Economic Forecast Conference

2010

with the Federal Reserve Bank of San Francisco

Tuesday, May 4, 2010 8:00 AM

Nevada County
Economic Resource Council
Foundation

Federal Reserve Bank
San Francisco

Federal Reserve Bank of San Francisco
Gary C. Zimmerman, Senior Economist

Economic Overview

Current situation – recovery begins:

- Signs of improvement
  - Industrial production, housing, consumer spending, credit conditions, global outlook, payroll jobs
- Yet areas of weakness remain
  - Labor market, commercial real estate, loan delinquencies, household balance sheet

Stance of Monetary Policy

- Tools (conventional and new)
- Recent readings from the FOMC

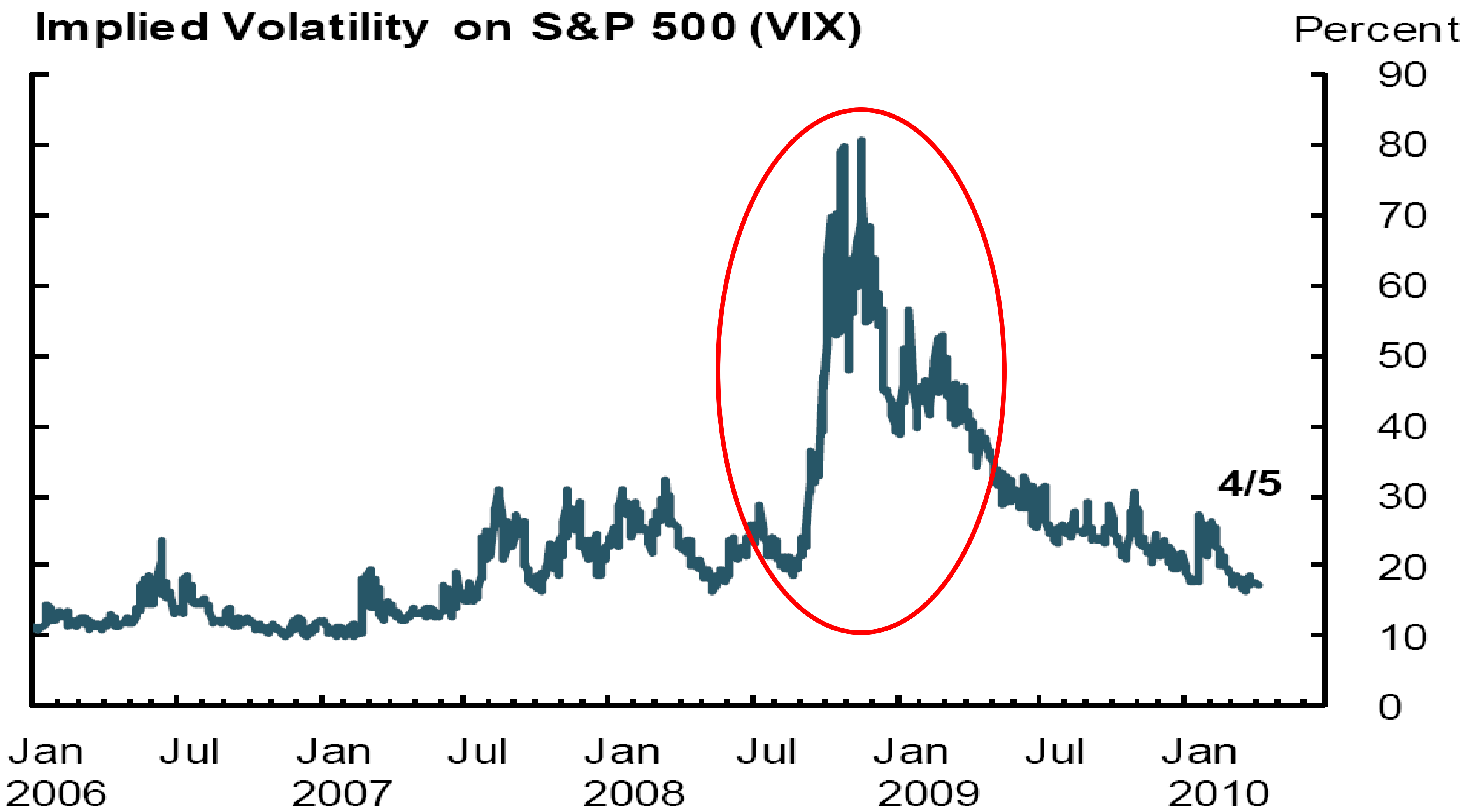
FRBSF national economic forecast

CURRENT SITUATION: SIGNS OF IMPROVEMENT

National Beige Book Survey Summary, April 14, 2010

- **Economic activity increased somewhat**
- **Increases in retail sales and vehicle sales**
- **Service sector reports—mixed**
- **Manufacturing activity increased**
- **Increased activity in housing markets <u>from a low level</u>**
- **Energy production increased**
- **Wage pressures—minimal**

Financial Markets Are Returning to More Normal Levels of Volatility



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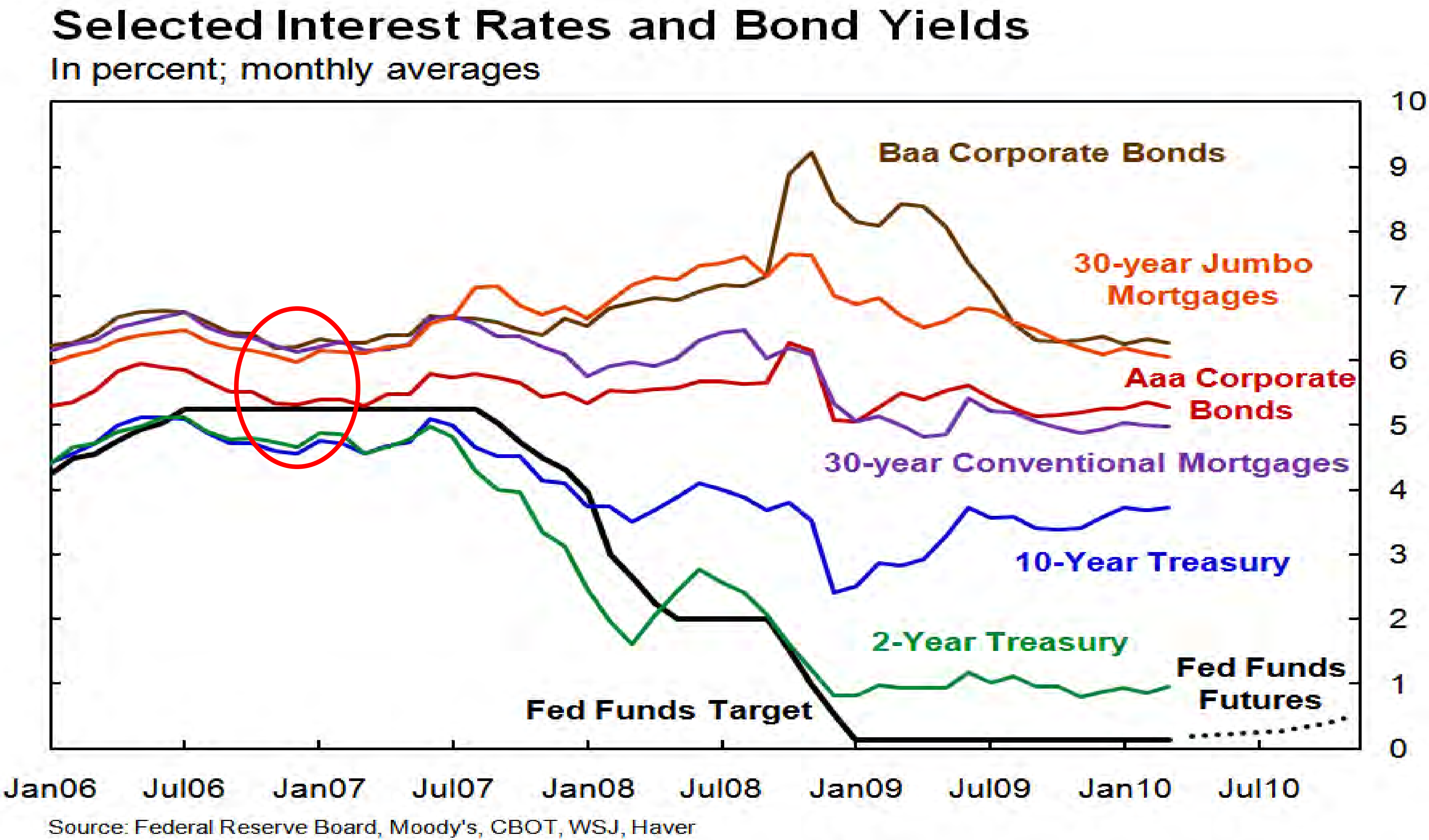
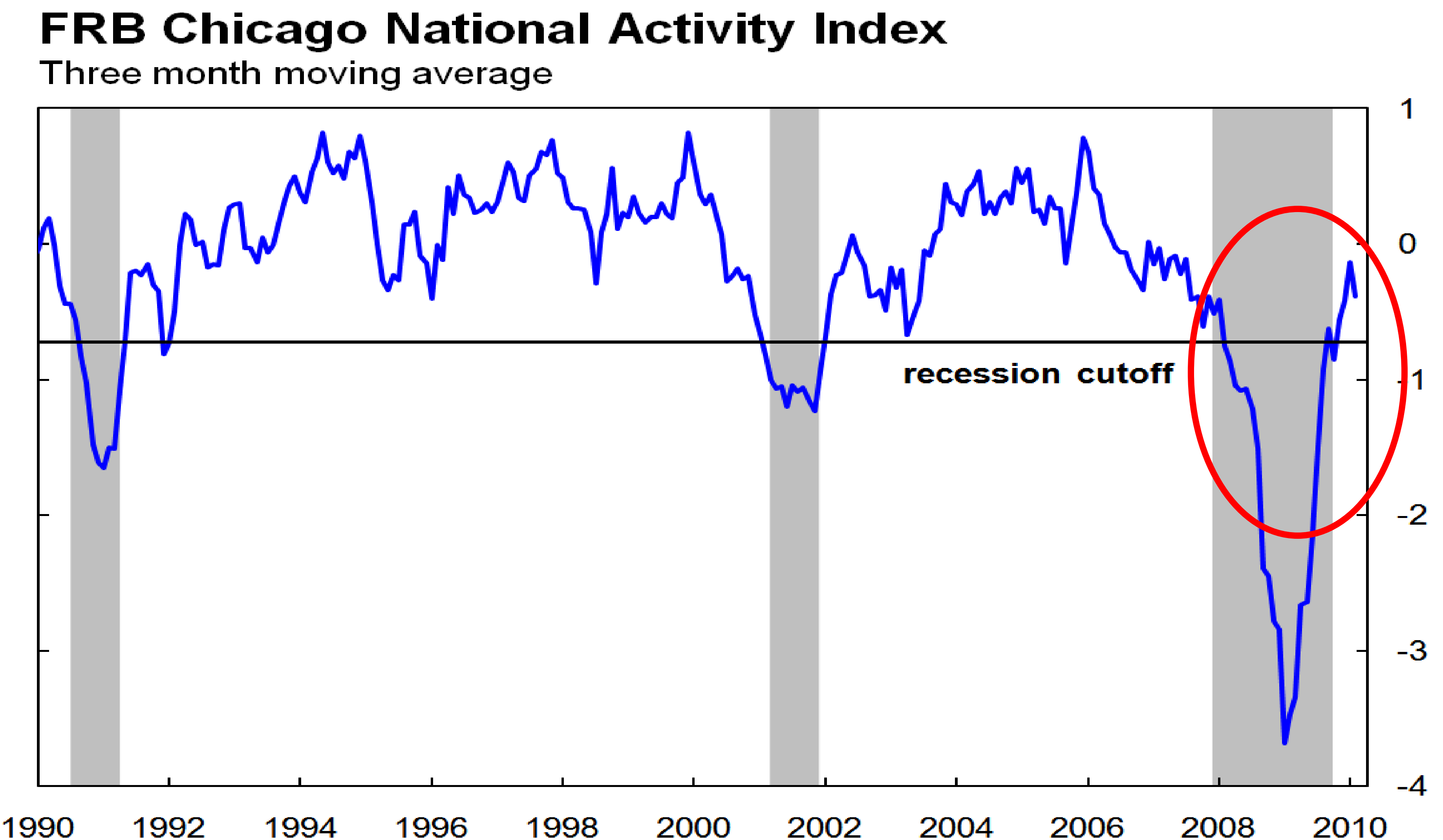
Credit Risk Spreads Narrow as Risk Subsides (Yet They Remain Above Pre-Crisis Levels)

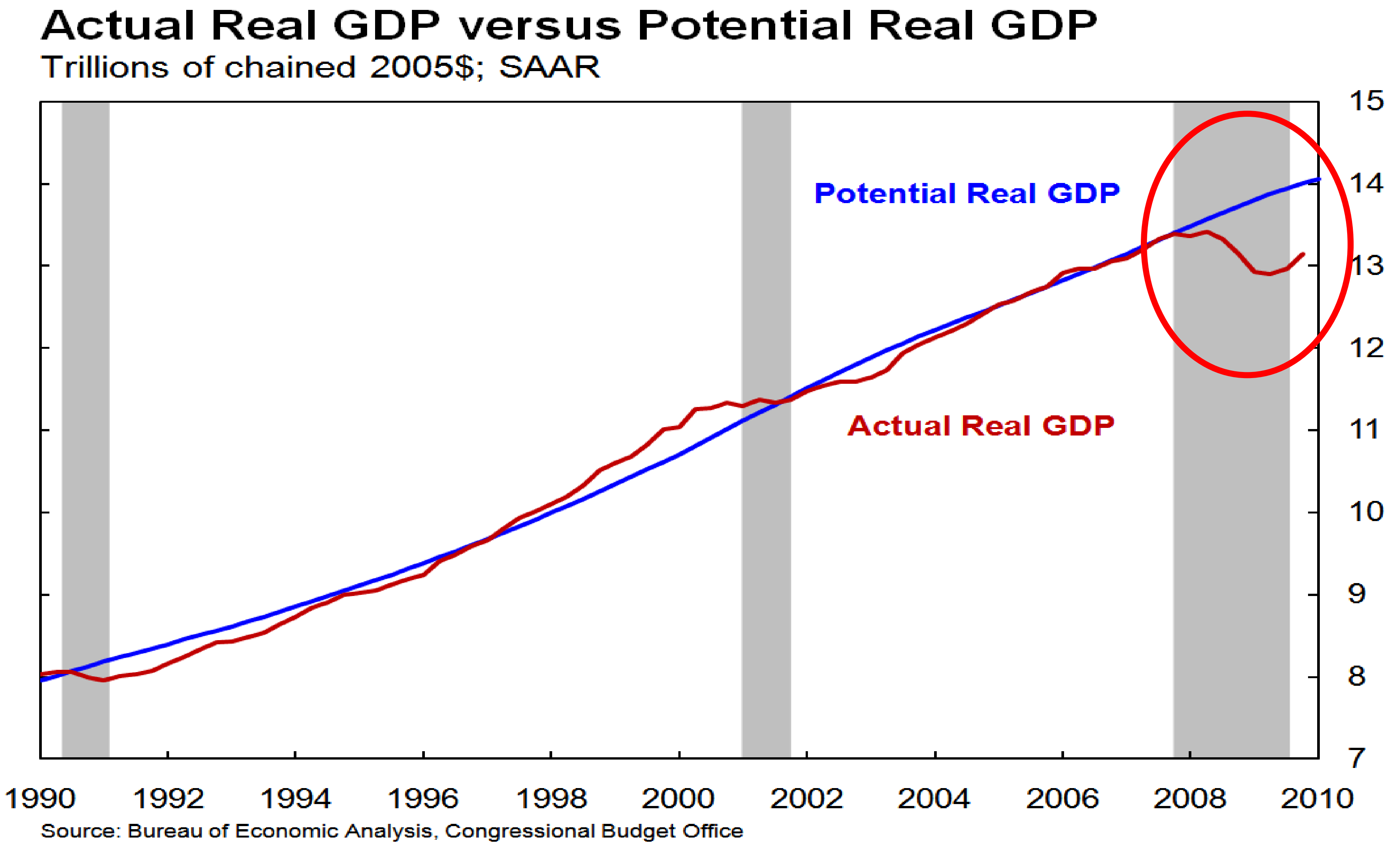


The Economy Appears to be in Moderate Recovery – Although the NBER Declined to Set a Date for the End of the Recession

