

PORTLAND STATE  
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# **University Symposium Economic Briefing**

*November 30, 2006*

**Gary Zimmerman, Senior Economist**

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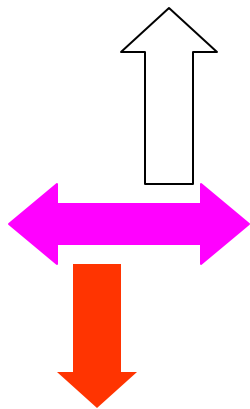
**Federal Reserve Bank of San Francisco**

# ***FOMC Simulation: Part I***

***Fed Economists will discuss:***

- I. Current state of the economy**
- II. Forecast**
- III. Potential risks to the forecast**
- IV. Policy alternatives**

# I. *Current Indicators: Big Picture*



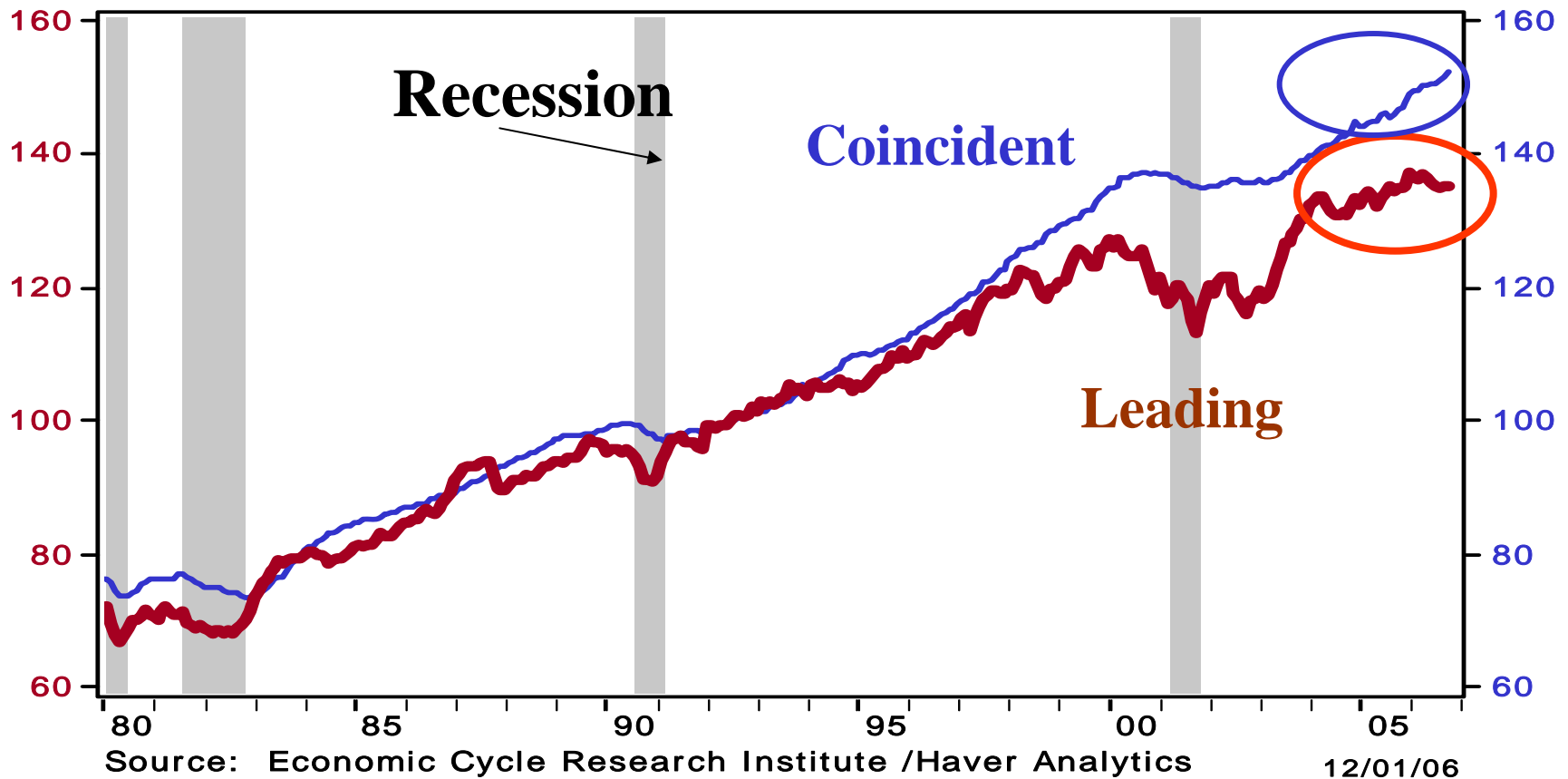
- ***Indicators: Expansion***
  - Output growth moderating
  - Job market tightening
  - Core inflation relatively high and risk elevated
- ***Concerns: Key issues***
  - Housing markets
  - Energy impacts
- ***Policy: “Moderately restrictive”***

**Janet Yellen, speech 10/16/2006**

# *Business Cycle Indicators: Moderation in Sight as Leading Indicators Flatten*

ECRI Weekly Leading Index  
1992=100

ECRI Coincident Index  
1992=100



# *Focus: Economic Expansion* **Moderates**

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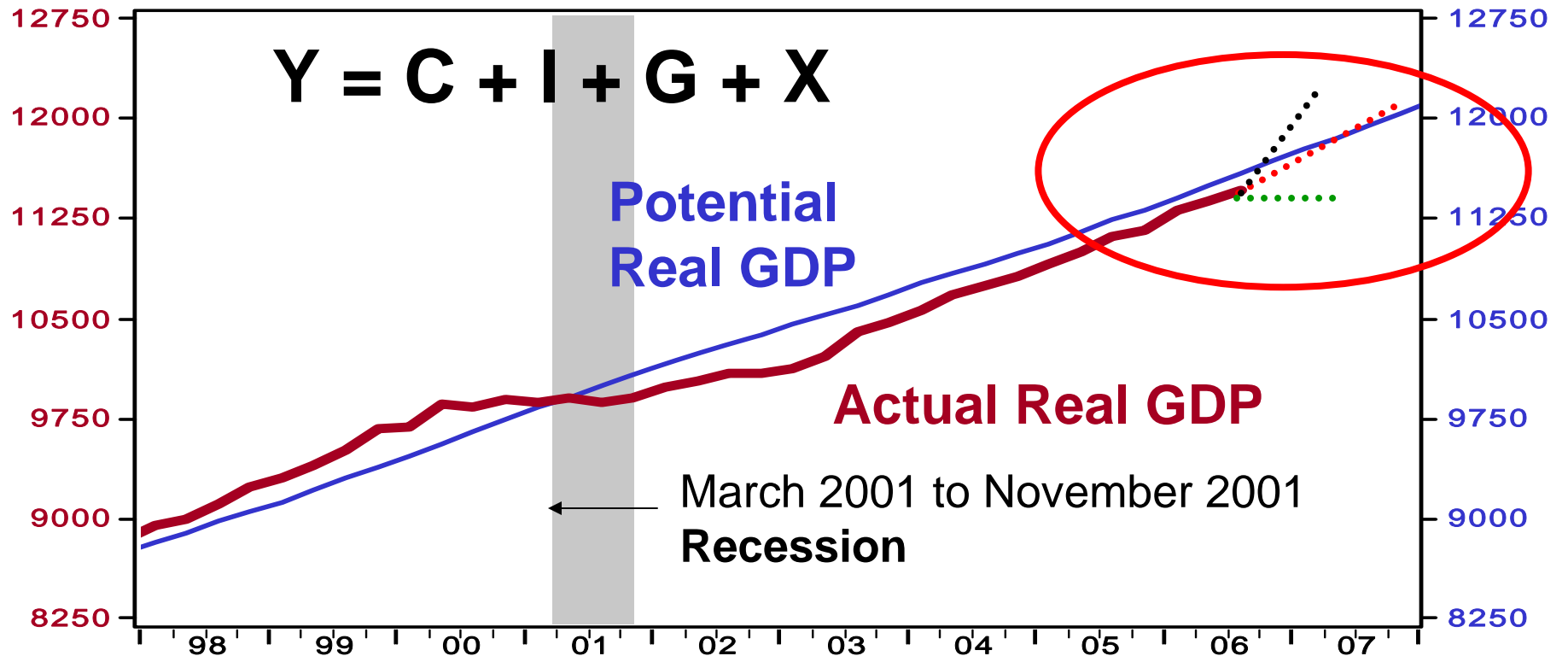
- *Real Gross Domestic Product (Output)*
  - Real GDP growth rate slowed to 2.2% in 2006:Q3 (preliminary estimate)—(up from initial 1.6% advanced figure)
  - Housing and vehicles cause slowing
- *Labor market tightening*
  - Unemployment rate down to 4.4%
  - Added 92,000 jobs in October (below average, but previous months strong)

# *U.S. Economic Output (Real GDP) Expands Toward Potential Growth Path—Significance: Full Employment? Inflation Pressure?*

Real Gross Domestic Product  
SAAR, Bil.Chn.2000\$

**Billions of 2000\$**

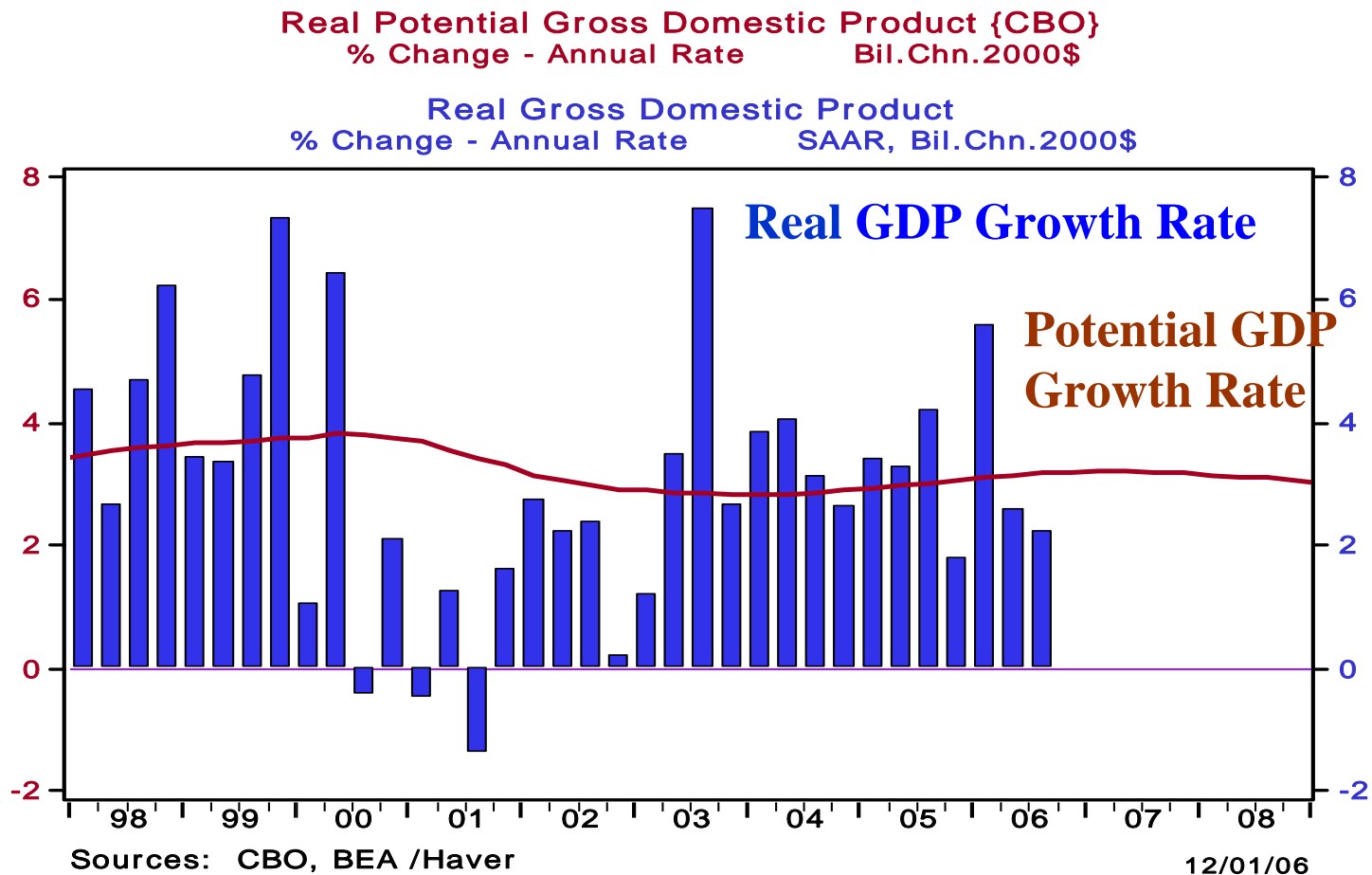
Real Potential Gross Domestic Product {CBO}  
Bil.Chn.2000\$



