Twelfth Federal Reserve District

FedViews

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Sylvain Leduc, research advisor at the Federal Reserve Bank of San Francisco, states his views on the current economy and the outlook.

- Incoming data have generally been in line with our view that the U.S. economy is growing at a moderate pace. Despite the continued recovery, improvements in the labor market remain sluggish, leaving a substantial amount of economic slack. Combined with steady inflation expectations, the slack is keeping inflationary pressures at bay.

- The U.S. unemployment rate fell three-tenths of a percentage point in September to 7.8%, according to the U.S. Bureau of Labor Statistics (BLS) household survey, the largest single-month drop since January 2011. September's lower unemployment rate reflected a surprisingly large 873,000 increase in employment.

- In contrast with the sharp drop in the unemployment rate, nonfarm payroll employment grew only modestly in September, posting a gain of 114,000 jobs, according to the BLS establishment survey. This is slightly above the level of job gains needed to keep up with labor force growth. July and August payrolls were revised up by a total of 86,000 jobs, mostly in the public sector. This is positive, given that public-sector employment fell between March and June. Since the beginning of the year, the economy has added an average of 146,000 jobs per month.

- The BLS establishment and household surveys occasionally differ in the picture they give of the labor market, due in part to differences in sampling and definitions of employment. A similar discrepancy occurred in January when the household survey reported an employment increase of 895,000, but the establishment survey found that nonfarm payrolls grew by 295,000. The household survey tends to be more volatile because its sample size is smaller.

- The housing sector has been improving. Housing starts and sales rose in August. And house prices climbed 1.2% in July from a year earlier, according to the S&P/Case-Shiller Home Price Index of 20 metropolitan areas. The Core Logic House Price Index has also posted increases.

- The Federal Open Market Committee eased monetary policy further at its September meeting, stating that the pace of recovery was insufficient to substantially improve labor market conditions and that the inflation outlook was subdued. The FOMC said the Fed will buy additional agency mortgage-backed securities at a pace of $40 billion per month and continue the program announced in June to increase holdings of longer-term Treasury securities and decrease holdings of short-term Treasuries. If the labor market outlook does not improve substantially, the Fed will continue purchases of agency mortgage-backed securities, carry out additional asset purchases, and employ other policy tools as appropriate until improvement is achieved in a context of price stability.

- The FOMC emphasized that it expects a highly accommodative stance of monetary policy to remain appropriate for a considerable time after the economic recovery strengthens. Moreover, the FOMC extended its forward policy guidance, stating it anticipates exceptionally low levels for the benchmark federal funds rate are likely to be warranted at least through mid-2015.

- The additional monetary policy easing appears to have brought down mortgage rates further. After moving roughly sideways during July and August, the 30-year conventional mortgage declined below 3.4% in the first week of October, close to an all-time low.

- We expect the economy to grow moderately for the remainder of 2012 and over the following two years. Taking into account incoming data and the additional monetary stimulus, we anticipate that gross domestic product will expand about 2.5% in 2013 and 3.3% in 2014. This is consistent with a fall in the unemployment rate to 7.7% by the end of 2013 and 7.3% by the end of 2014. We assume that Congress will let the payroll tax reduction and extended unemployment benefits expire at year end, but will agree to extend the Bush tax cuts and adjust the alternative minimum tax. We also expect Congress to limit the spending cuts mandated in the Budget Control Act of 2011.

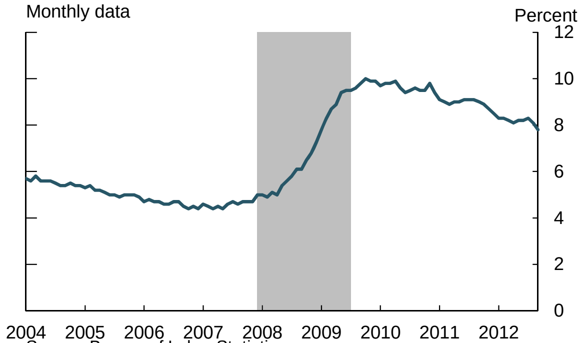
- We expect inflation to remain low over the next two years, reflecting high economic slack, subdued wage growth, and steady inflation expectations. We expect both overall and core consumer prices to grow at an annual rate of roughly 1.7% in 2013 and 2014, slightly below the FOMC's inflation target.

- The European debt crisis continues to pose a serious risk to the outlook. European Central Bank support measures announced in September succeeded in lowering Italian and Spanish sovereign borrowing costs to more sustainable levels by reducing the short-run risk of a disorderly outcome in the euro area. Still, the situation remains volatile, as shown by the recent Standard & Poor's downgrade of Spanish sovereign debt.

- The looming fiscal cliff is also an important risk to the outlook. The combination of tax increases and spending cuts scheduled for the beginning of 2013 if Congress fails to agree on budgetary changes would lead to massive fiscal contraction, according to the Congressional Budget Office (CBO). The CBO estimates that the federal deficit would fall from 7.3% of GDP in fiscal 2012, to 4% in fiscal 2013, and 1% by fiscal 2017 if the full fiscal cliff package goes through. The CBO also estimates that the complete package would lead to a recession next year and push the unemployment rate toward 9%. However, the uncertainty around this forecast is high because estimates of the transmission of fiscal policy changes to the economy vary widely in the economic literature.