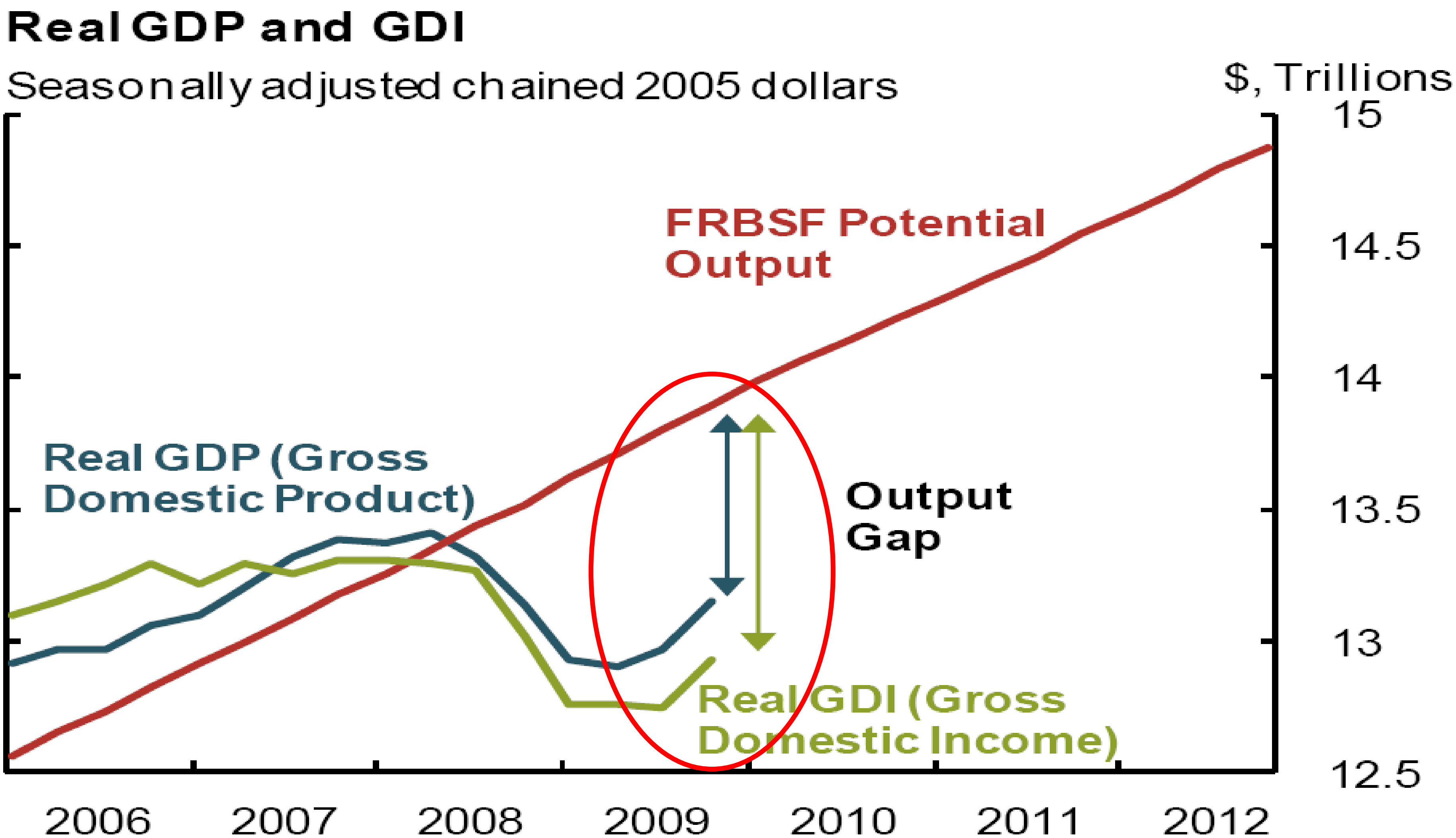


Source: Federal Reserve Bank of Chicago

The Output Gap Remains Sizeable



Moreover, there Is Uncertainty about the Size of the "Output Gap"



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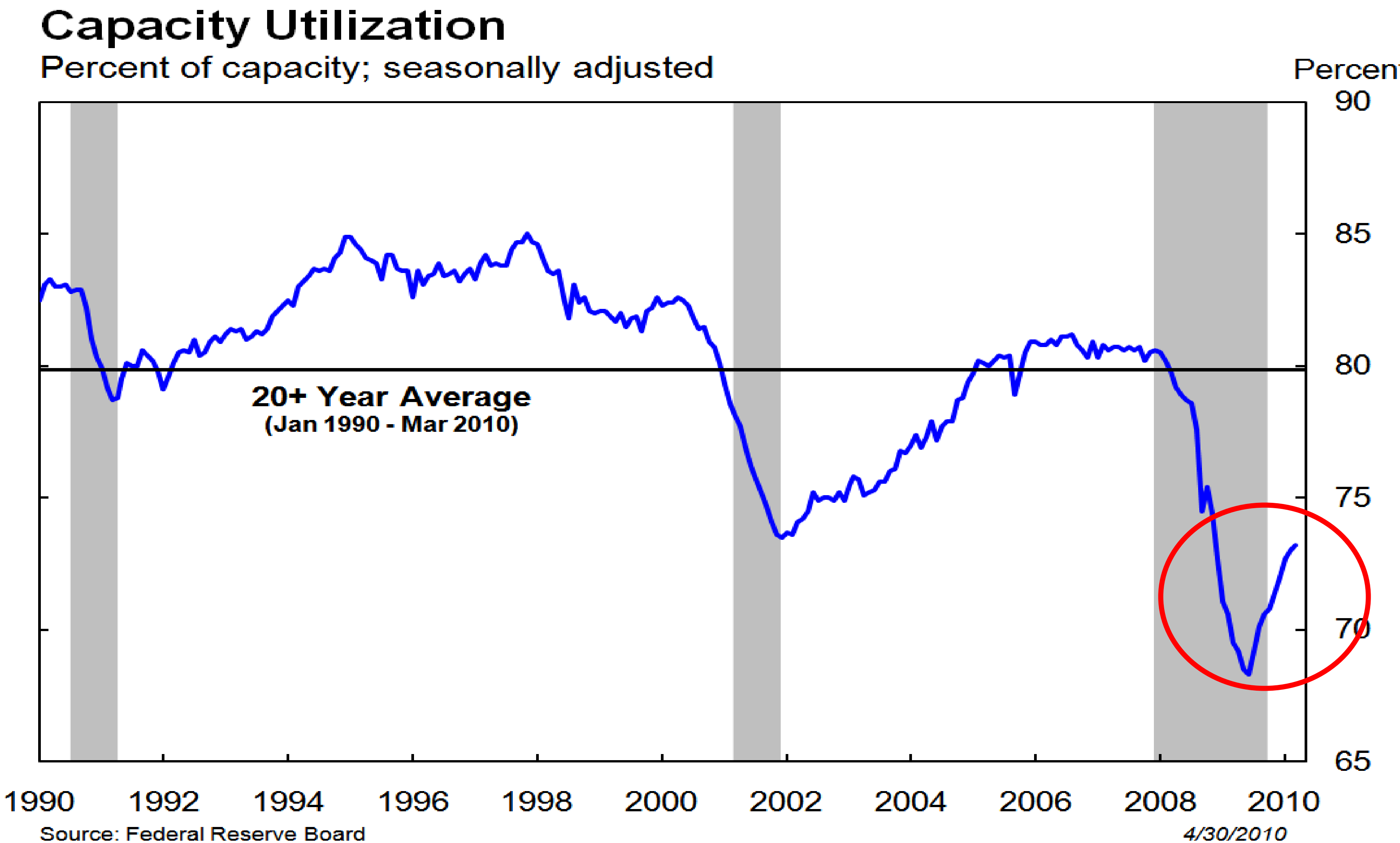
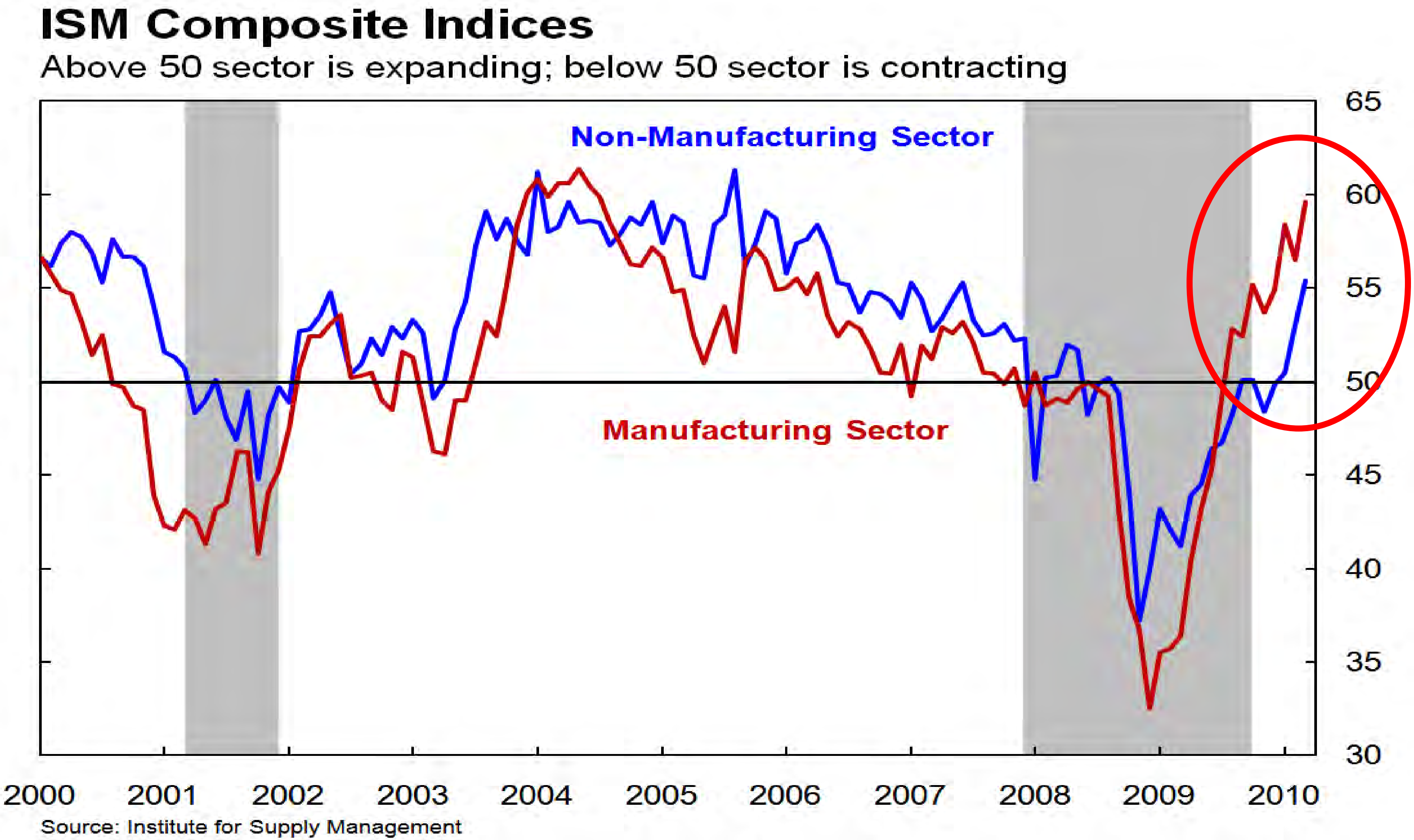
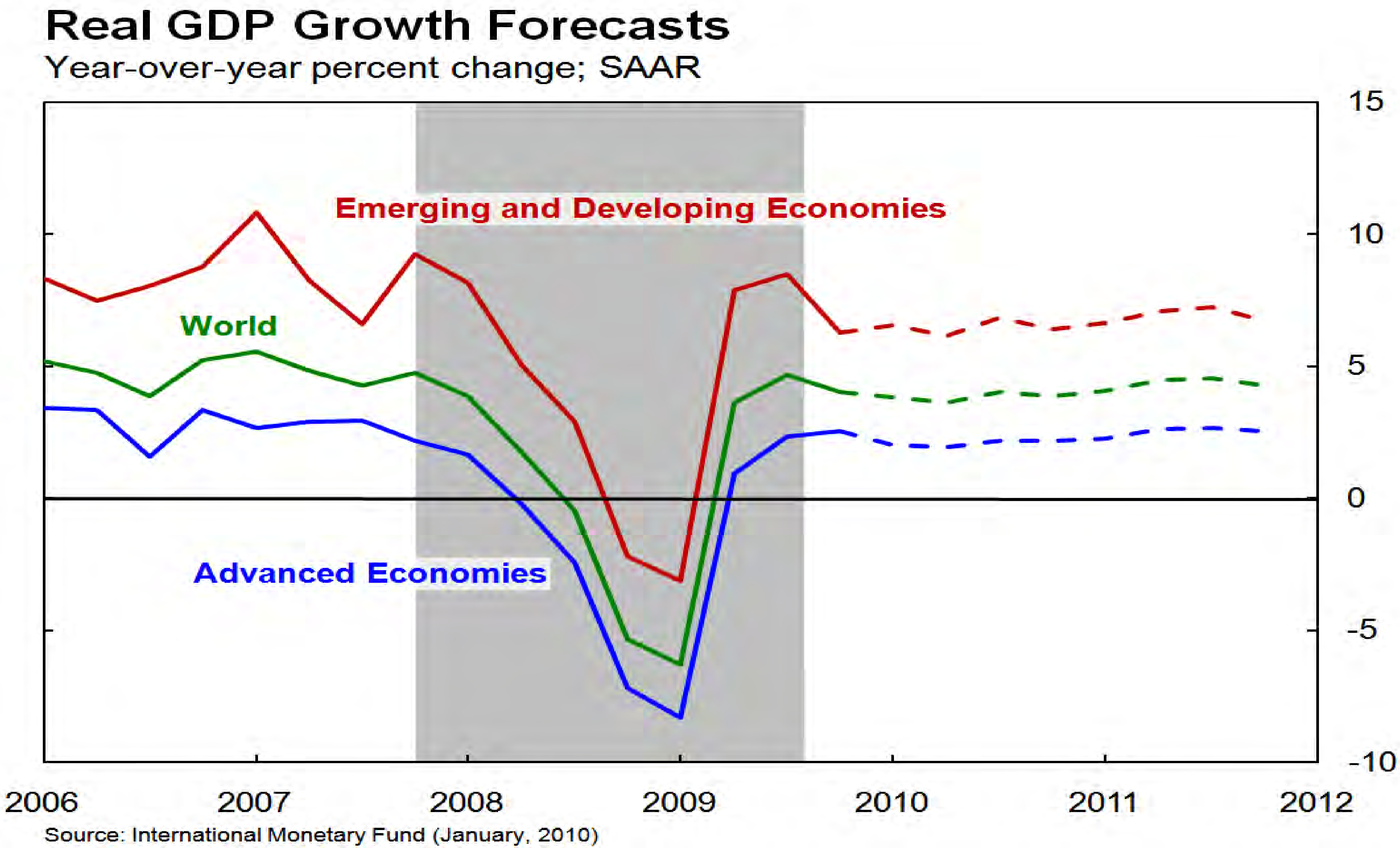
The Large “Output Gap” Is Reflected in a Low Level of Industrial Capacity Utilization