Sources: BEA, CBO /Haver

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# Comparing Real GDP Growth Rates: Actual is Well Below Potential

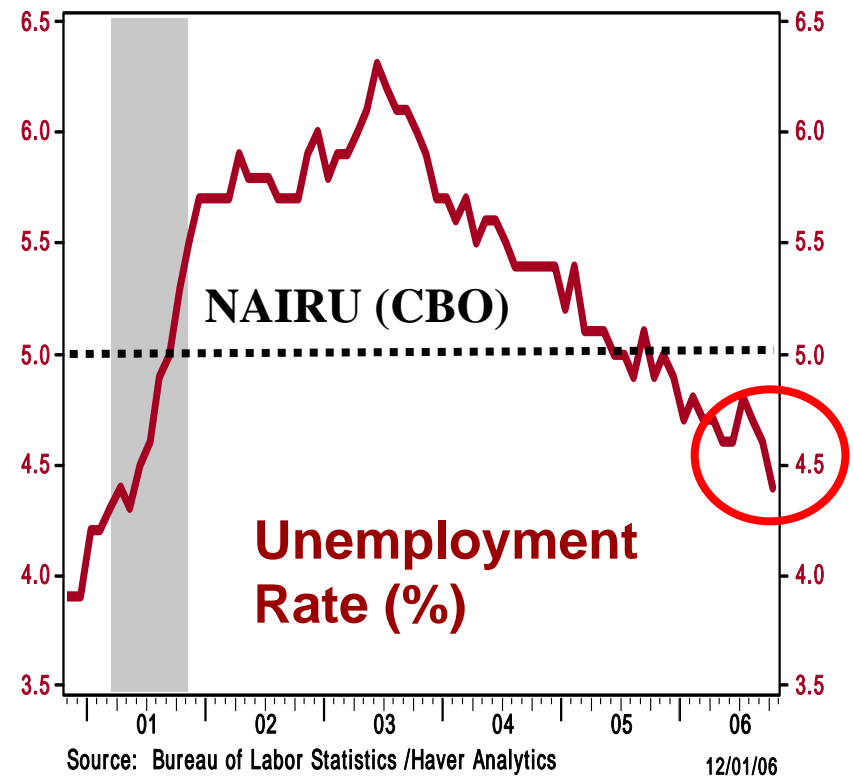


# U.S. Job Market Trends: Continued Improvement

## Number of Payroll Jobs (000s)



## Unemployment Rate (%)



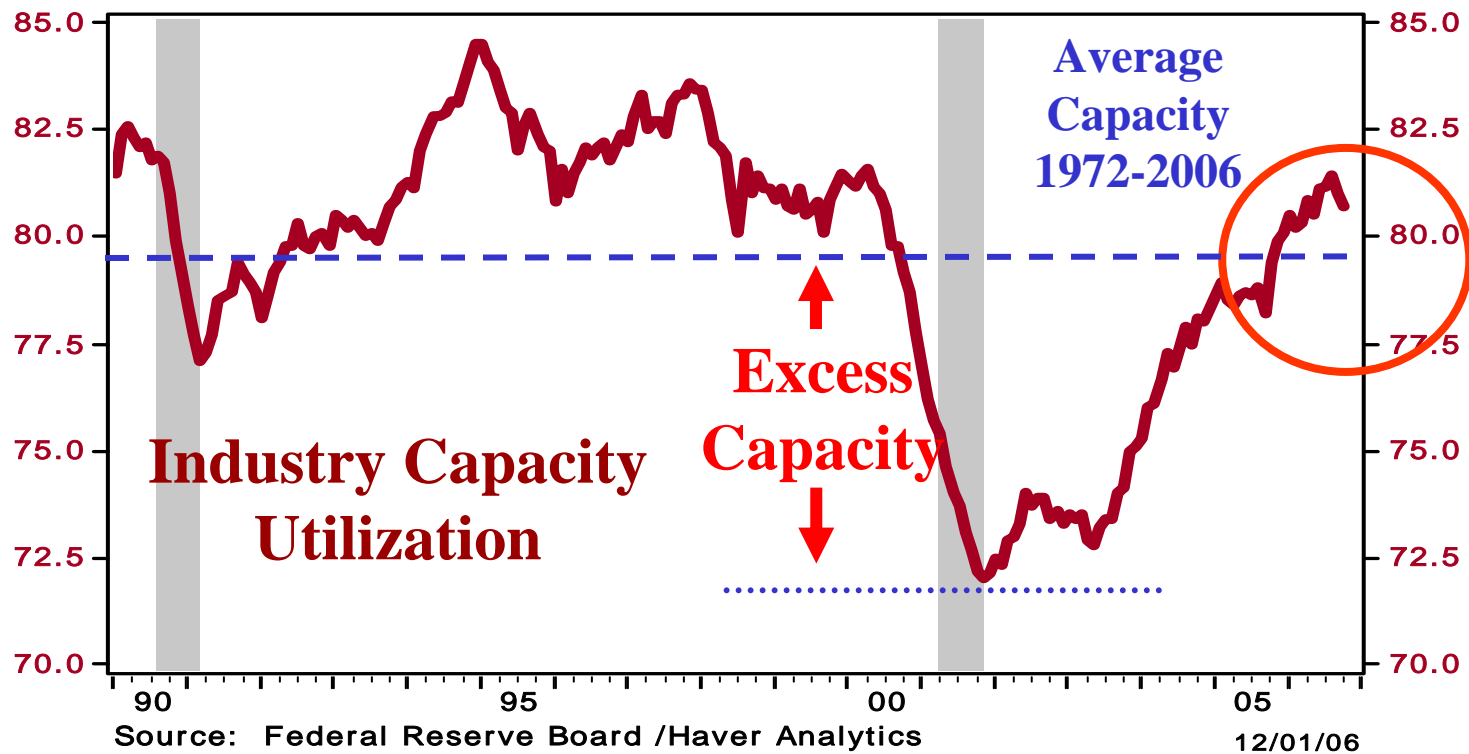
**CBO = Congressional Budget Office**



# *Manufacturing Excess Capacity is Limited: Capacity Utilization Above Long-Term Average*

Capacity Utilization: Manufacturing [SIC]

SA, Percent of Capacity





# ***Beige Book: Survey Released on November 29, 2006***



2006

Summary of Commentary on  
**Current Economic Conditions**  
by Federal Reserve District

<http://www.federalreserve.gov/FOMC/BeigeBook/2006/20061129/default.htm>

- ✓ Continued moderate growth
- ✓ Continuing softness in vehicle and housing-related sales
- ✓ Cautiously optimistic outlook for holiday season retail sales
- ✓ Labor markets tight, especially for highly-skilled occupations
- ✓ Wage pressures for some specialized professions

