recession pace.
- With wage pressures contained, inflation is likely to remain subdued. Overall prices have risen rapidly over the past year, reflecting a sizeable bump from commodities and imports. Some of this bump has shown up in other goods and services as well. However, commodity prices, though remaining high, appear to have stabilized. We expect inflation to run at around a 1½% pace for the next few years.