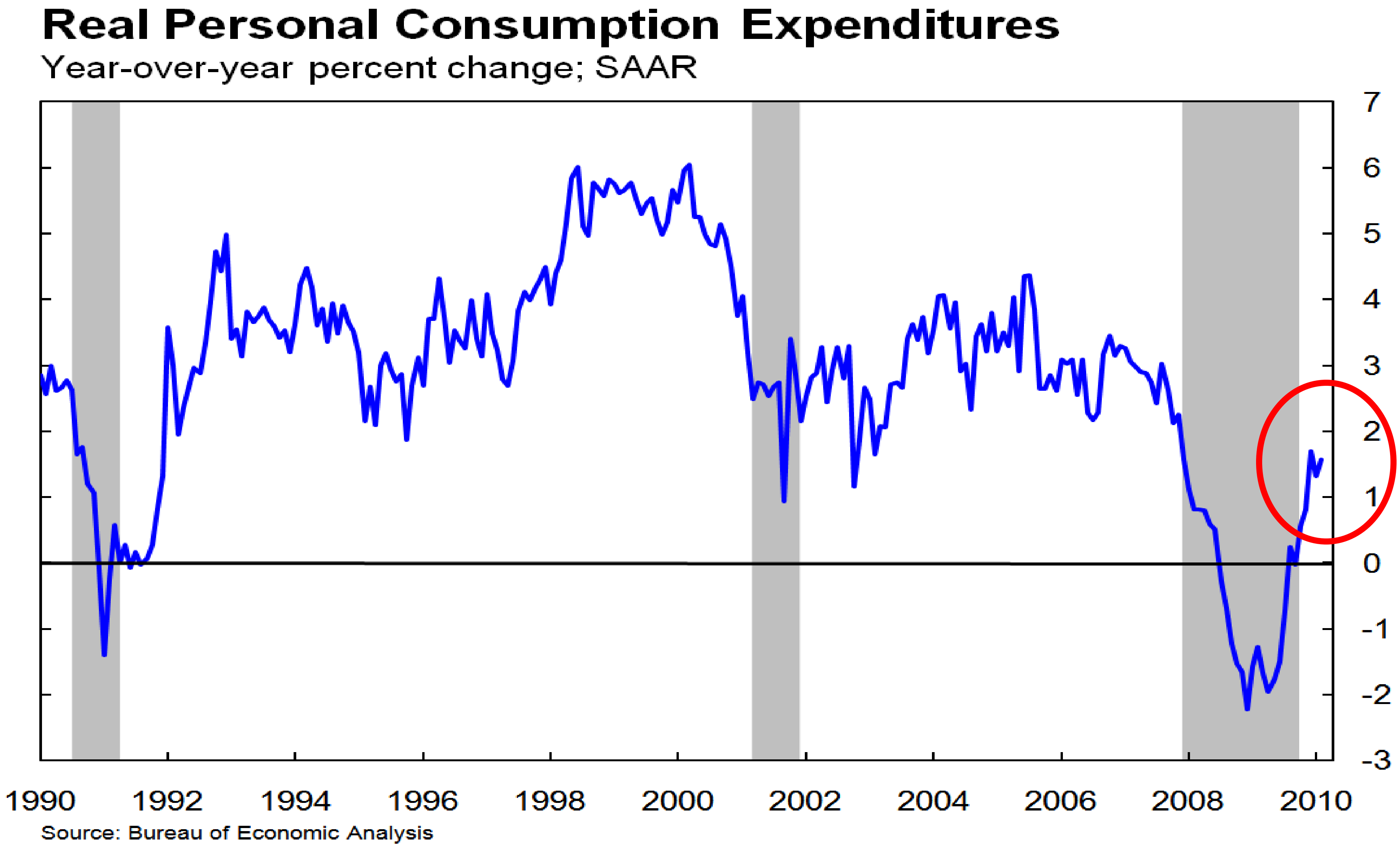
Manufacturing and Non-Manufacturing (Services) Both Rebound



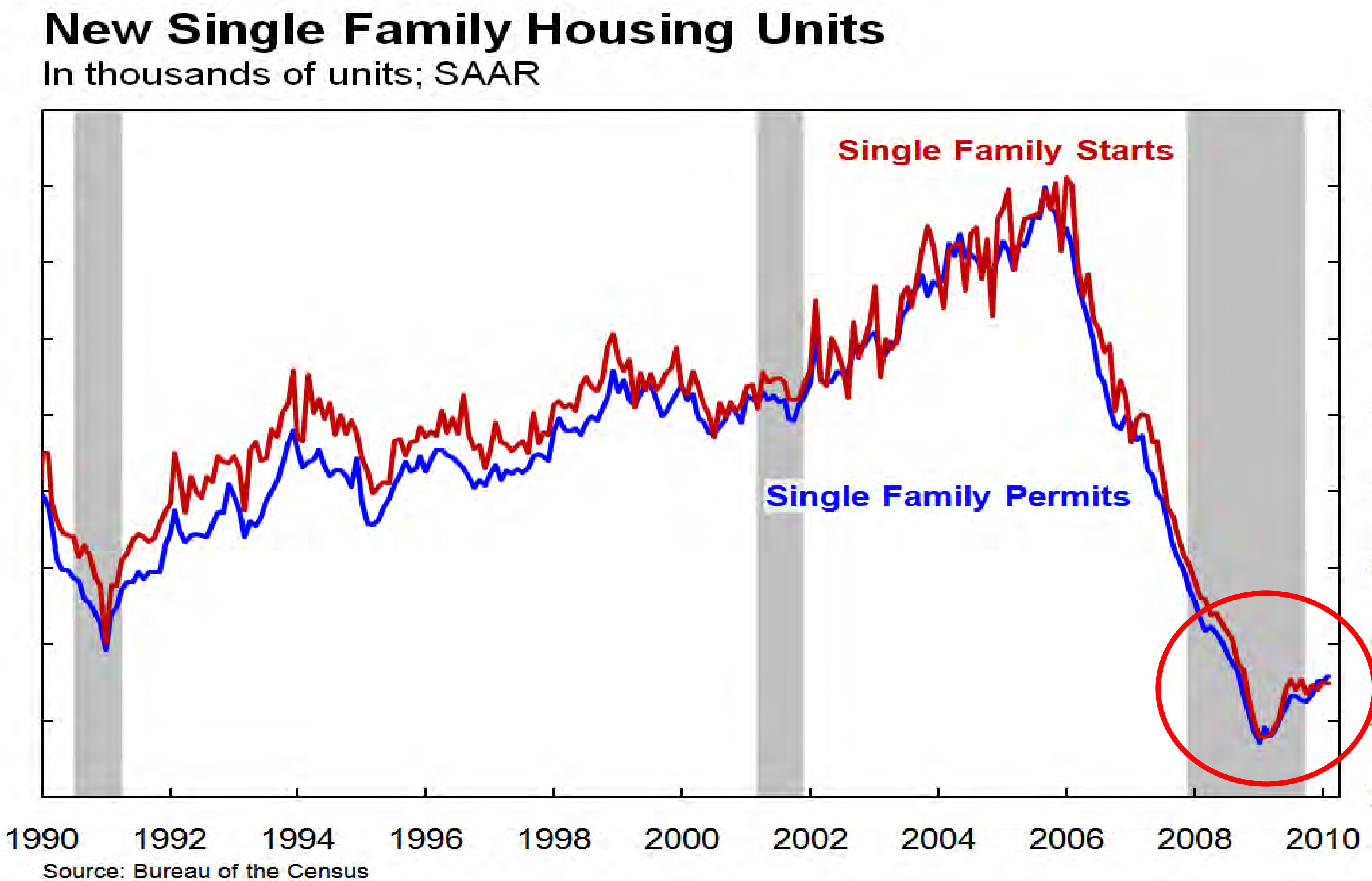
Global Economic Growth: Will Boost U.S. Production and Exports



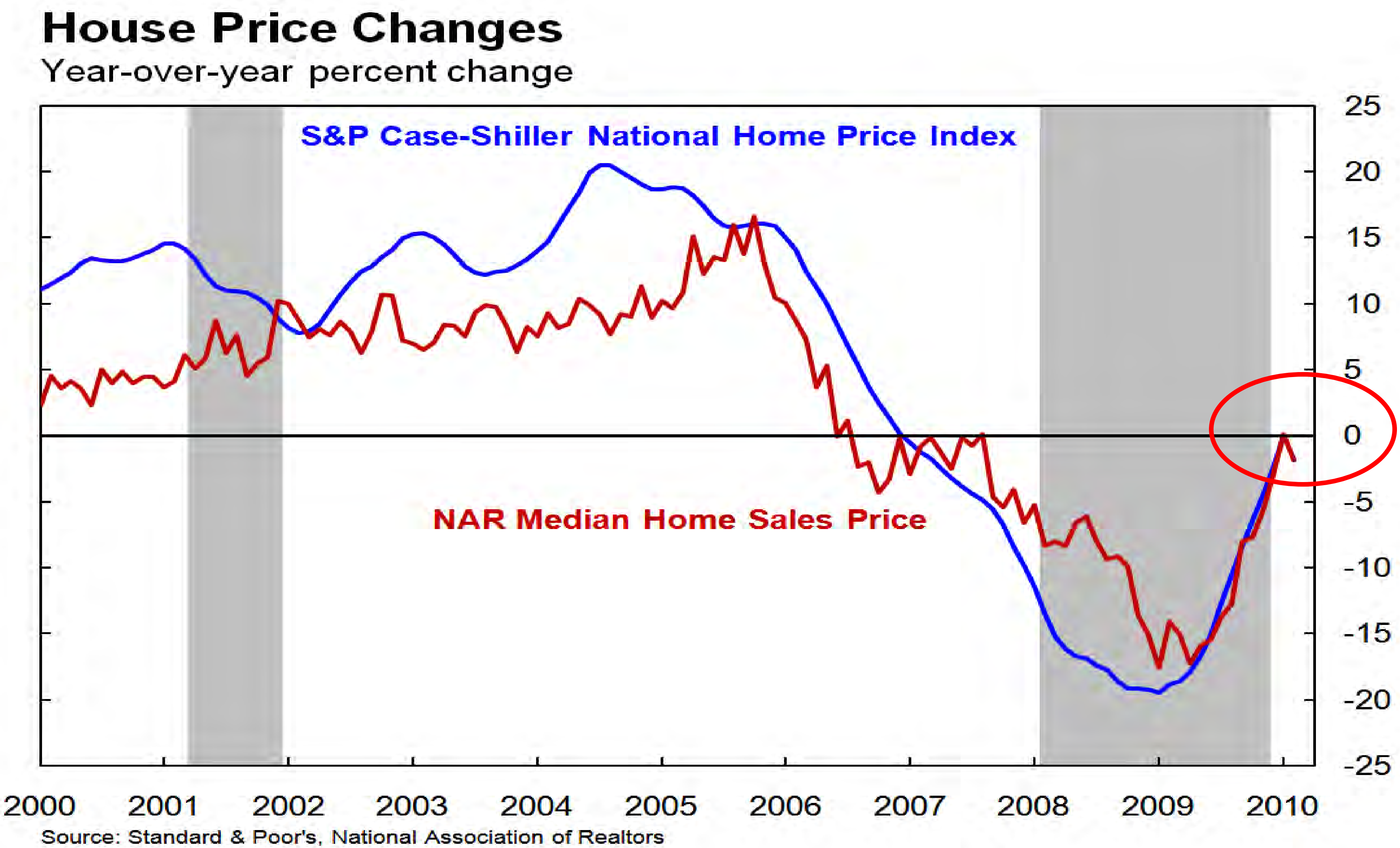
Consumption Spending Growth Rate Turns Positive Again



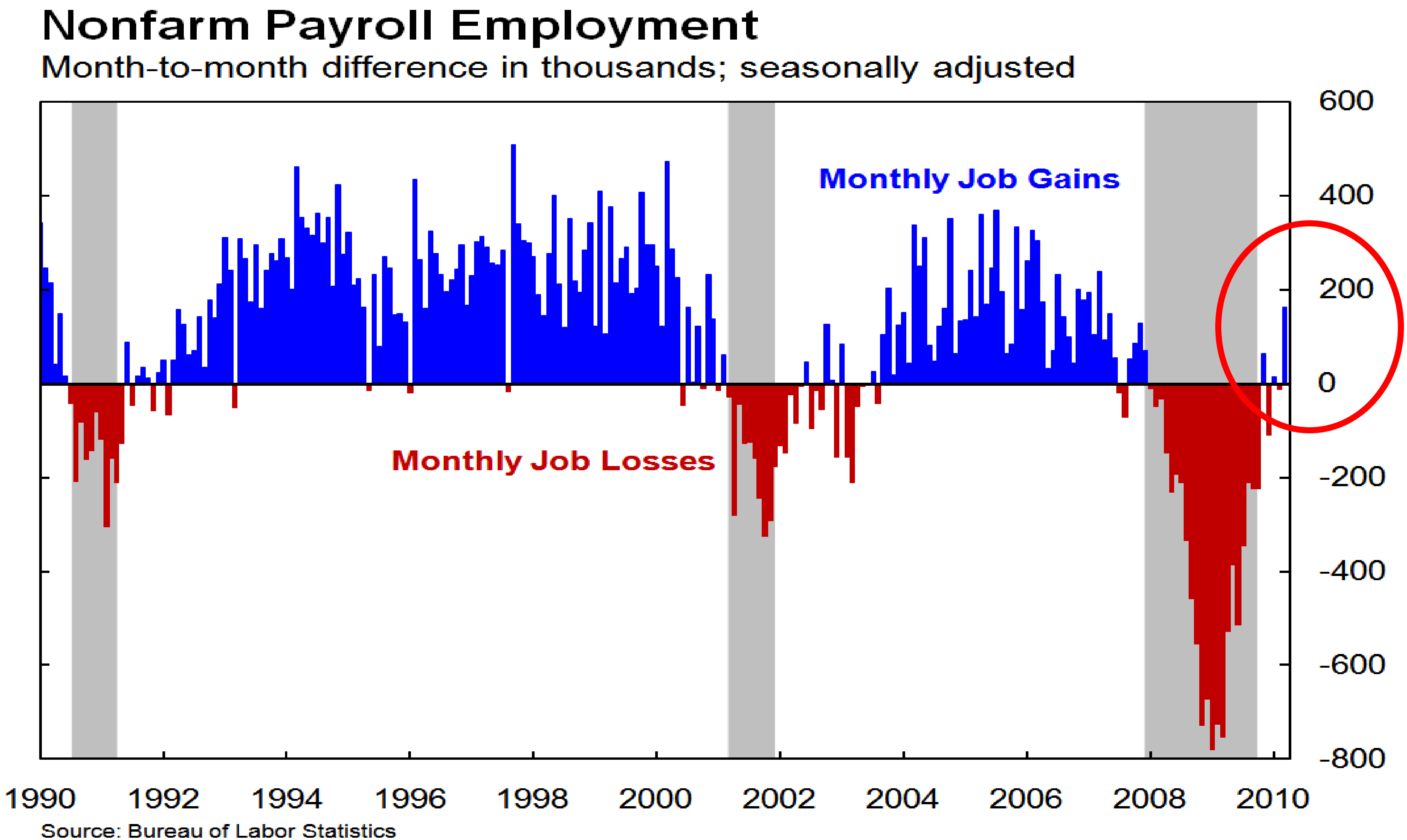
New Residential Construction Activity Hits Bottom: No Longer Subtracting from Growth