## *Consumer Sector: Spending Still Helping the Expansion*

- *Consumers: Still spending*

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- **Retail sales**

- Concerns about future spending
- Vehicle sales

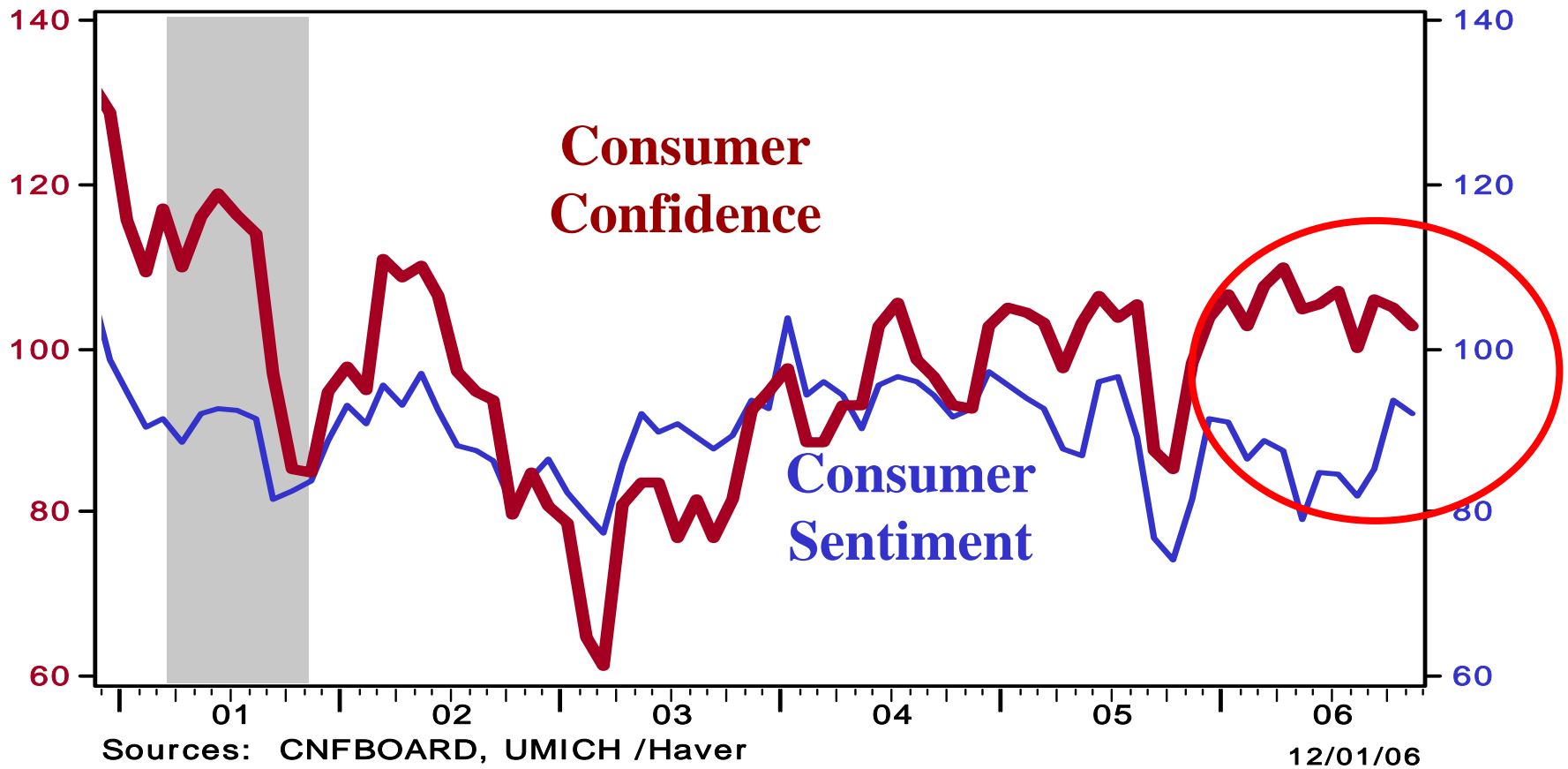
- **Consumer surveys moved by:**

- Energy
- Interest rates
- Housing and stock market wealth
- Jobs

# *Consumer Surveys: Implications for Future Spending?*

Conference Board: Consumer Confidence  
SA, 1985=100

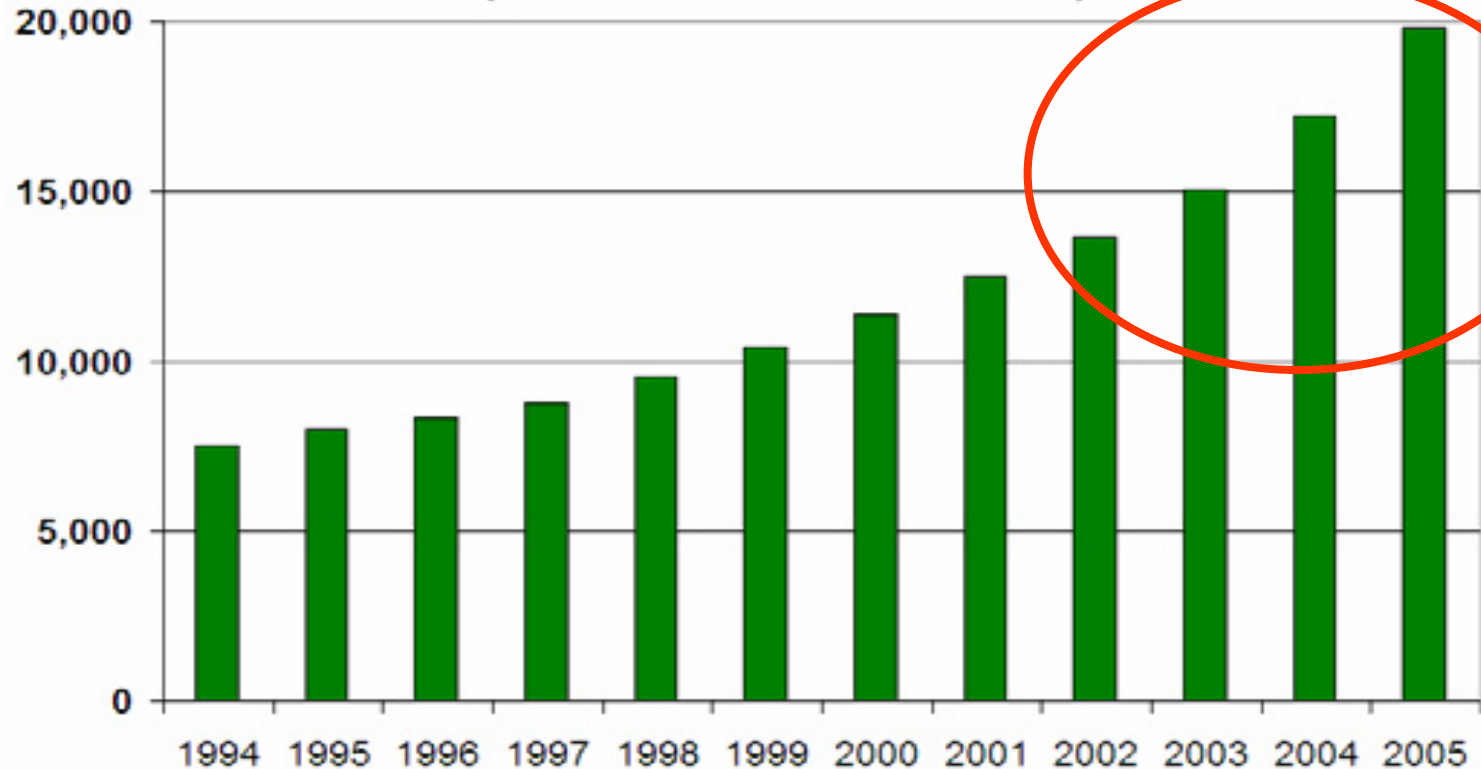
University of Michigan: Consumer Sentiment  
NSA, Q1-66=100



# *The Wealth Effects: Rising Housing Market Values → Boosted Spending*

## Household Real Estate Assets

(current dollars, in billions)



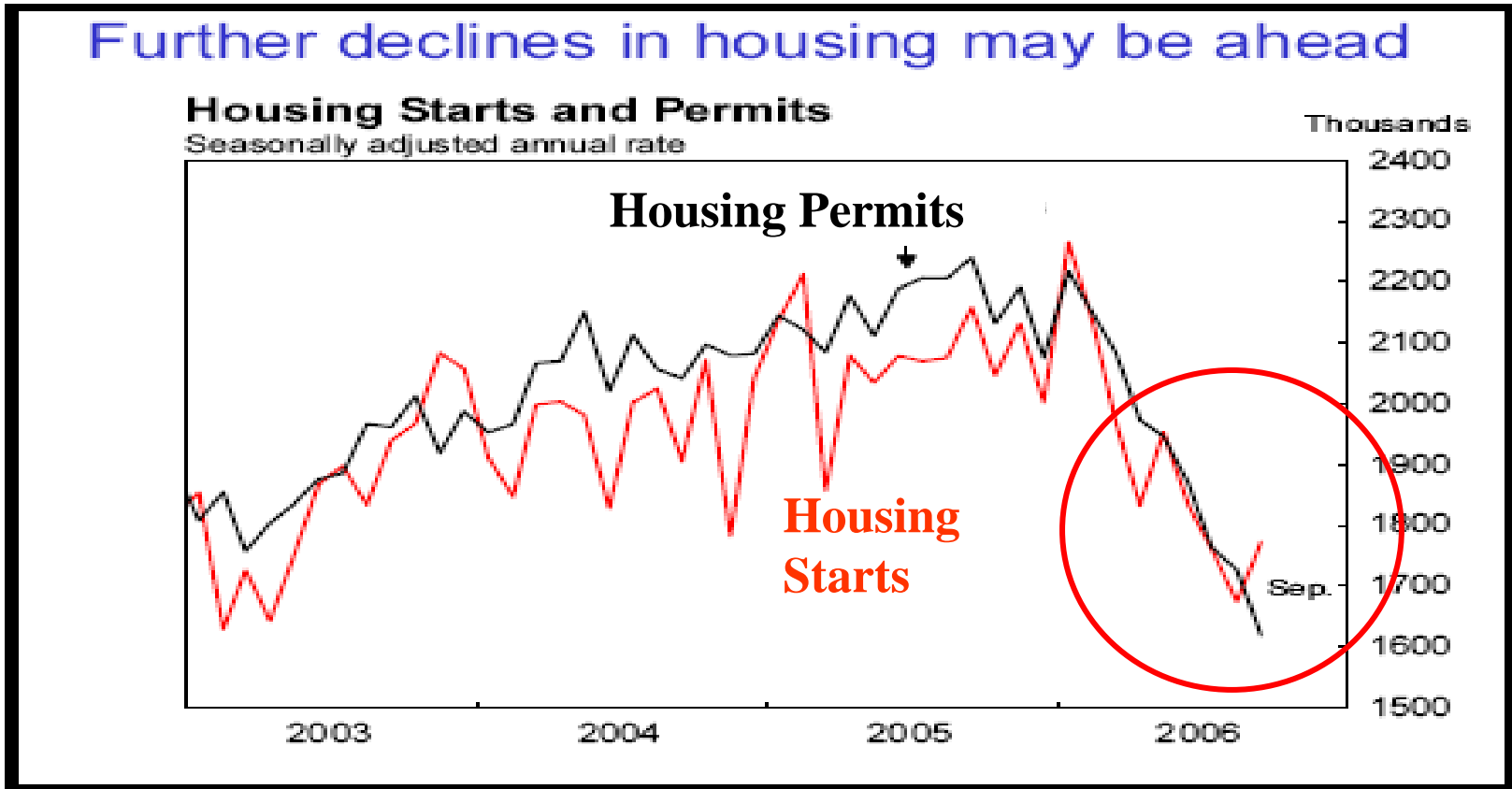
Source: Federal Reserve Board, Flow of Funds, 2005.

# ***Key Investment Components:*** **Investment Contributes to Growth**

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- ***Technology***—investment climbing
  - Computer hardware and software
  - User cost of capital remains low
- ***Commercial Structures***—recovering
  - Vacancies and rents
- ***Residential Structures***—downturn
  - Sales and new activity down sharply
  - House price appreciation—turning negative by some measures