A surprisingly large drop in unemployment

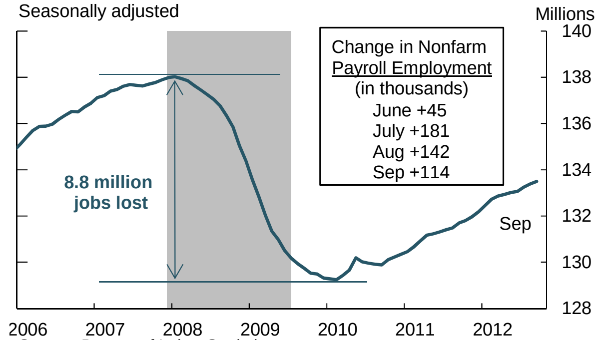
Unemployment Rate
Monthly data



Source: Bureau of Labor Statistics

Payroll employment grew modestly

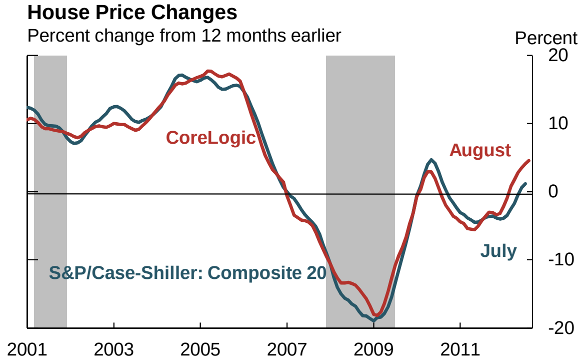
Nonfarm Payroll Employment
Seasonally adjusted



Source: Bureau of Labor Statistics

House prices have started to rise

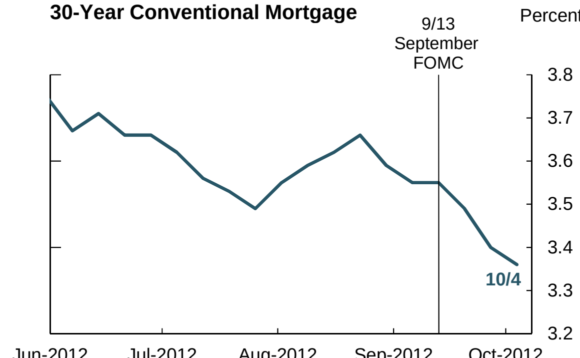
House Price Changes
Percent change from 12 months earlier



Source: S&P, Fiserv, and MacroMarkets LLC; CoreLogic

Mortgage rate came down

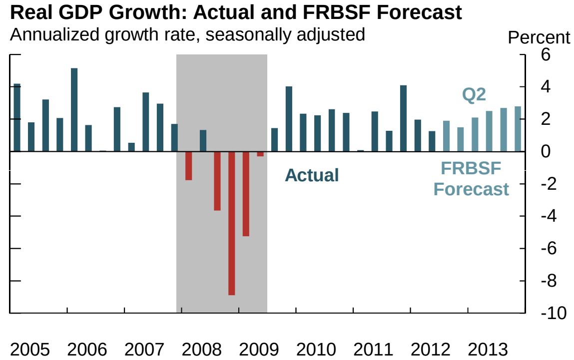
30-Year Conventional Mortgage



Source: Board of Governors, Federal Reserve System

We forecast moderate growth…

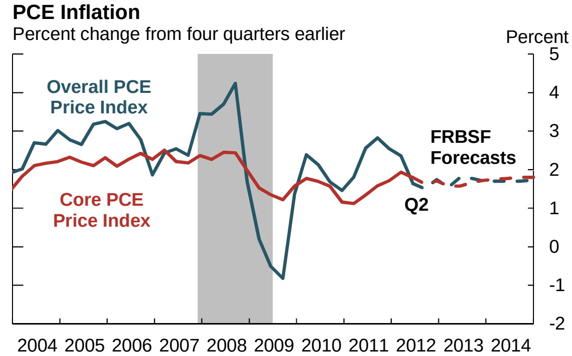
Real GDP Growth: Actual and FRBSF Forecast
Annualized growth rate, seasonally adjusted



Source: Bureau of Economic Analysis and FRBSF staff

…and subdued inflation

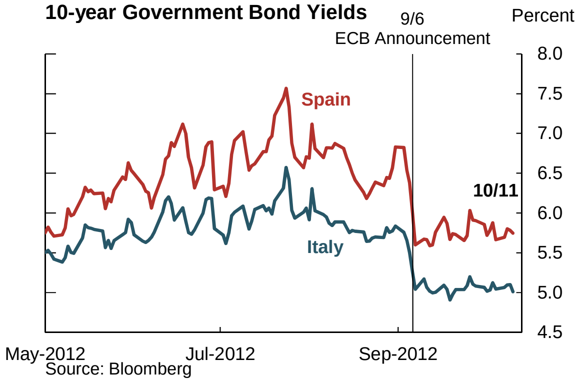
PCE Inflation
Percent change from four quarters earlier



Source: Bureau of Economic Analysis and FRBSF staff

Lower borrowing rates in Europe

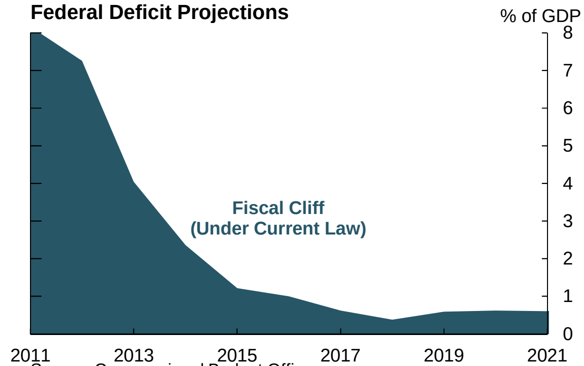
10-year Government Bond Yields



Source: Bloomberg

Approaching the fiscal cliff

Federal Deficit Projections



Source: Congressional Budget Office