National House Prices Show Signs of Stabilization: Only Small Changes from a Year Ago



Payrolls Add 162,000 Jobs in March – More than 8.2 Million Jobs Lost Since December 2007

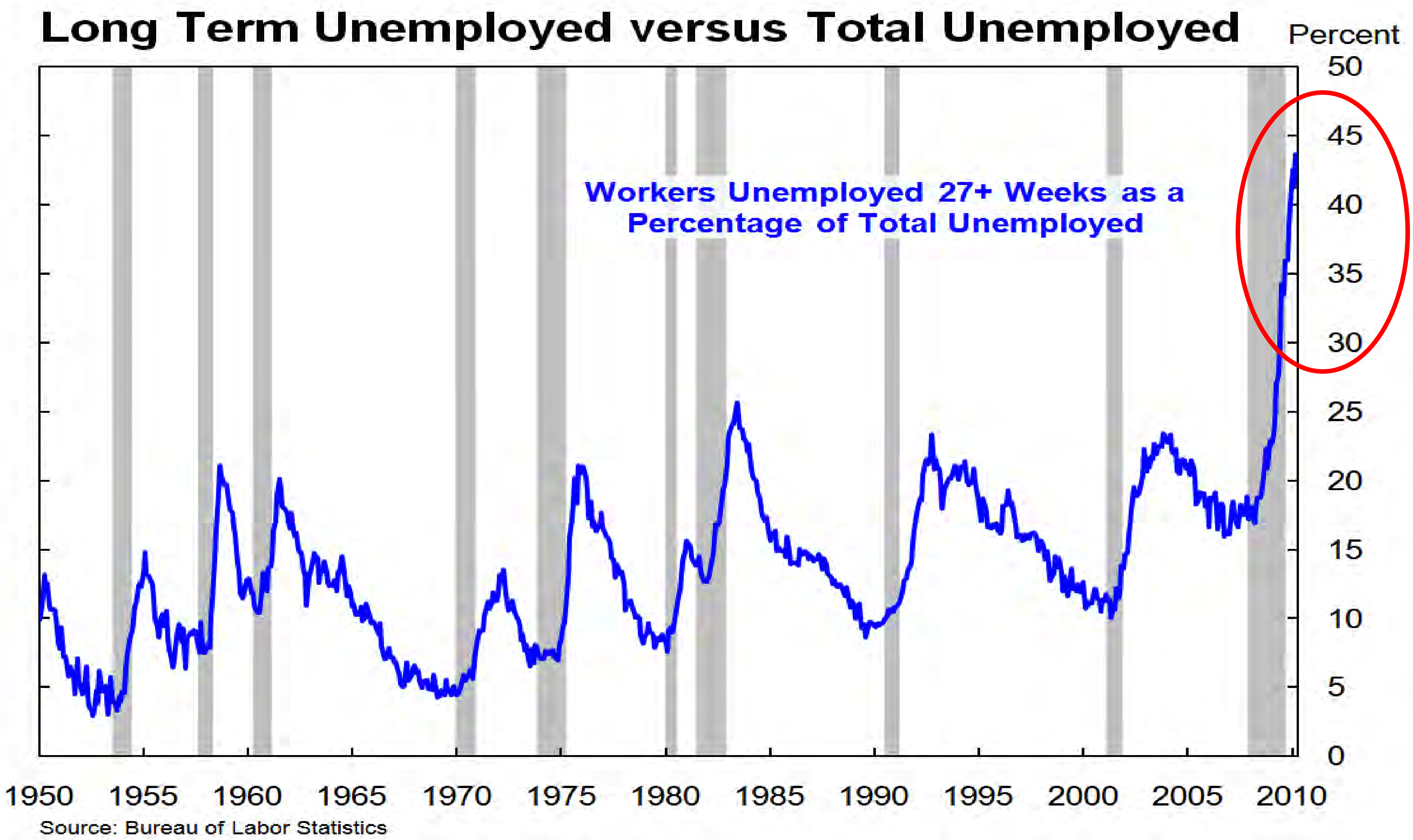


CURRENT SITUATION: SIGNS OF WEAKNESS

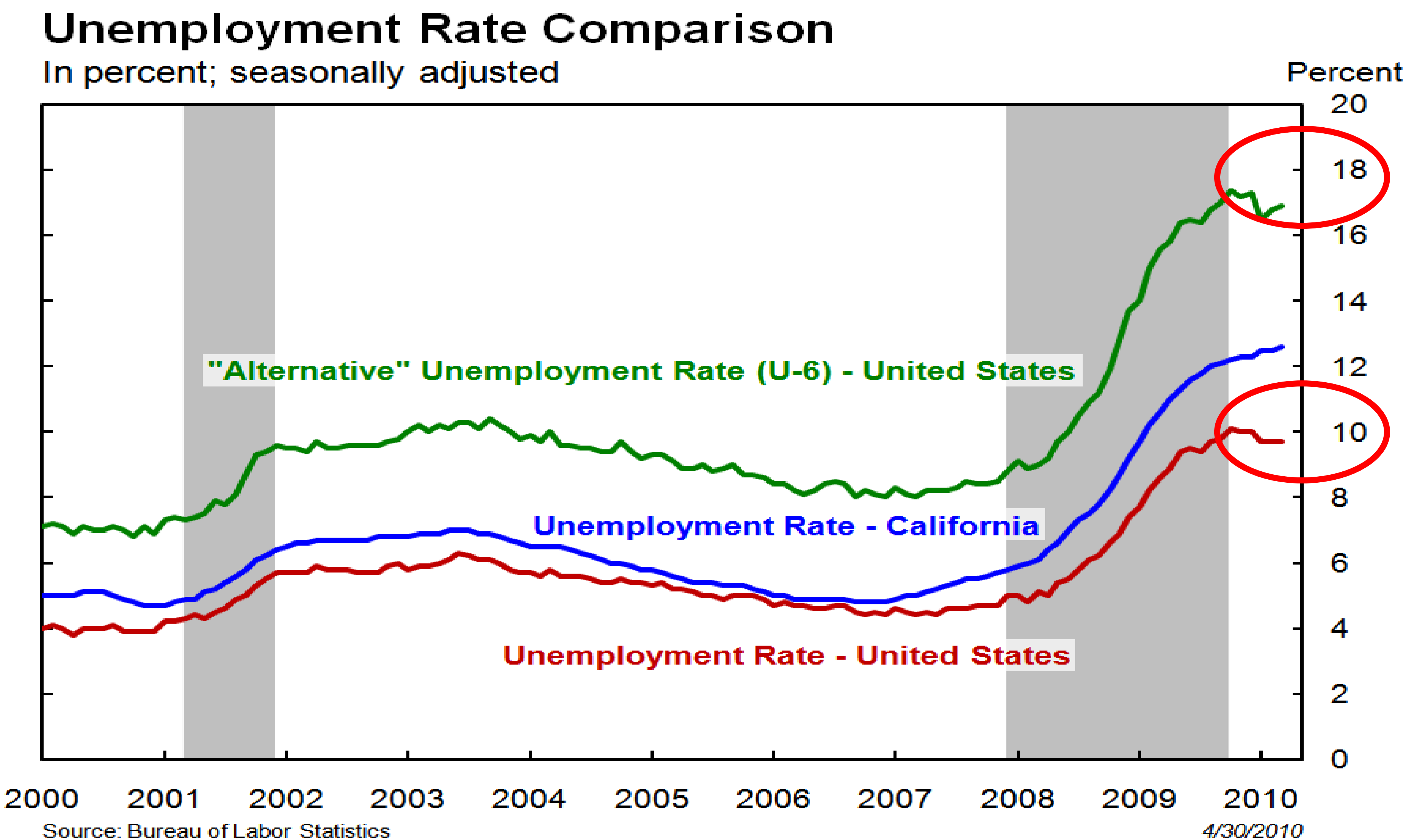
National Beige Book Survey Summary, April 14, 2010

- **Increased activity in housing markets <u>from a low level</u>**
- **Commercial real estate—very weak**
- **Banking and finance sector—mixed, as loan volumes and credit quality fell**
- **Agriculture mixed**
- **Labor markets generally weak**

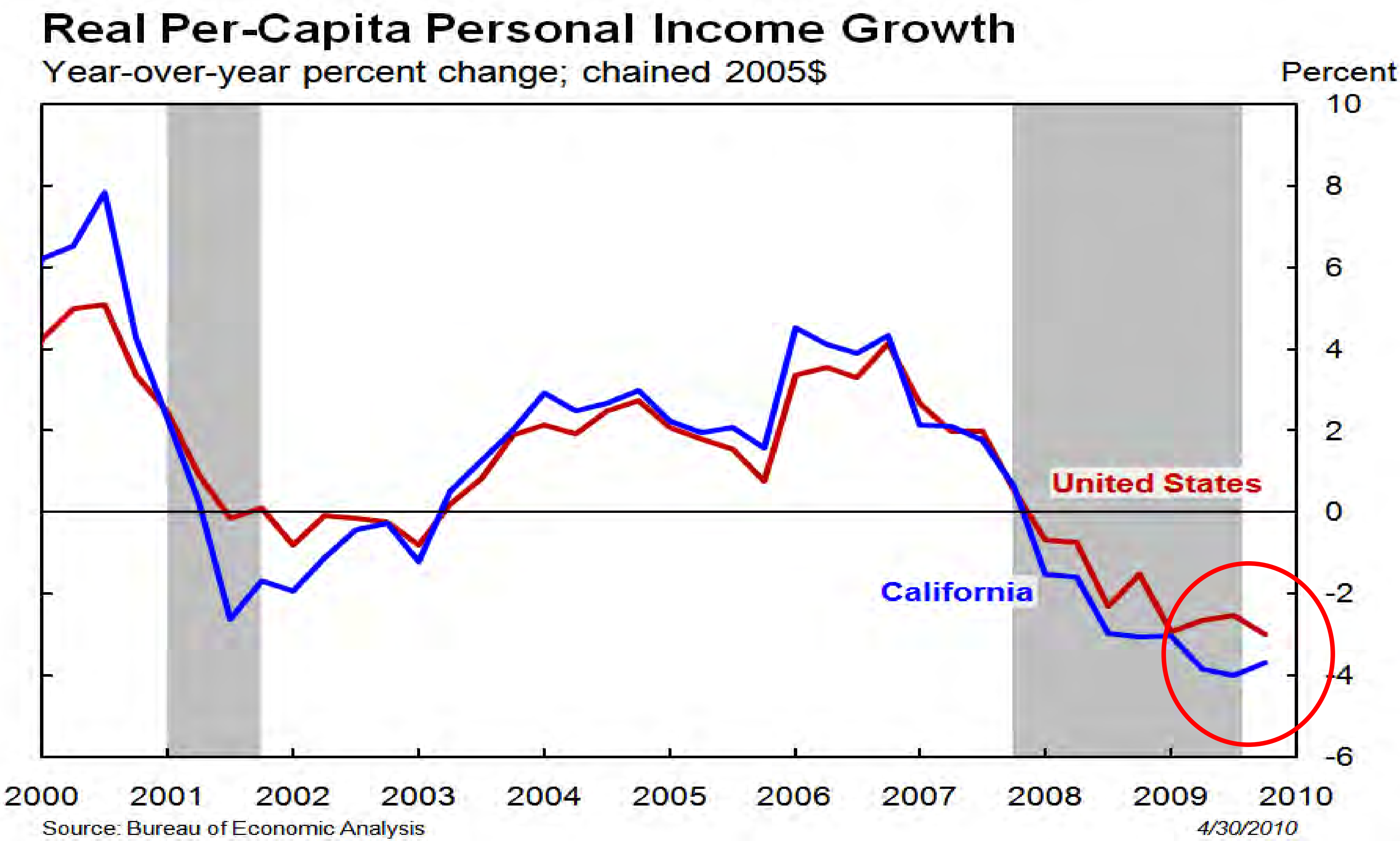
Joblessness is Increasingly Concentrated Among the Long-Term Unemployed (6 months or longer)



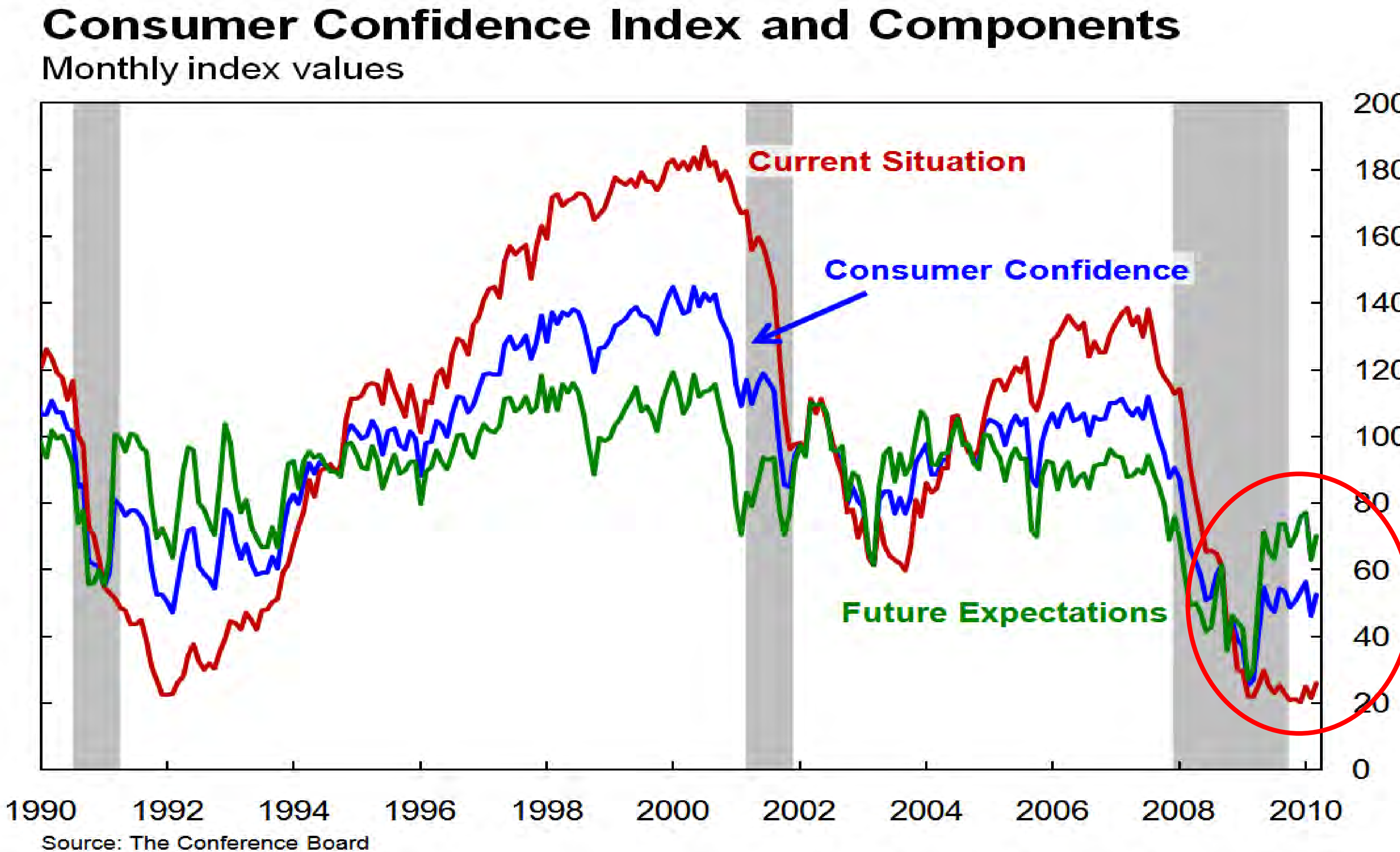
Unemployment Rates Show the Extent of Labor Market Weakness