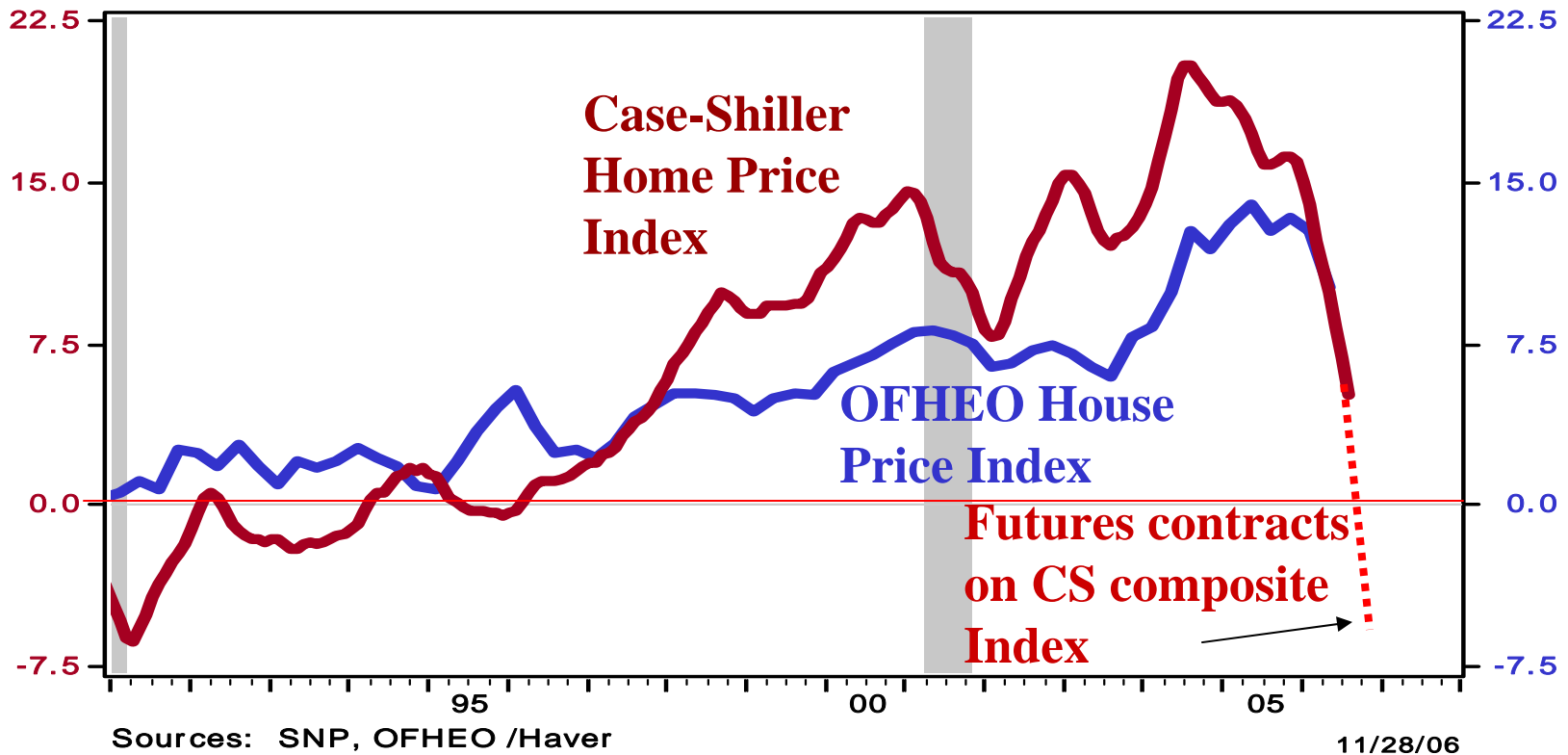
# *FRBSF Real GDP Forecast: Housing Slowdown Impacts Growth*



# Case-Shiller House Price Futures: Suggest Falling Prices

S&P/Case-Shiller Home Price Index: Composite  
% Change - Year to Year Jan-00=100

House Price Index, United States  
% Change - Year to Year NSA, Q1-80=100





# Stimulative Fiscal Policy

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## Fiscal stimulus

- Boosting demand
- Large deficits
- Defense spending
- Tax cuts

# *International Considerations:* **Deficit Puts Pressure on the Dollar**

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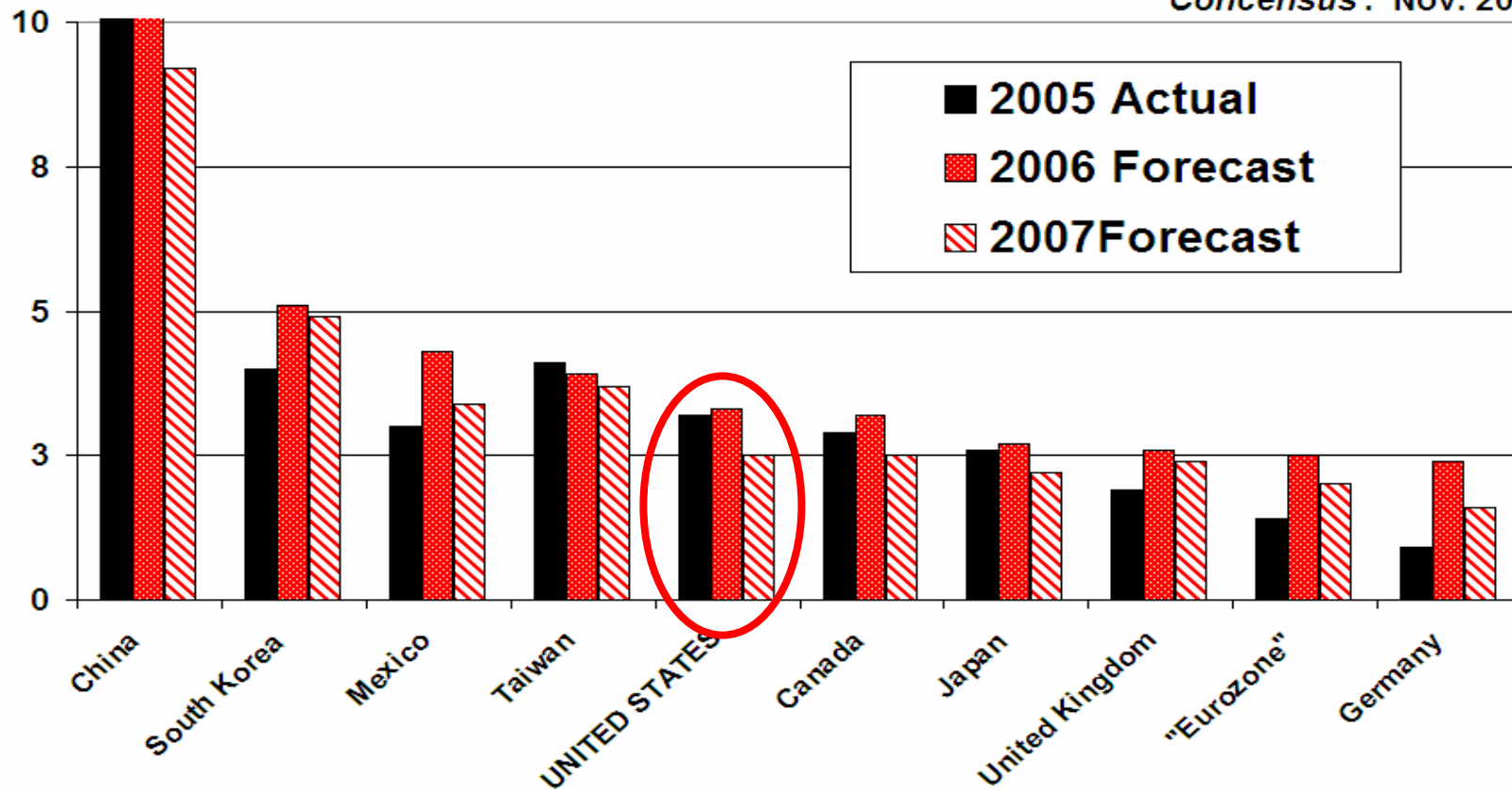
- *Large and persistent deficits*
  - Increased U.S. demand for foreign capital
  - Risks of sudden reversal?
  - Downward pressure on the dollar
- *Dollar remains low*
  - Helps pricing of U.S. exports
  - Higher import prices: inflation pressure
  - Adjustment limited by currency pegging
- *Overseas economies*
  - Growth trends of key trading partners
  - Demand for U.S. debt and assets