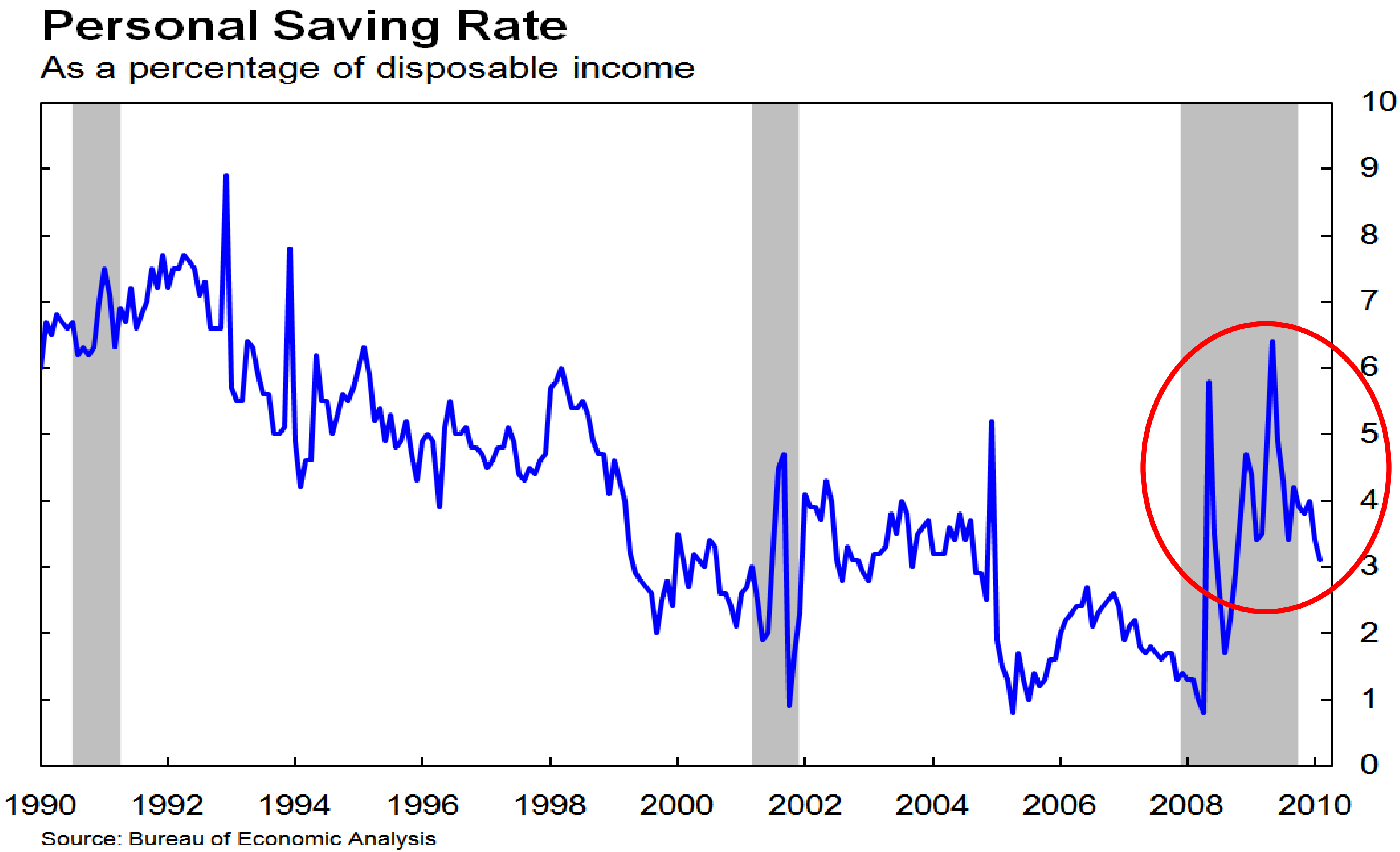
Per-Capita Real Personal Income Declines in California Exceed those for the U.S.



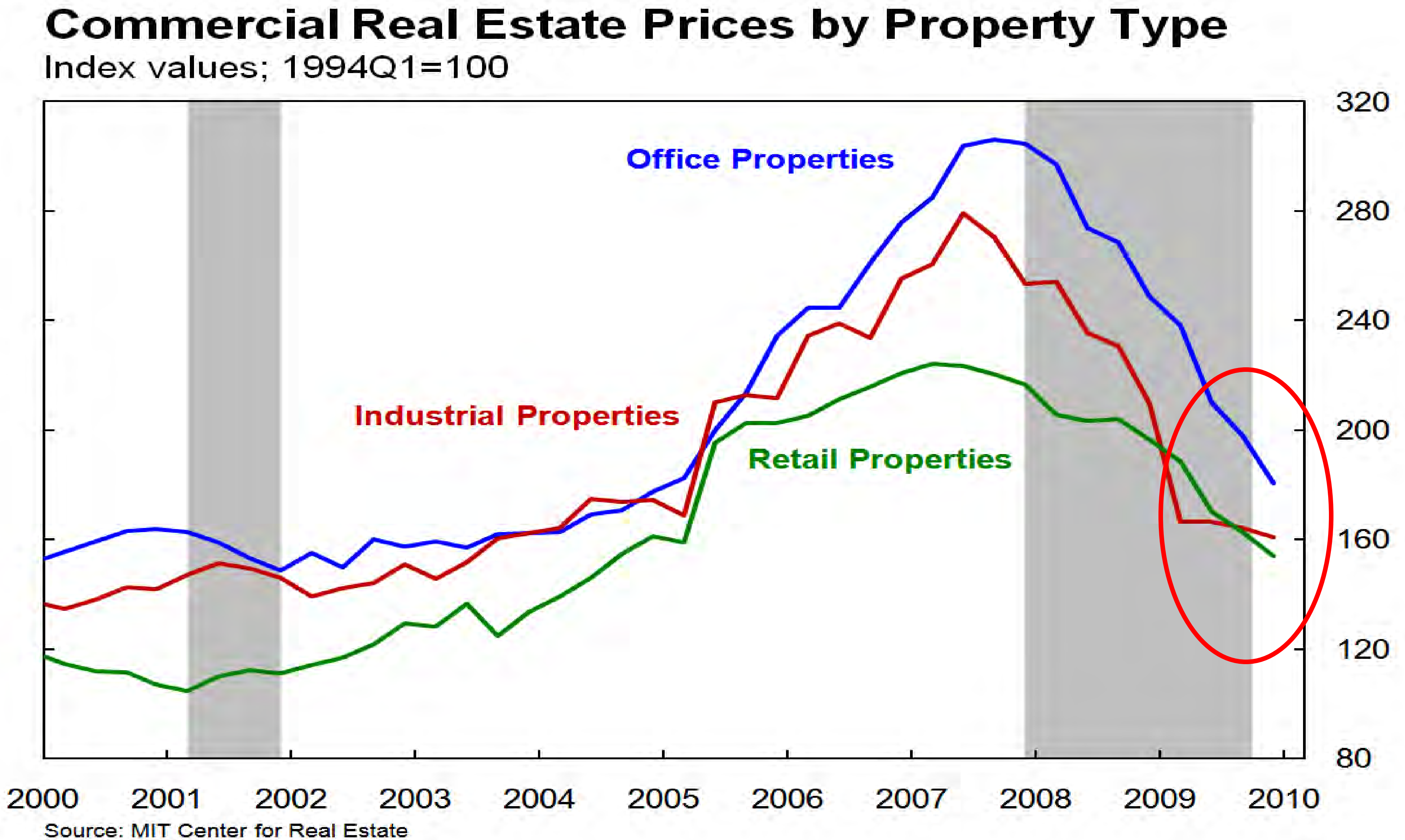
Although Expectations Have Improved from Mid-Recession, U.S. Consumers Remain Cautious



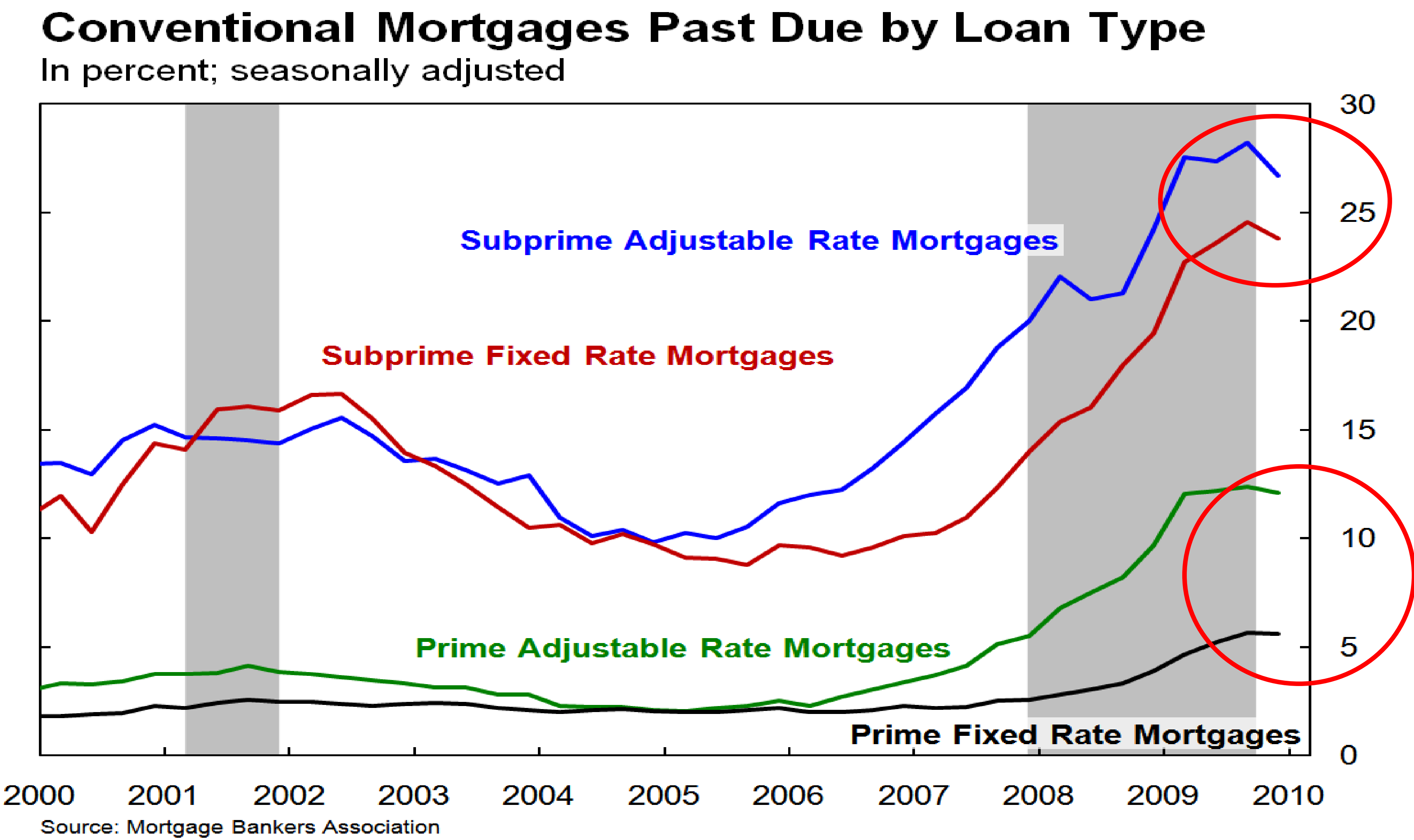
Declines in Wealth, Jobs, Income, and Confidence Pushed Up Household Saving



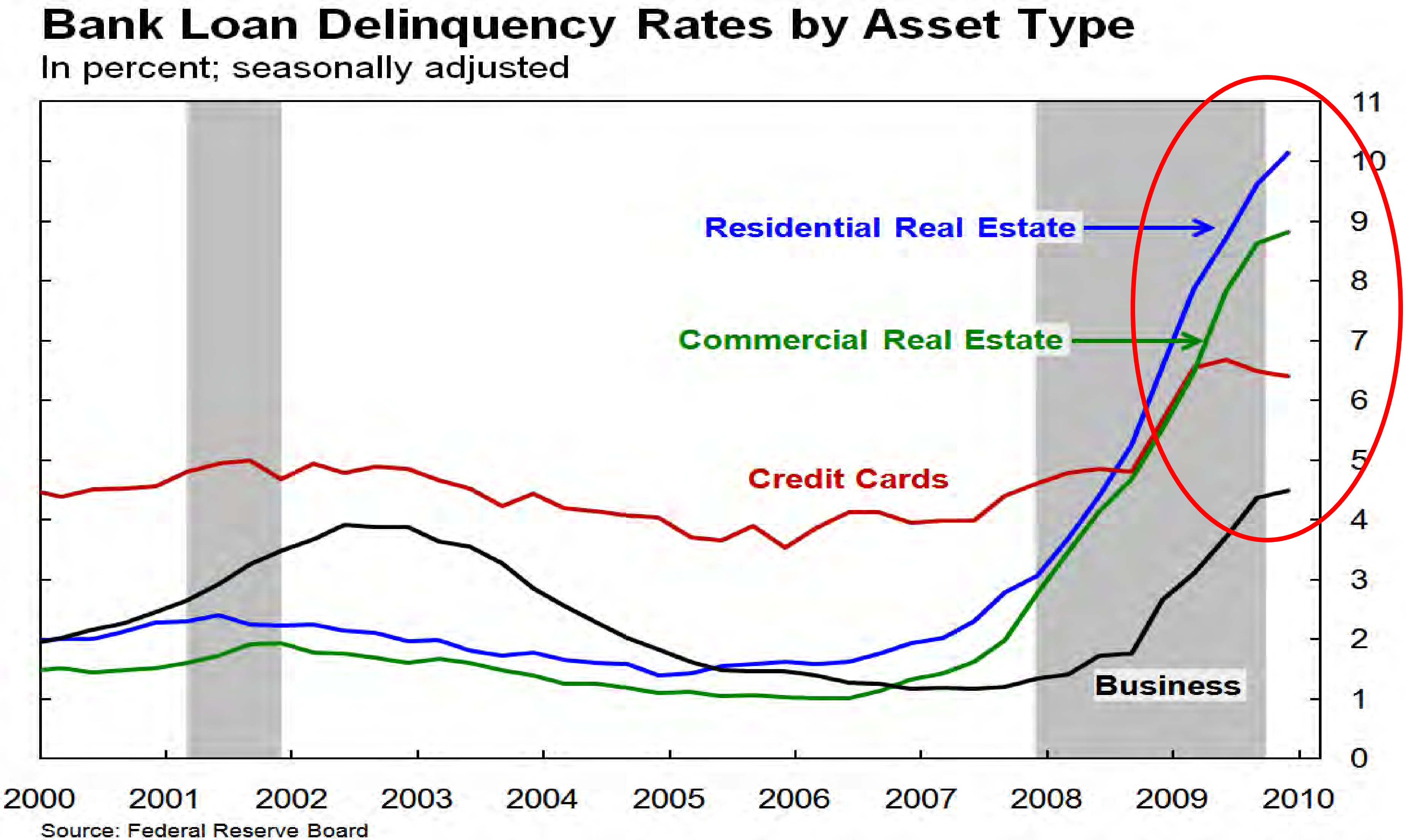
Commercial Real Estate Prices Are Falling; Few Signs this Trend Is Reversing