# World Economy: Blue Chip International Projects Strong Growth in 2006 to Slow Somewhat in 2007

## International Economic Forecasts for 2006 and 2007

Percent Change in Real GDP by Year by Country

Blue Chip International  
Consensus: Nov. 2006

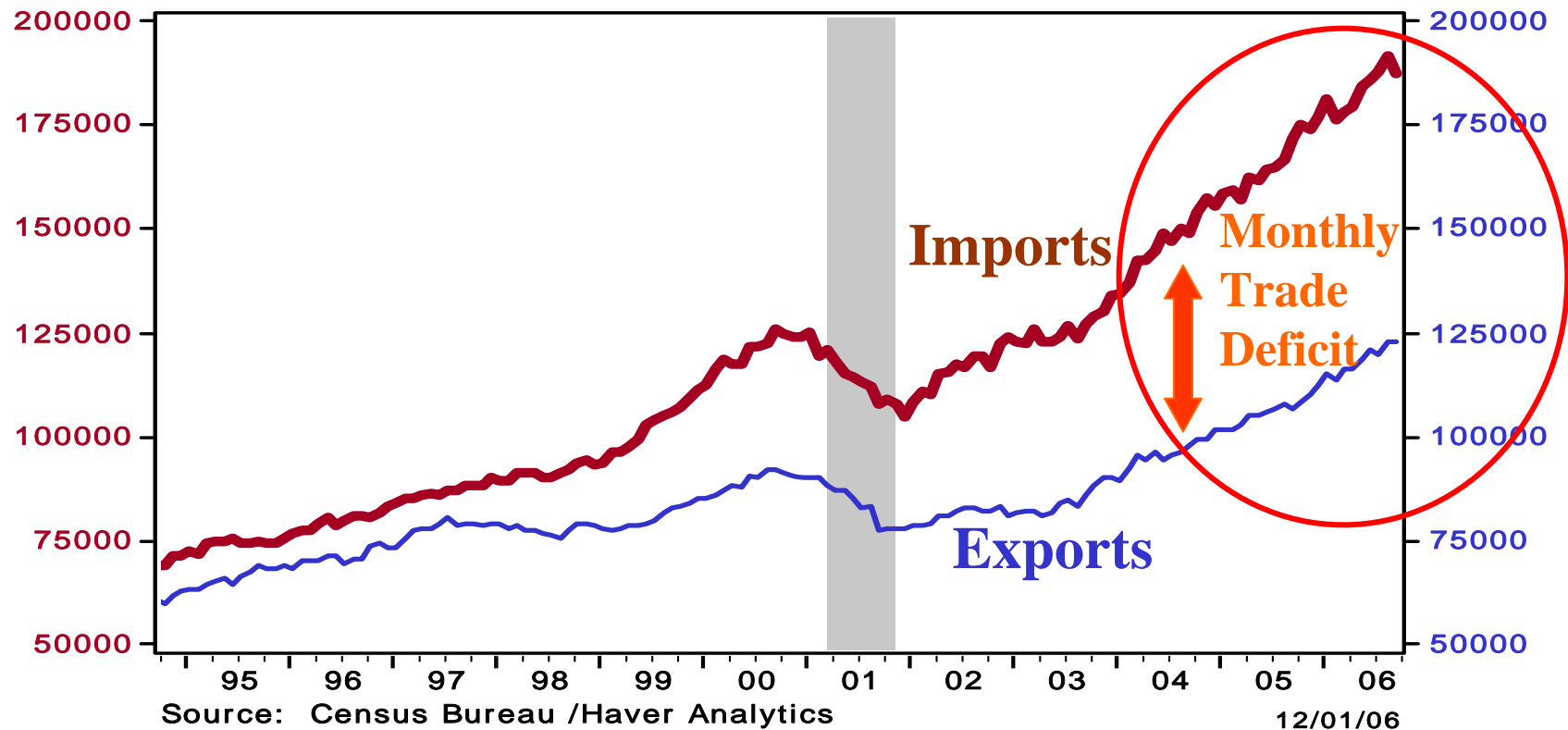


# *International Trade:* Trade Deficit Continues to Grow

Imports: Goods and Services, BOP Basis  
SA, Mil.\$

Exports: Goods and Services, BOP Basis  
SA, Mil.\$

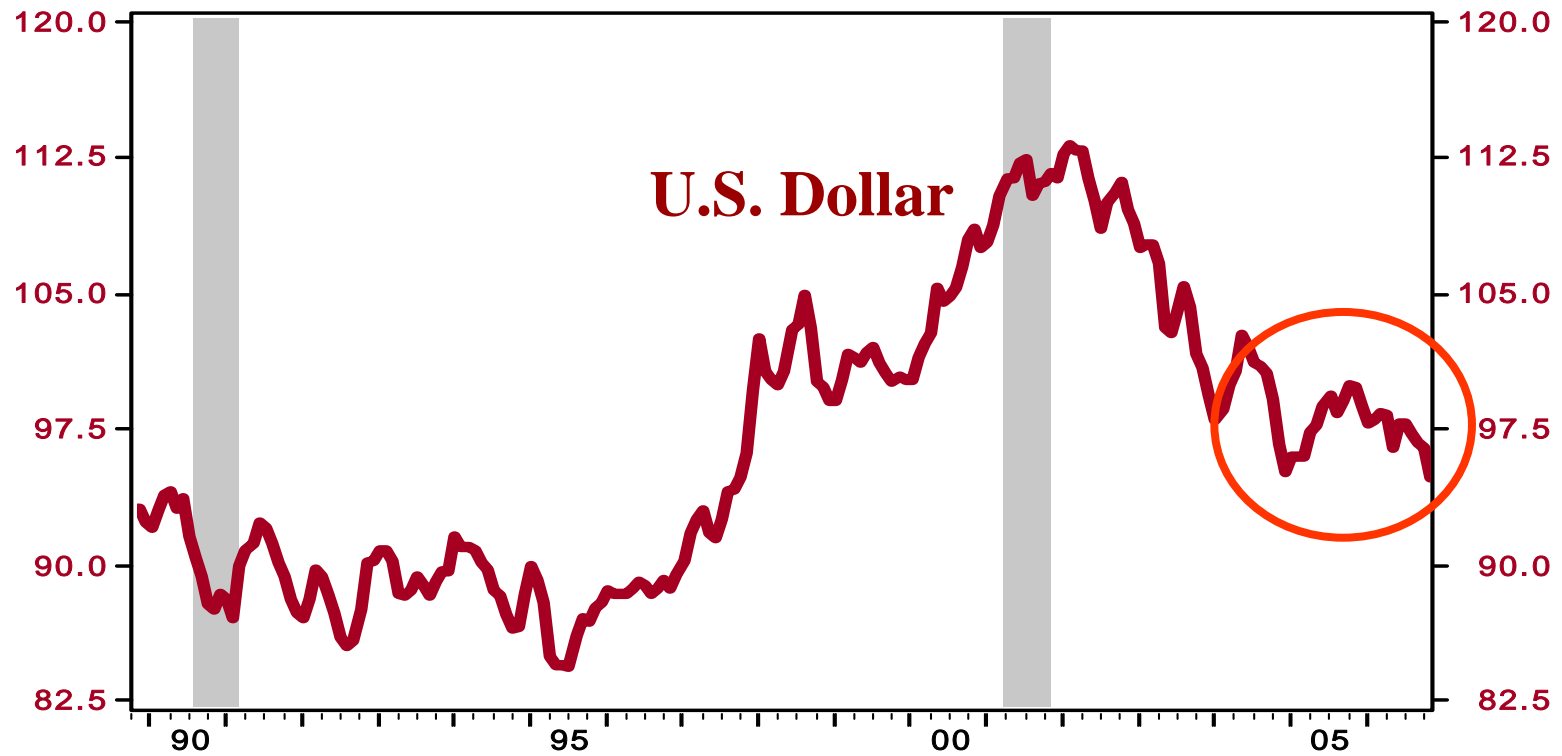
Record 2005  
Trade Deficit of  
\$726 Billion



# *Foreign Exchange Markets:* **Dollar Remains Low...**

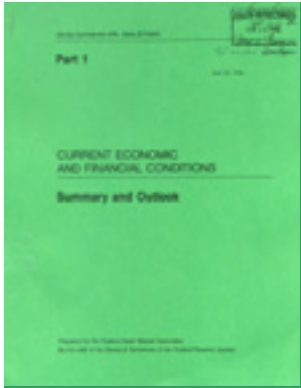
Real Broad Trade-Weighted Exchange Value of the US\$

Mar-73=100



Source: Federal Reserve Board /Haver Analytics

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## II. FRBSF *FedViews* Forecast

“Neutral!”

### *Outlook for 2006 and 2007*

• **FRBSF FedViews**  
**Forecast:**

– Available at [www.frbsf.org](http://www.frbsf.org)

• **Blue Chip Consensus**  
**Forecast comparison:**

– Survey of 50 forecasters

- **Moderation in GDP Growth**
- **Gradual Moderation in Core Inflation**



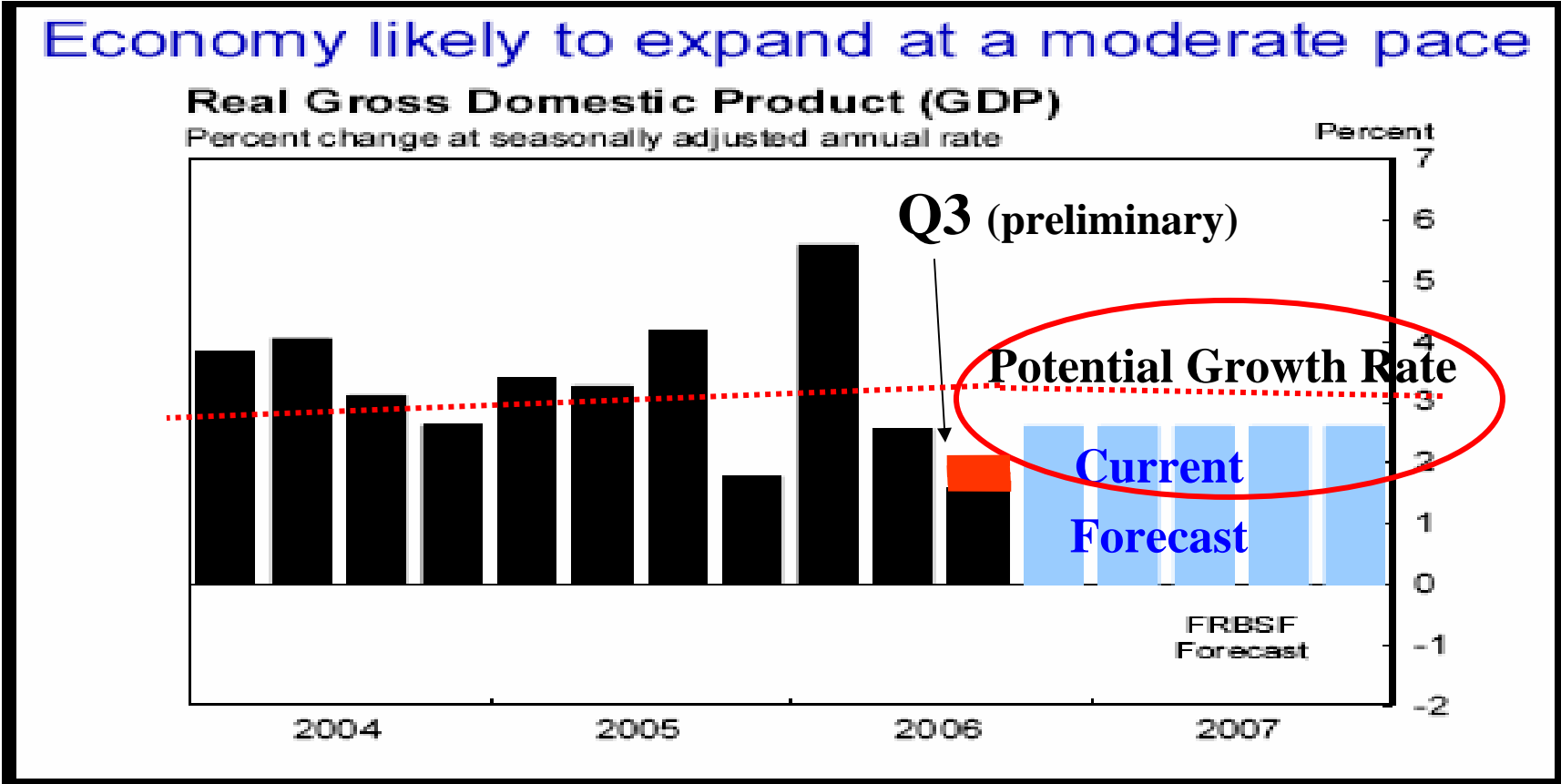


# ***2006 U.S. Forecast: Continued Growth Expected***

	FedViews	Blue Chip	
	2006:Q4 & 2007	2006	2007
GDP Growth Rate	2.5 % - 2.75 %	3.30%	2.50%
Core PCE Inflation	at 2.5%, trending down to 2% by 2008	2.4% (Dec/Dec)	2.1% (Dec/Dec)

From Nov. 10, 2006, *FedViews* & Nov. 10, 2006 *Blue Chip Economic Indicators*

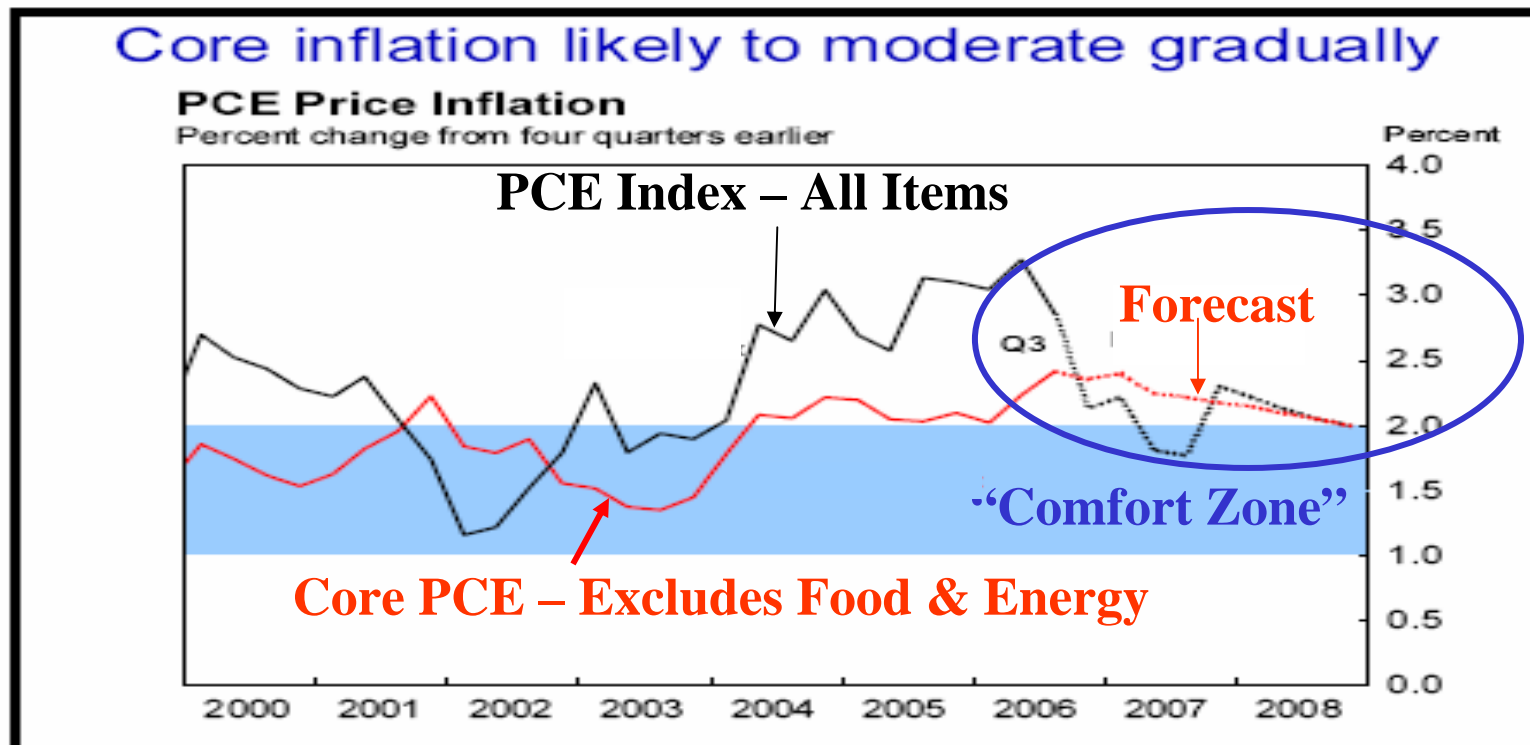
# *FRBSF Real GDP Forecast: Slightly Below Average Growth for 2007*





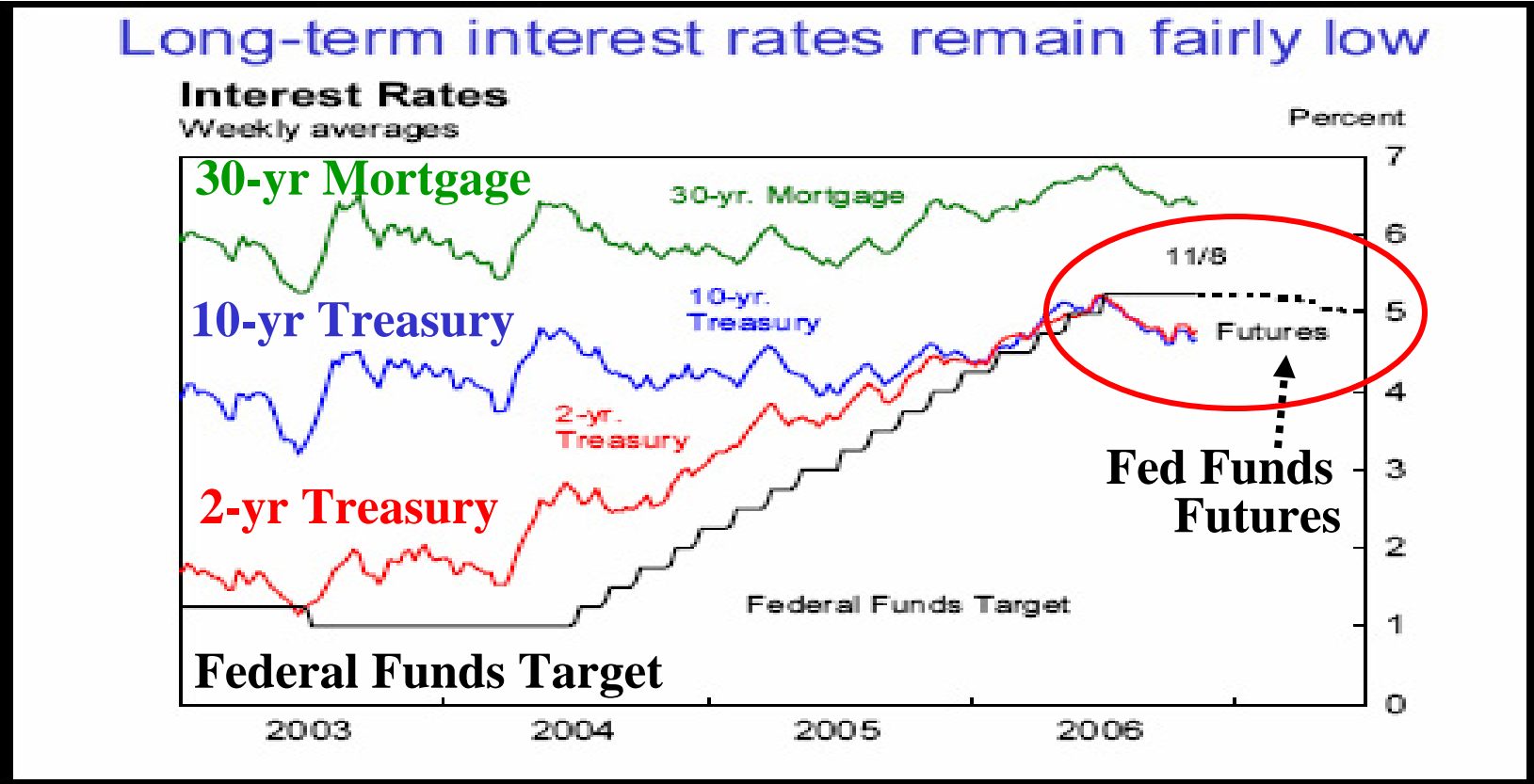
# *FRBSF Core PCE Inflation Forecast: Core Inflation to Fall as Growth Moderates*

**Personal Consumption Expenditures (PCE) Inflation: Overall vs. Core**



*FedViews* of November 10, 2006

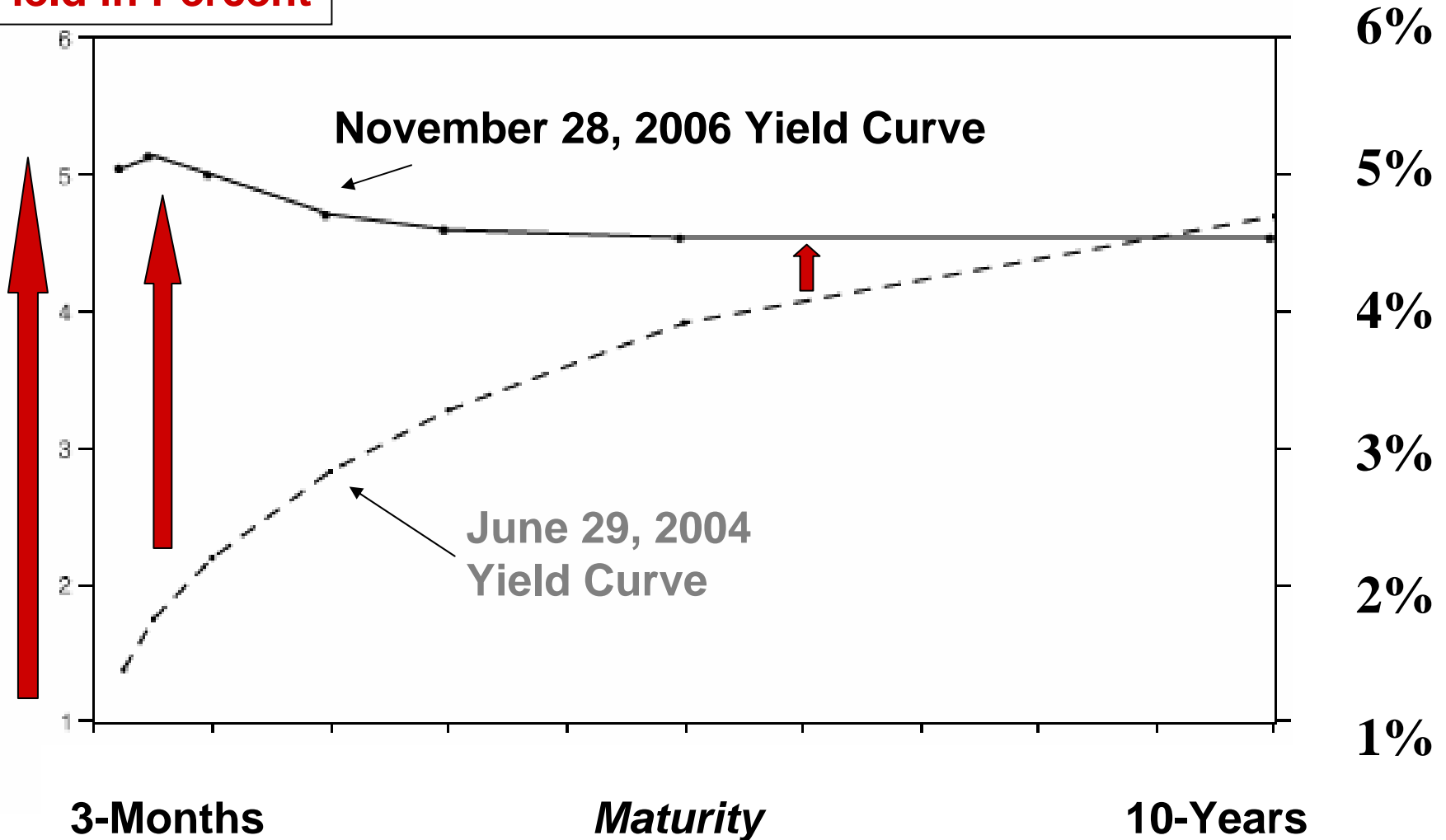
# Market Interest Rates and Fed Funds Futures Forecast: Flat Through Early 2007



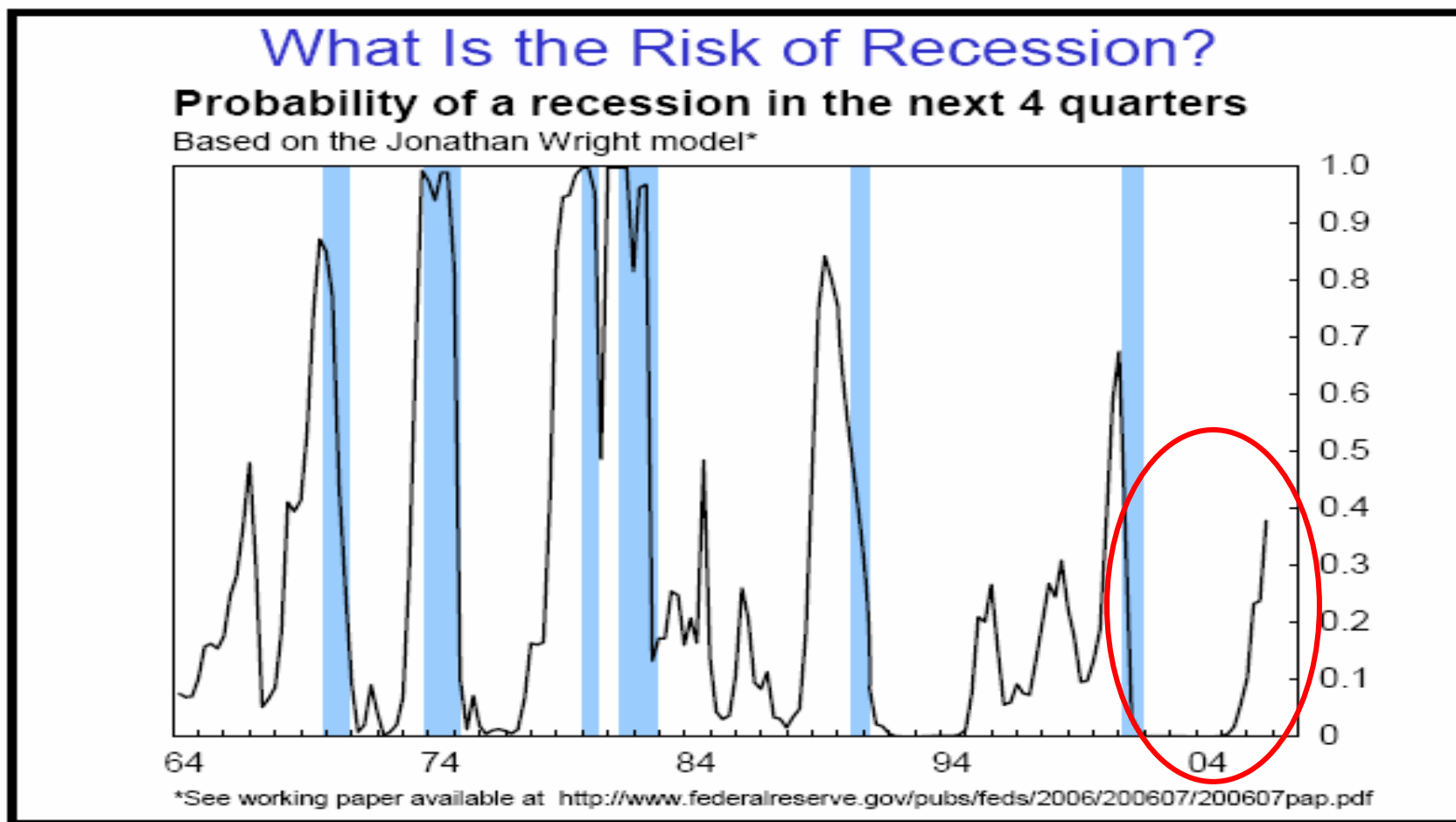
# *Yield Curve – Humped:* **Inflation Expectations Contained?**