No Sign of Let-Up in Loan Mortgage Delinquencies



Surge in Loan Delinquencies is Not Limited to Residential Real Estate



STANCE OF MONETARY POLICY

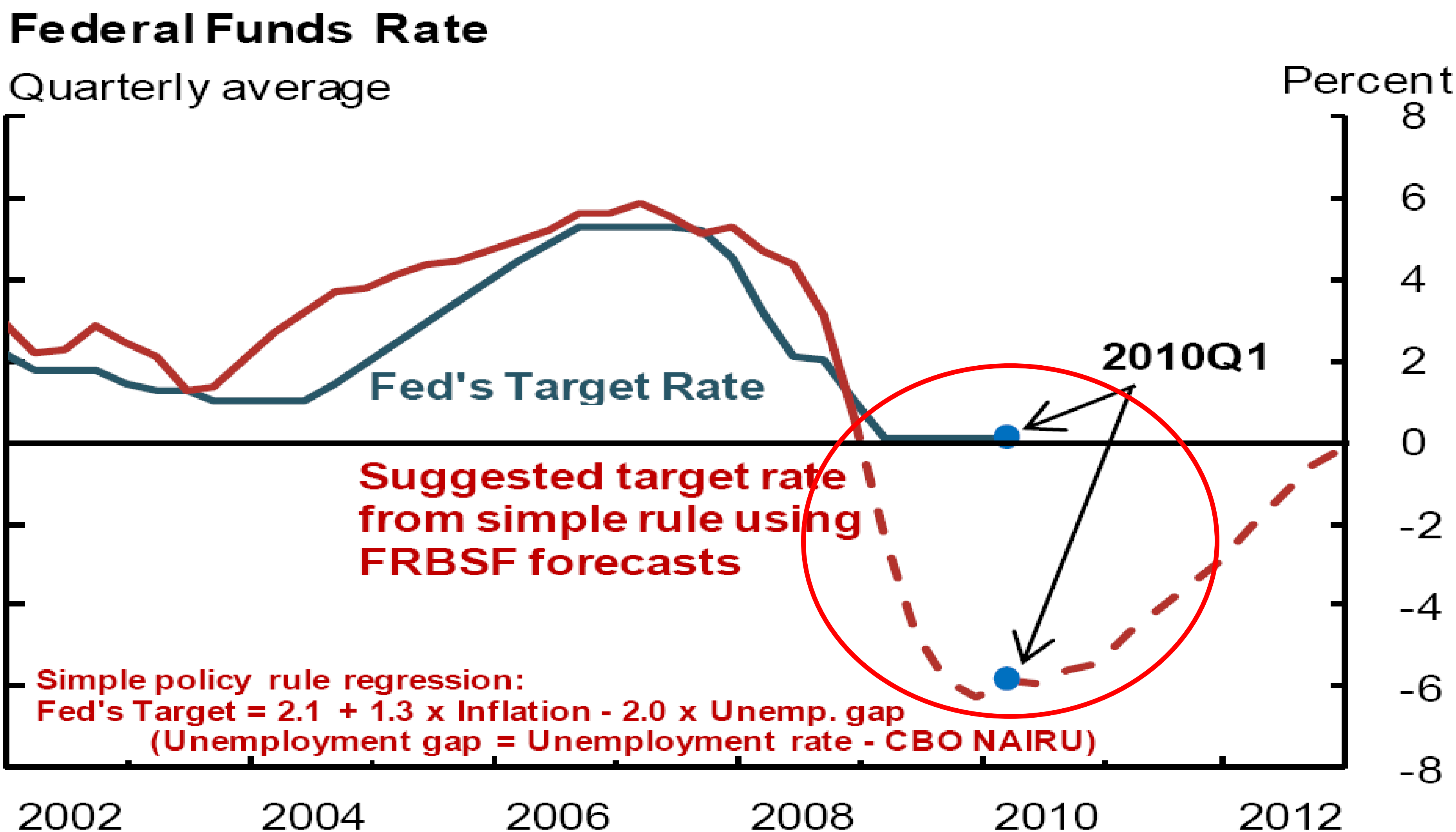
Monetary Policy

- **Conducting monetary policy**

  Dual goals: (1) maximum sustainable output and employment and (2) price stability

- **Tools**
  - Conventional tool: federal funds rate
    - "Zero bound"
  - Nonconventional tools: Fed balance sheet
    - Size has been relatively steady over the past year, but the composition has changed dramatically

Monetary Policy Stimulus is Still Needed



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Recent Statement from the FOMC on Monetary Policy Regarding Conventional Tools

"The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, **including low rates of resource utilization, subdued inflation trends, and stable inflation expectations,** are likely to **warrant** exceptionally low levels of the federal funds rate for an extended period."

FOMC Statement of April 28, 2010

http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

Recent Monetary Policy Actions: Unconventional Policy Tools

Unconventional Tools (Fed Balance Sheet)

- Emergency short-term lending facilities
- Purchases of longer-term securities
  - U.S. Treasuries (longer term); $300 billion
  - Agency debt (Fannie & Freddie); $175 billion
  - Agency mortgage-backed securities (MBS); $1.25 trillion

Exit Strategy

- Terminating lending facilities, concluded purchases
- Making policy with a large balance sheet

Recent Readings on Monetary Policy Regarding Unconventional Tools

Fed Exit Strategy Update:

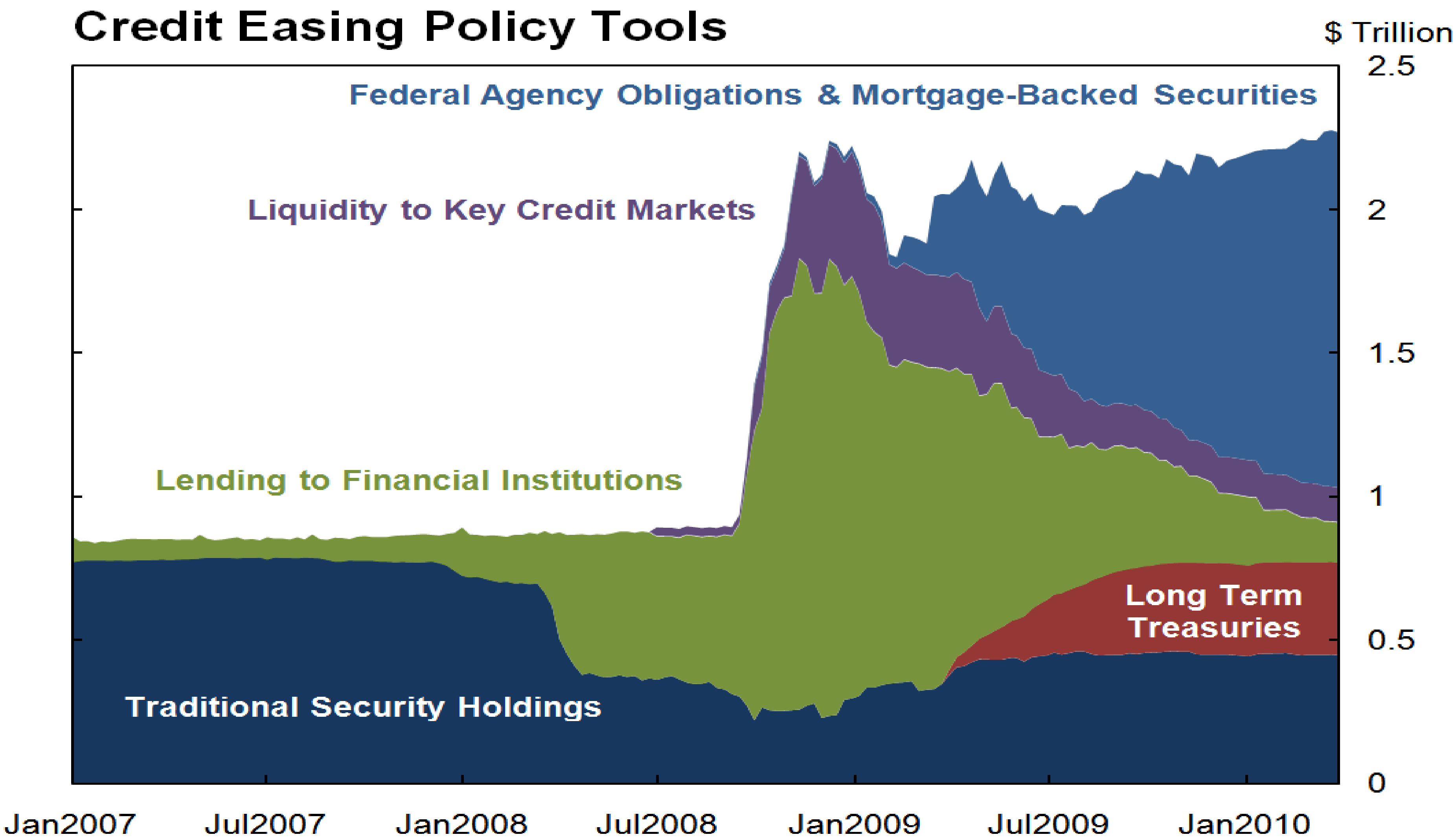
Decline in shorter-term liquidity and credit

- With one exception (TALF (CMBS) until June 2010), all have been terminated

Longer-term credit and asset purchases programs have been completed

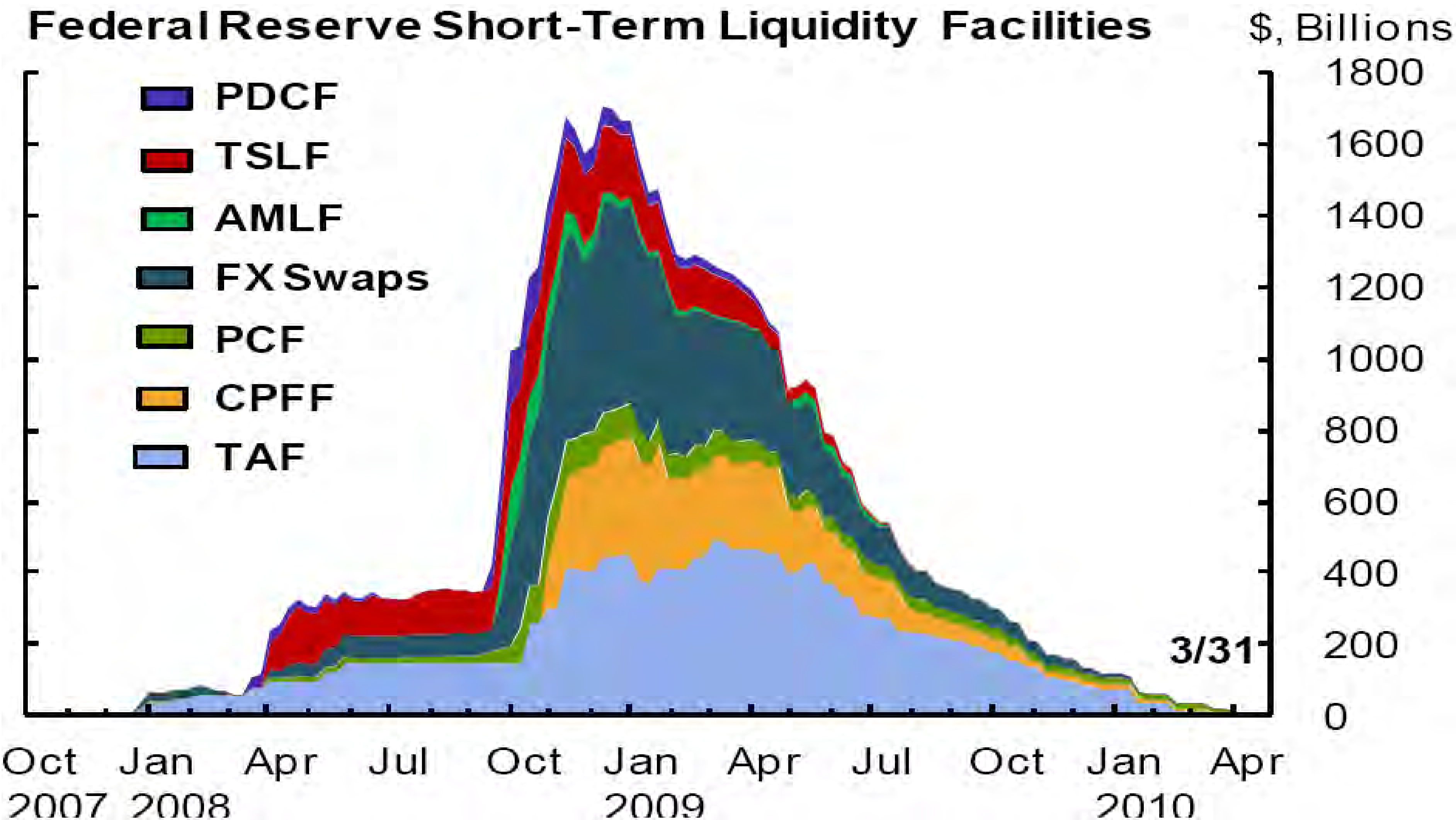
- Treasury securities purchases completed (Oct. 2009)
- Agency debt / MBS purchases completed (Mar. 2010)