US TREASURY YIELD CURVE

**Yield in Percent**



# *FRBSF Real GDP Forecast:* **Probability of a Recession is Up**



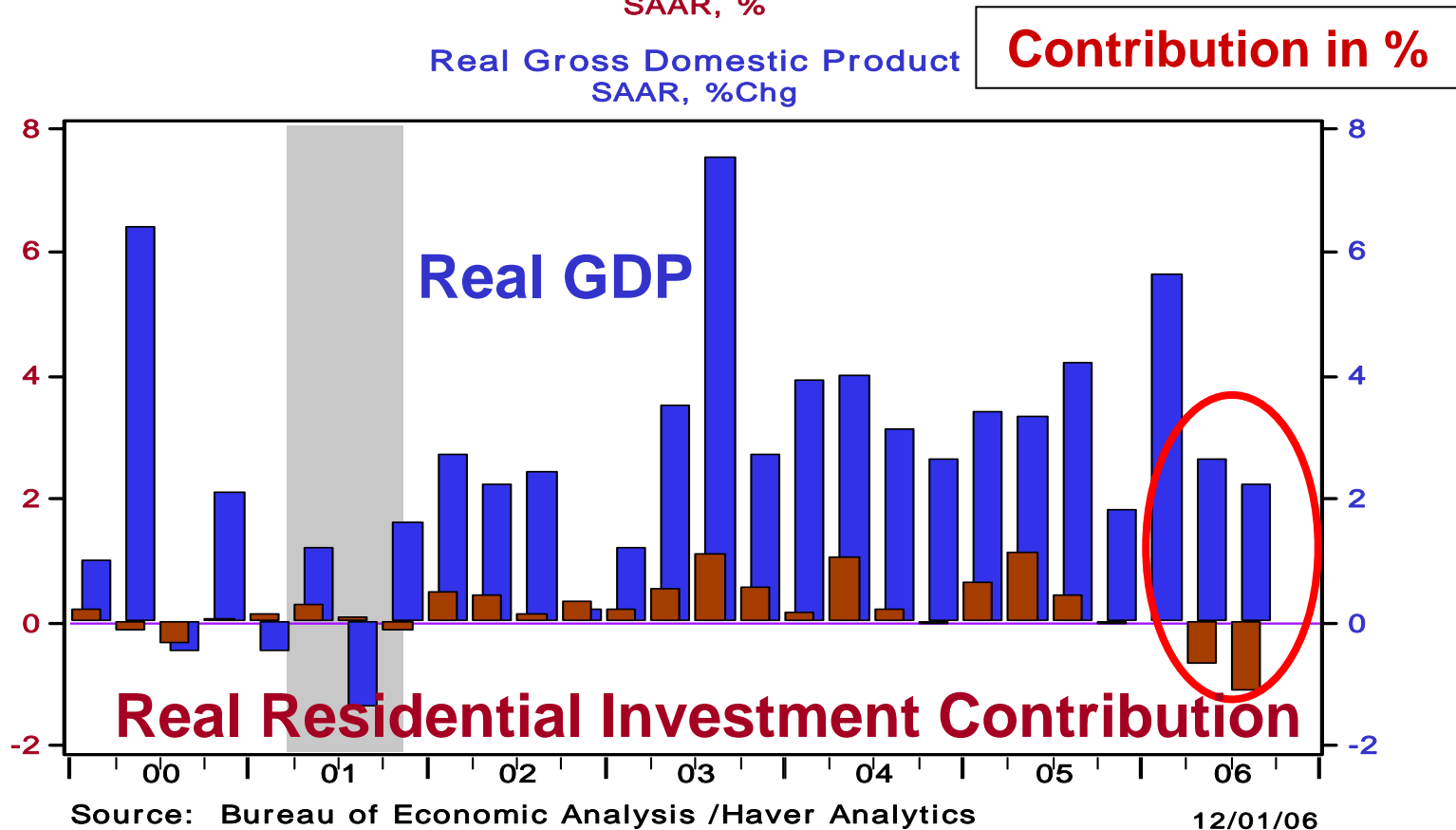
*FedViews* of October 16, 2006

# III. Potential Risks to the Forecast

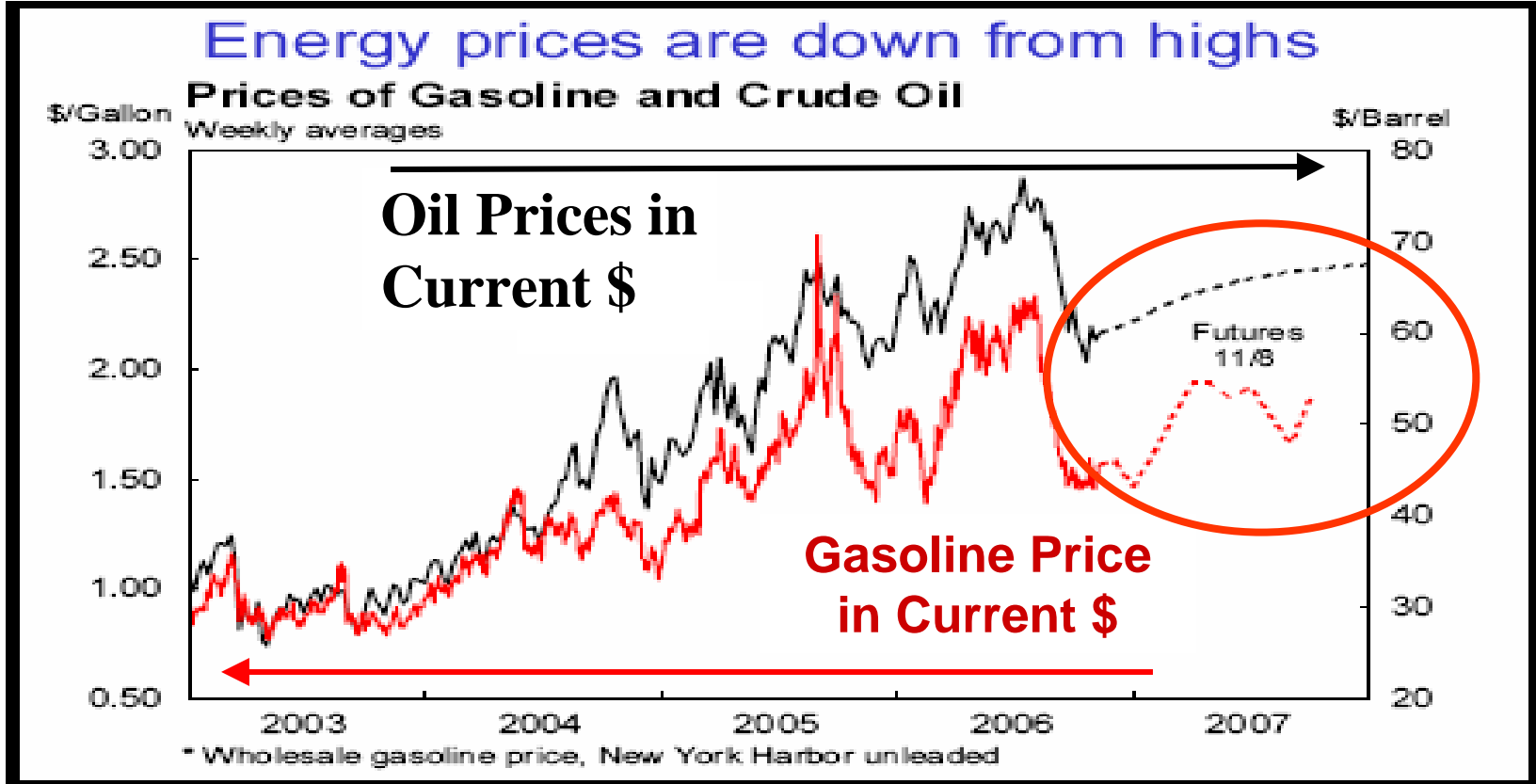
- *Oil and natural gas?*
- *Productivity?*
- *Housing?*
- *Deficits?*
- *Dollar?*
- *Supply of foreign capital?*
- *SHoCKS ???*

# Real GDP Growth: Reduced by Decline in Real Residential Investment

Real Residential Investment: Contribution to Real GDP Change  
SAAR, %



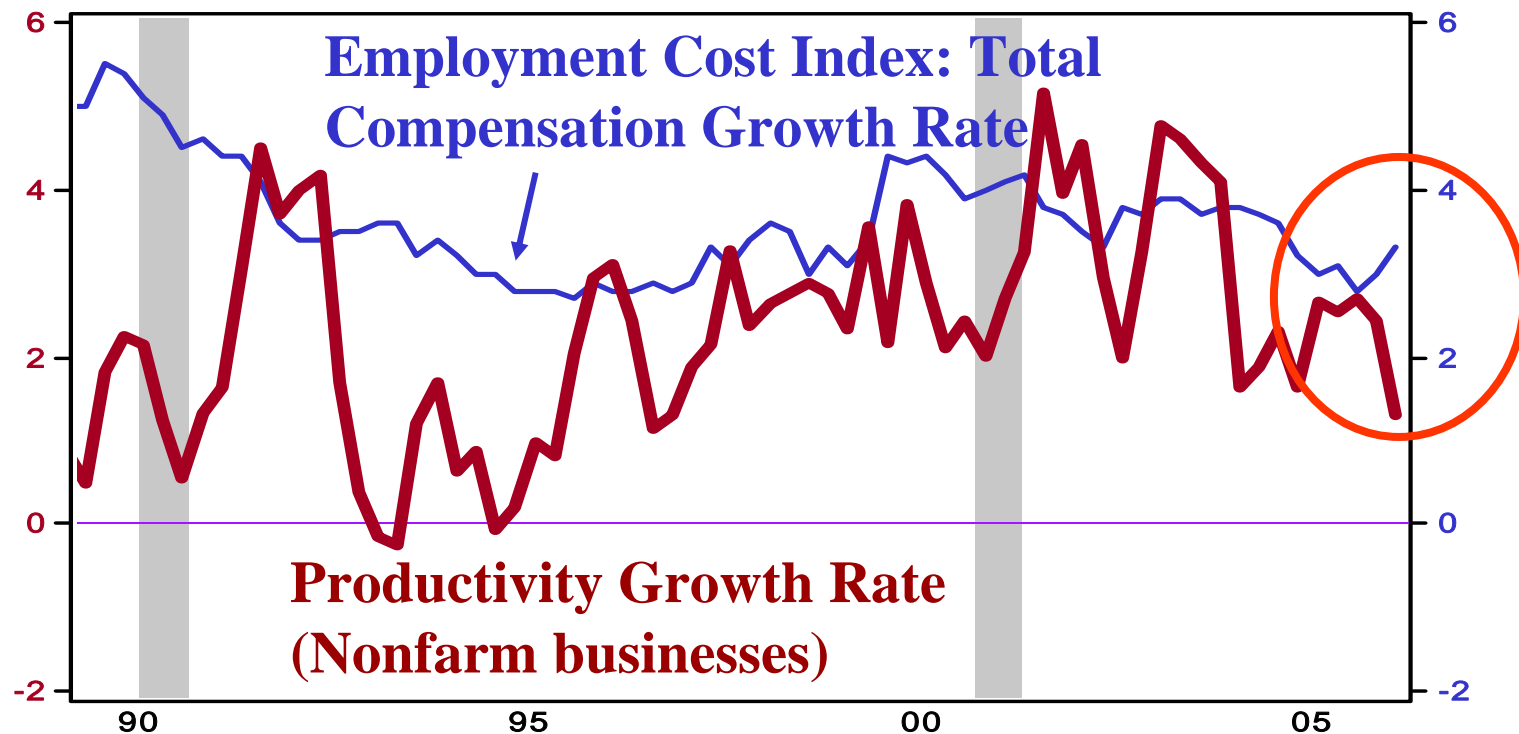
# Cost of Energy: Energy Prices Subside, but Remain High



# *Productivity Growth: Diverges from Compensation Growth*

Nonfarm Business Sector: Output Per Hour/All Persons  
% Change - Year to Year SA, 1992=100

ECI: Compensation: Civilian Wkrs  
NSA, 12-Mo %Chg



Source: Bureau of Labor Statistics /Haver Analytics

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## IV. Policy Alternatives

*Things to consider:*

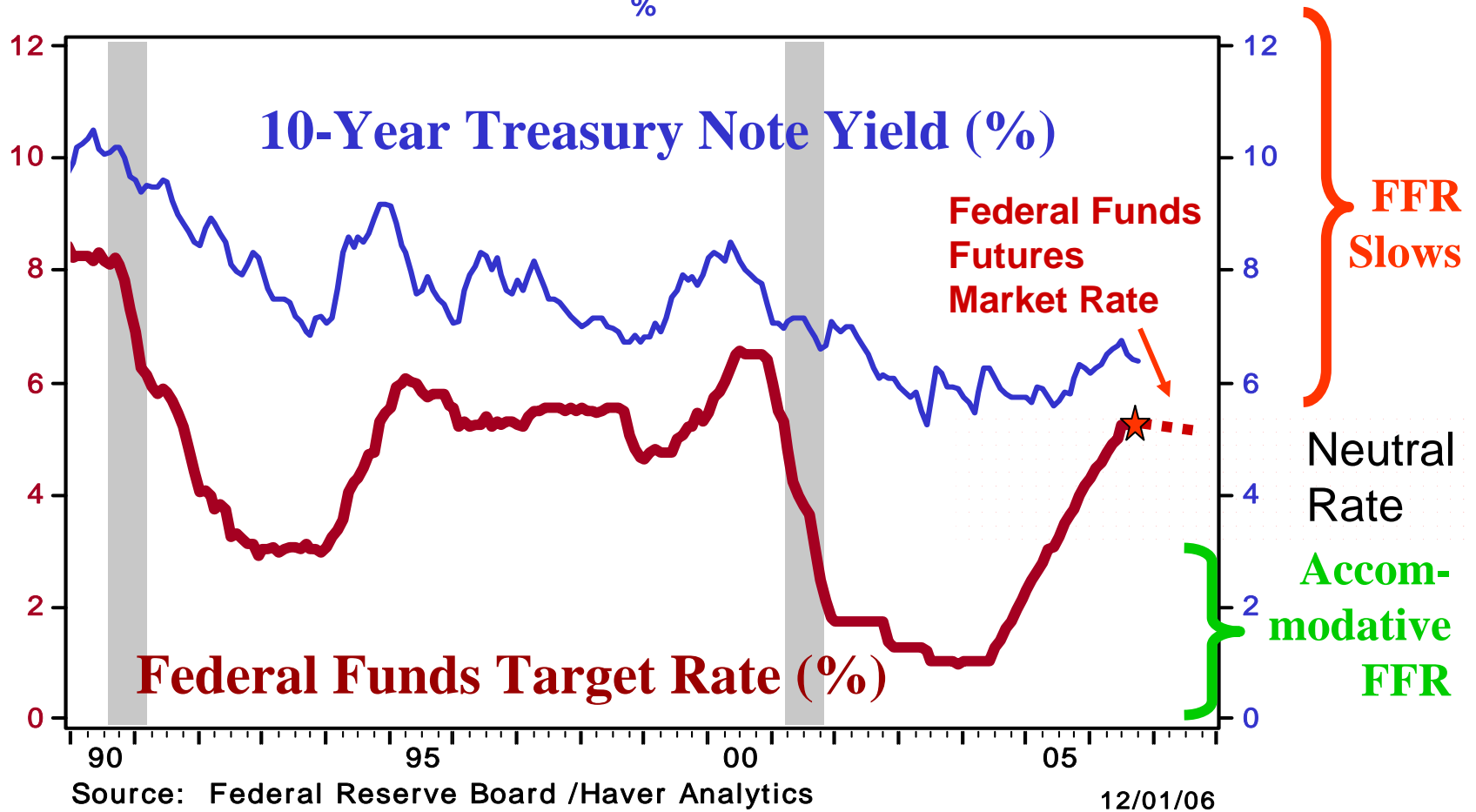
- **Policy Decision and Magnitude**
  - a. Lower Fed funds target rate to 5.00%
  - b. Hold rates constant at 5.25%
  - c. Raise rates to 5.5%
- **Impacts on the economy?**
  - Size and timing
- **Market expectations?**

# Monetary Policy: Fed Funds Rate is at the Top of Neutral Range

Policy  
Real Effect

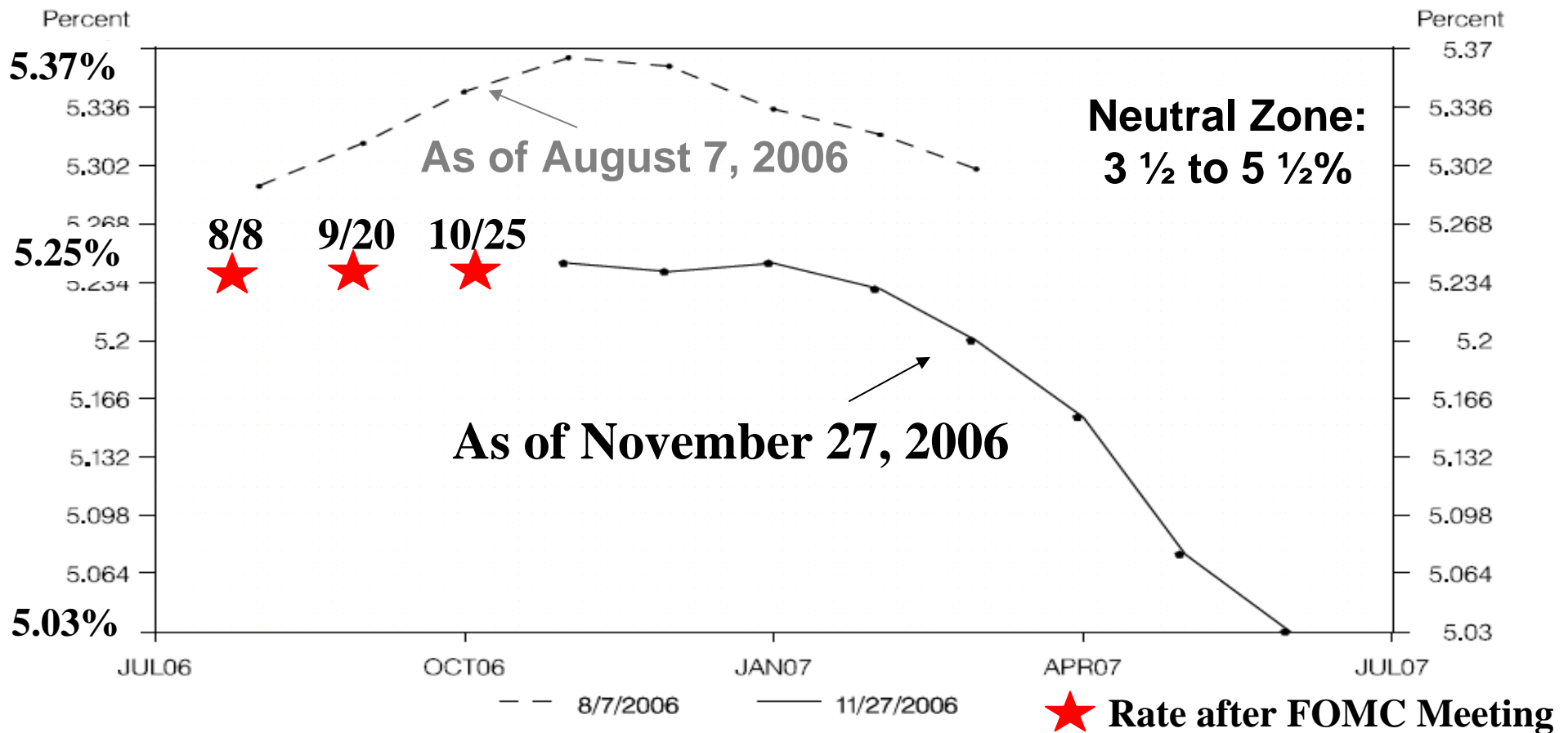
Federal Funds [effective] Rate  
% p.a.

Contract Rates on Commitments: Conventional 30-Yr Mortgages, FHLMC  
%



# Conclusion—Market Expectations for the Funds Rate: August 7, 2006 vs. November 27, 2006

FORWARD FED FUNDS RATE IMPLIED FROM FED FUNDS FUTURES



Note: Based on Federal Funds Futures after adjusting for a one basis point per month term premium

# ***FOMC Simulation: Part II***

*Student teams taking the role of  
FOMC members:*

**I. Chairman's comments and directive**

**II. "Go-around" comments:**

- Economic conditions and risks
- Monetary policy recommendations

**III. FOMC vote on the directive**

**IV. Questions**