Dramatic Change in Size and Composition of the Federal Reserve's Assets



Source: Federal Reserve Board and Federal Reserve Bank of Cleveland

Direct Lending Programs: Extraordinary Lending Support Has Ended



FOMC: Measuring the Policy Stance

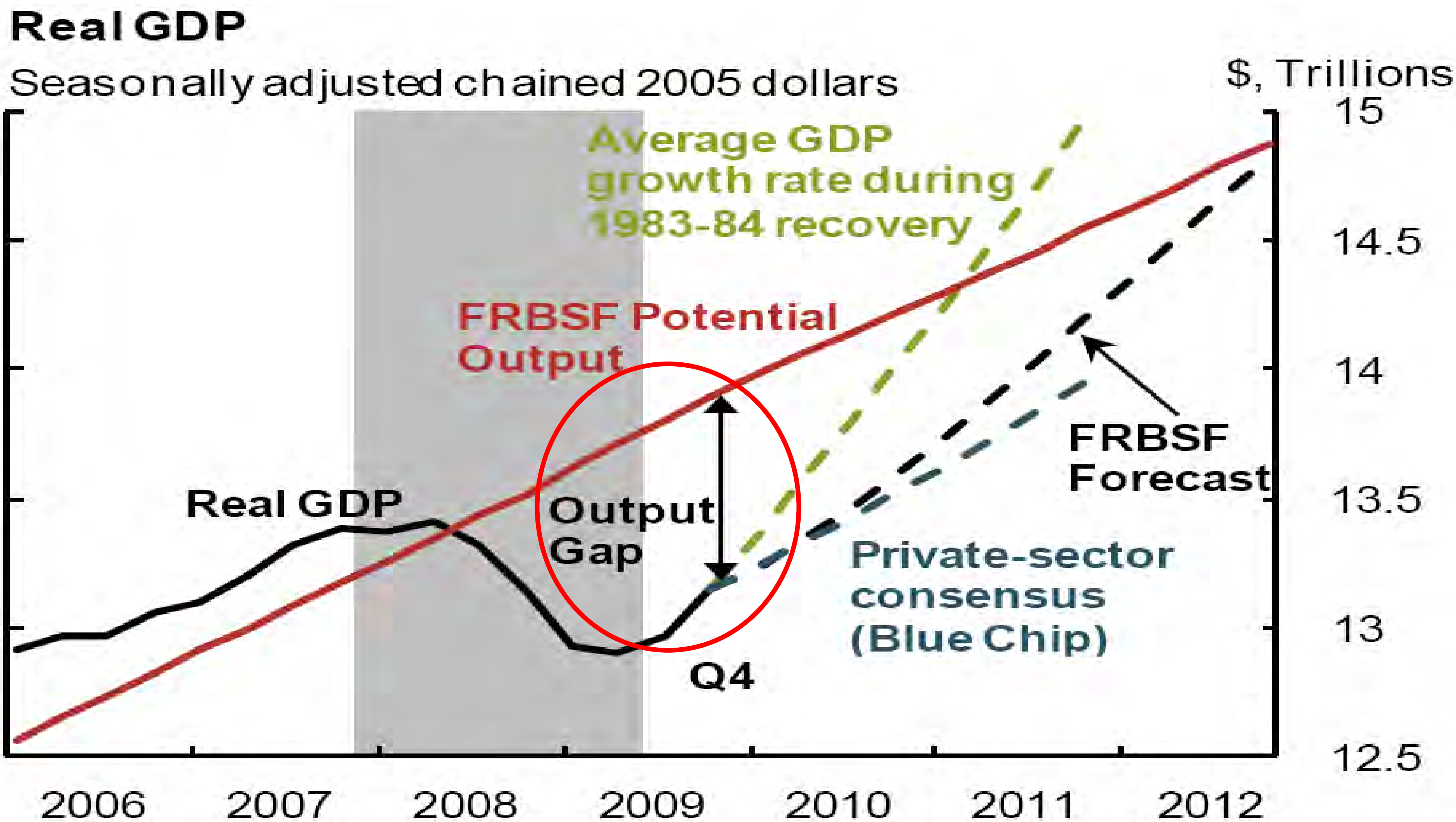
Unconventional Policy:

- Difficult to measure the impacts of unconventional actions
- No history to guide policy
- No single indicator (like the funds rate) to accurately measure policy
- Size of the Fed’s balance sheet may not be a useful indicator

FEDVIEWS

FRBSF NATIONAL ECONOMIC FORECAST

Large GDP Output Gap Likely to Persist



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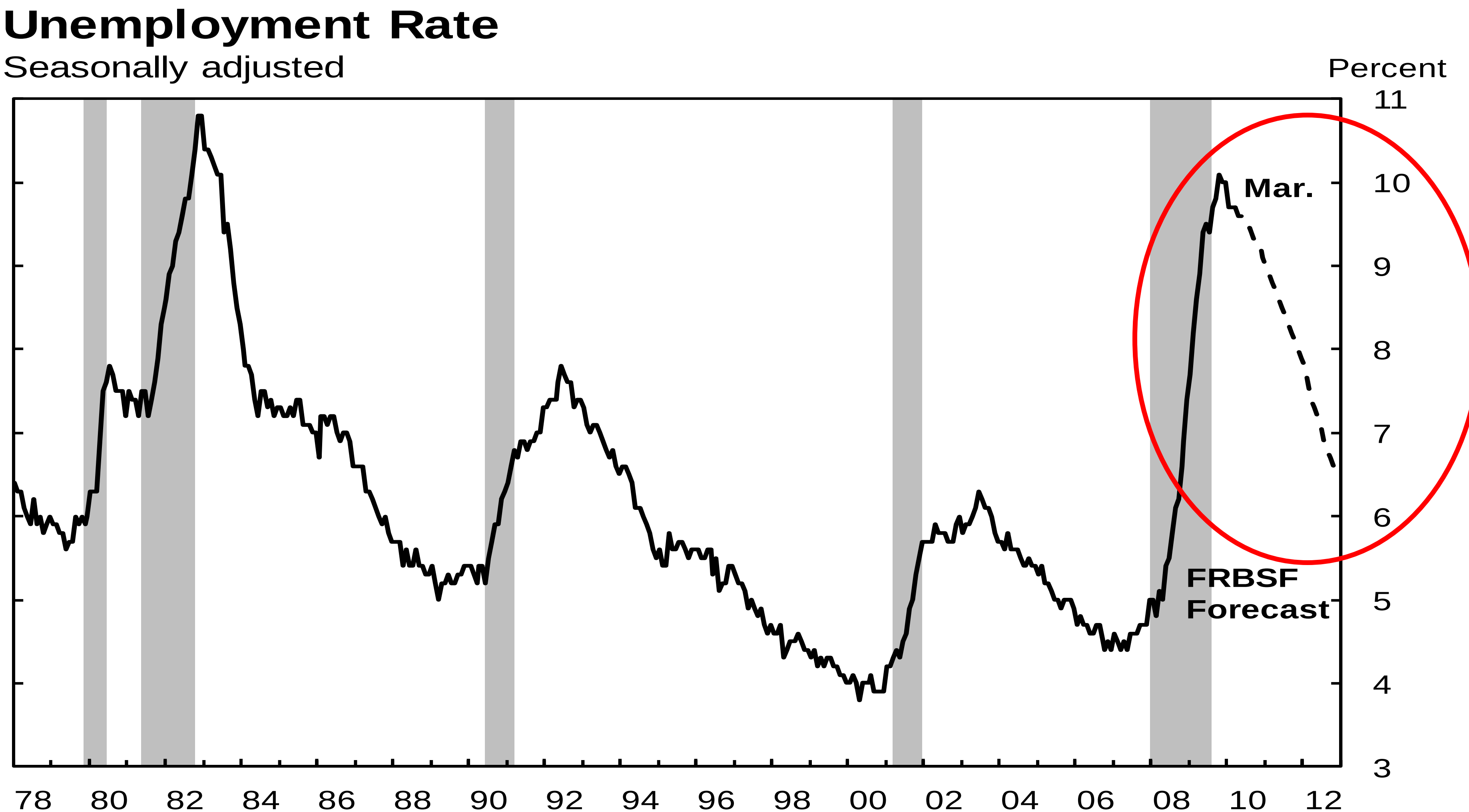
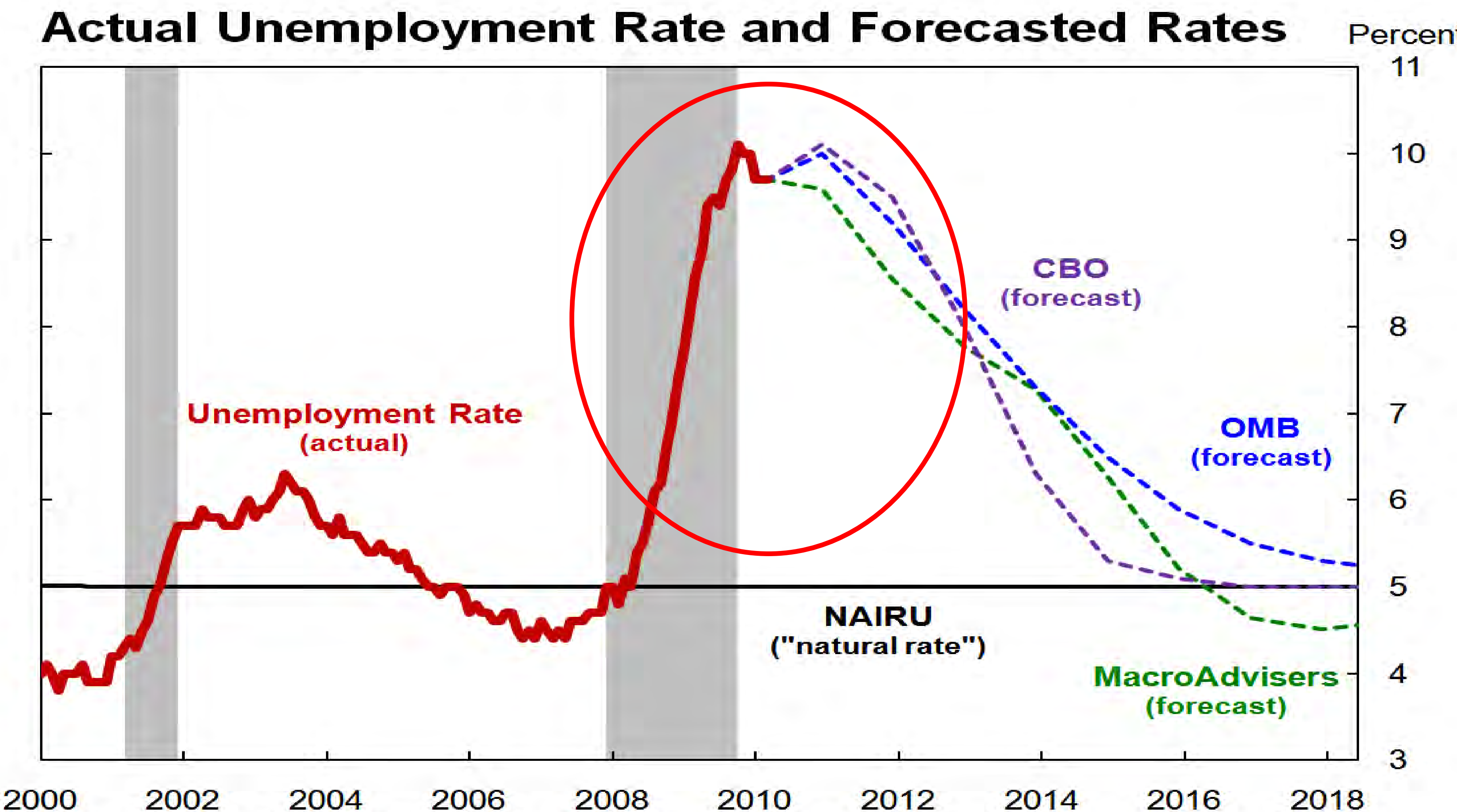
National Unemployment Rate Forecasts Remain Elevated



Source: FRBSF, April 2010.

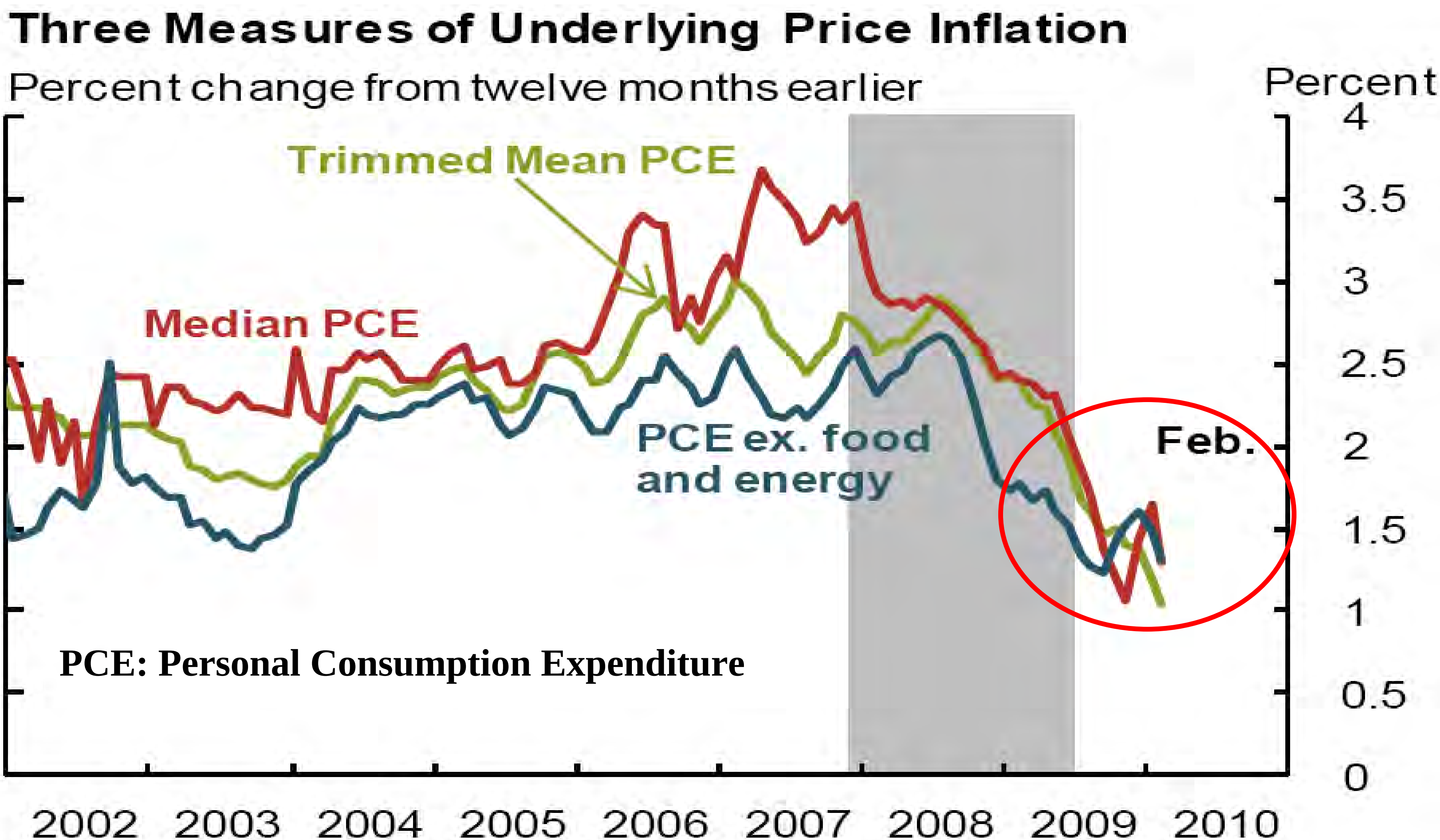
National Unemployment Rate Forecasts Remain Elevated



Source: BLS, CBO, OMB, Macroeconomic Advisers

Forecast dates: Congressional Budget Office (CBO) and Office of Management and Budget (OMB)-Jan. 2010. MacroAdvisors-Dec. 2009.

Current Readings Show that Inflation Is Trending Down



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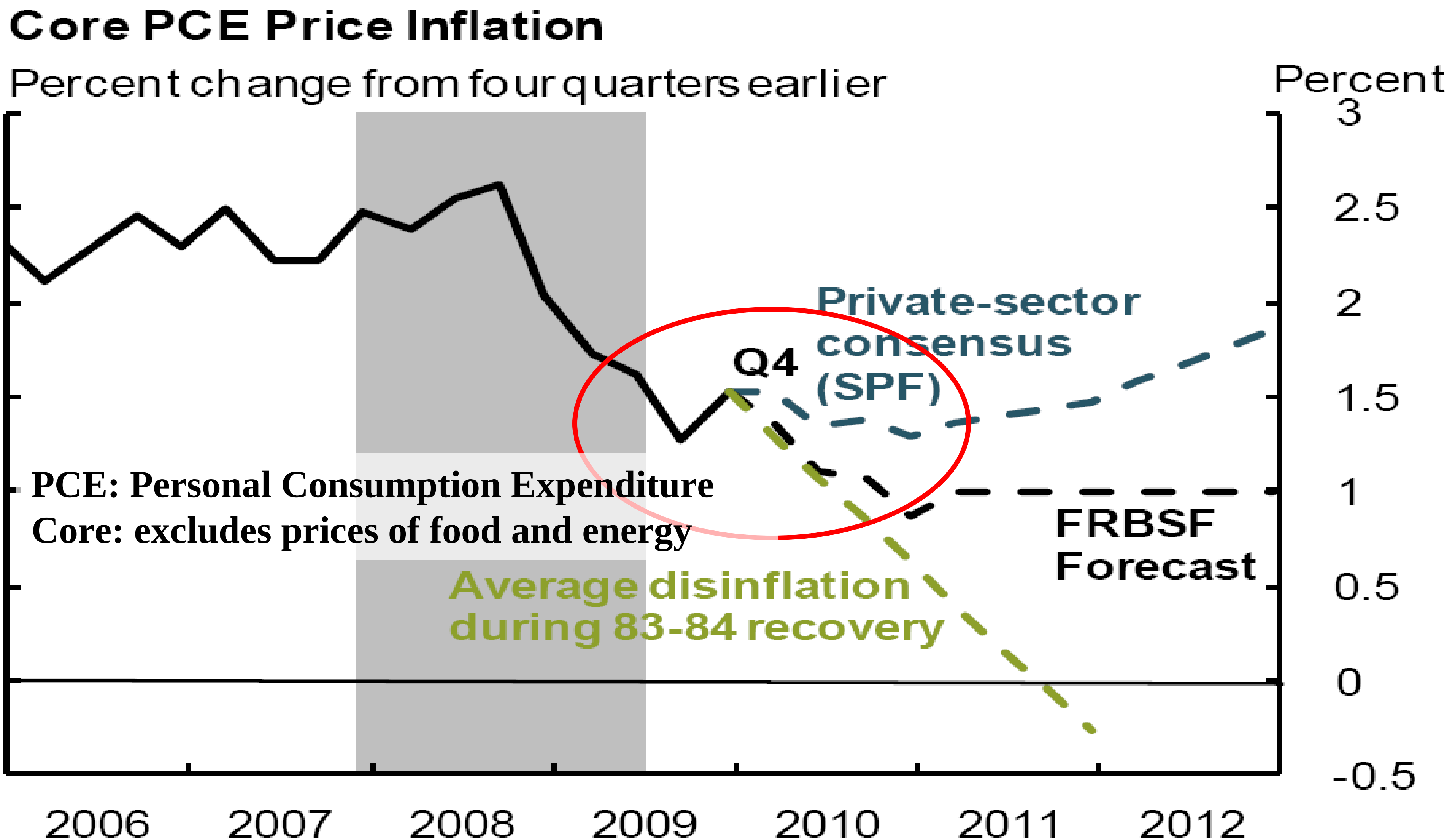
Lower Inflation is Expected in Near Term



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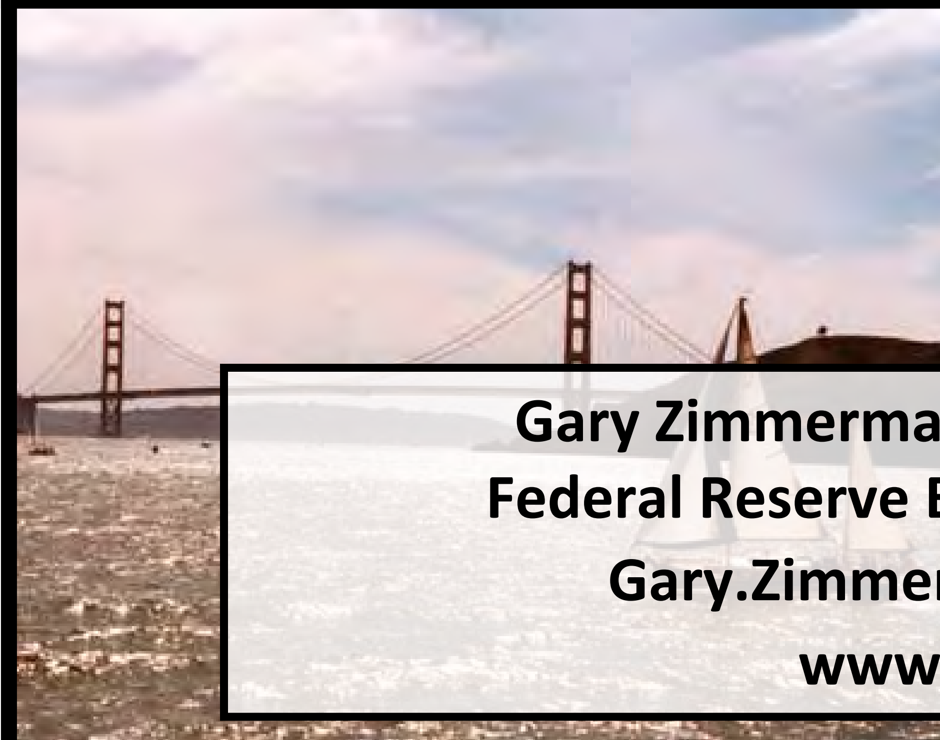
Summary Points

- **Financial crisis effects likely will result in a relatively slow recovery.**
- **Moderate recovery has begun, but underutilized capacity and a high unemployment rate are expected to persist for some time.**
- **Inflation appears to be trending lower as slack restrains cost pressures and inflation expectations.**
- **Fed’s unconventional lending facilities and asset purchases have been completed.**

Questions?



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Balance Sheet Management Tools

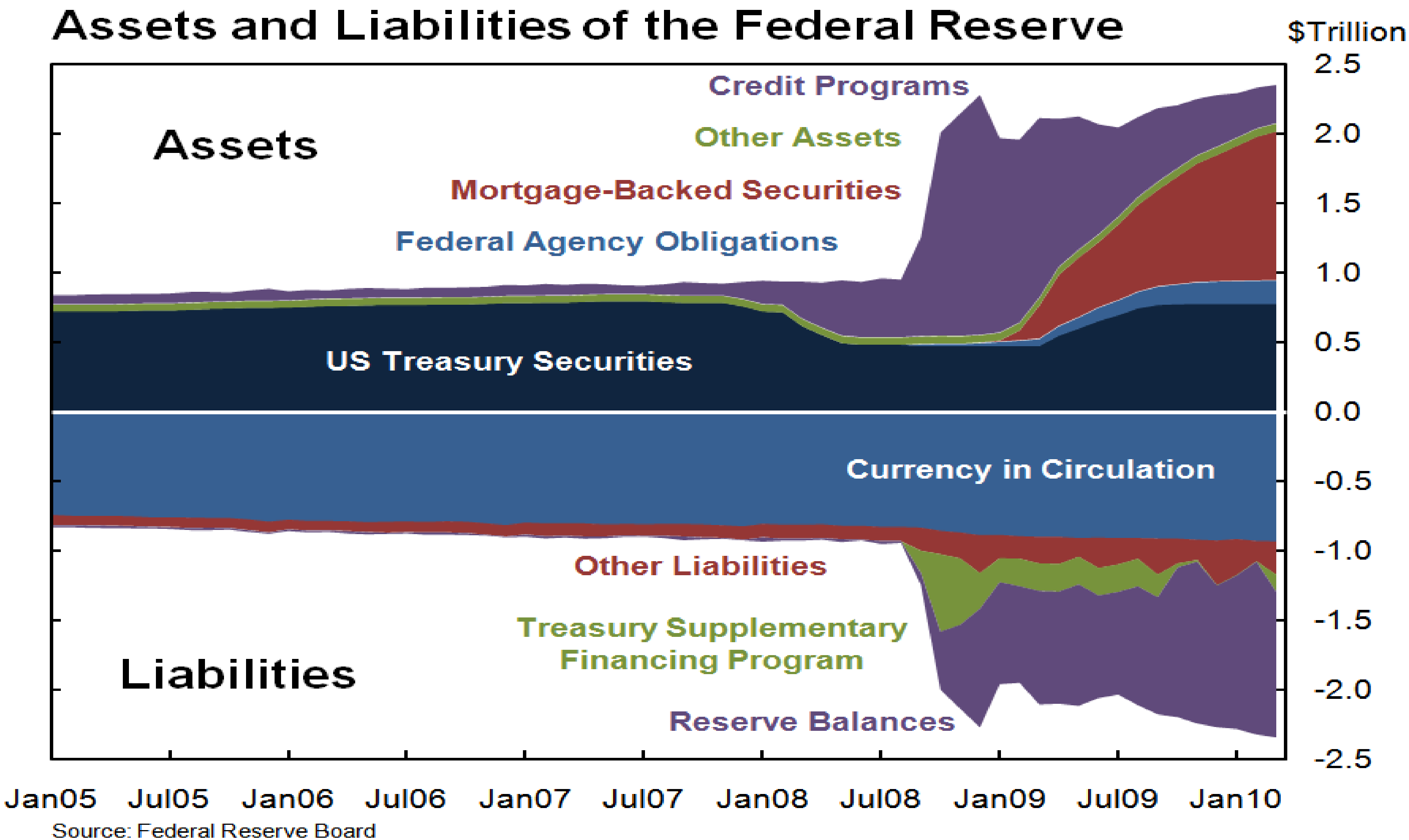
1. **Inducement for depositories to hold excess reserves**
   - **Paying interest on excess reserve balances (IOER)**
     - IOER has allowed the Fed to expand its balance sheet through the unconventional tools even with a target fed funds rate in the zero to 25 basis point range
     - When the Fed needs to remove monetary accommodation, raising the IOER rate will allow the fed funds rate (and other short-term interest rates) to rise even with unusually high levels of excess reserves

2. **Tools for reducing the excess reserves**
   - **Large scale Reverse Repurchase Agreements (RRPs)**
     - Replaces excess reserves held by depositories with RRP liabilities of the Fed, without reducing the size of the Fed's balance sheet

   - **Term Deposit Facility (TDF) at the Federal Reserve**
     - Replaces excess reserves held by depositories with term deposits held by depository at the Fed, without reducing the size of the Fed's balance sheet

   - **Asset Sales**
     - Reduces excess reserves by shrinking the Fed's balance sheet

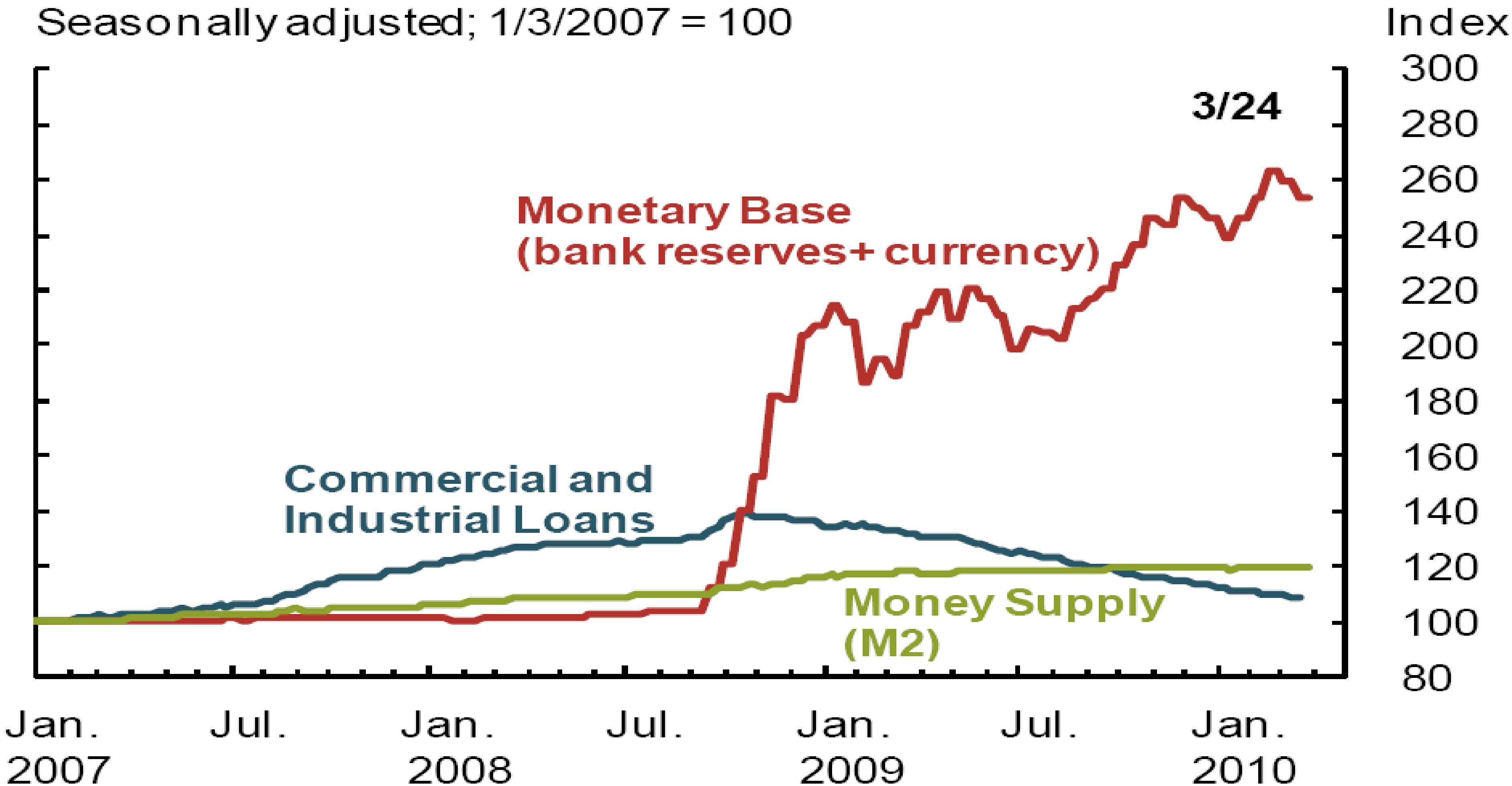
Dramatic Change in Size and Composition of the Federal Reserve's Balance Sheet



The Fed's Balance Sheet Expansion Has Not Caused Similar Growth in the Money Supply: New Tools to Control Bank Reserves

Monetary Base, Money Supply, and Bank Loans

Seasonally adjusted; 1/3/2007 = 100



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