FEDERAL RESERVE BANK OF SAN FRANCISCO, ECONOMIC RESEARCH DEPARTMENT

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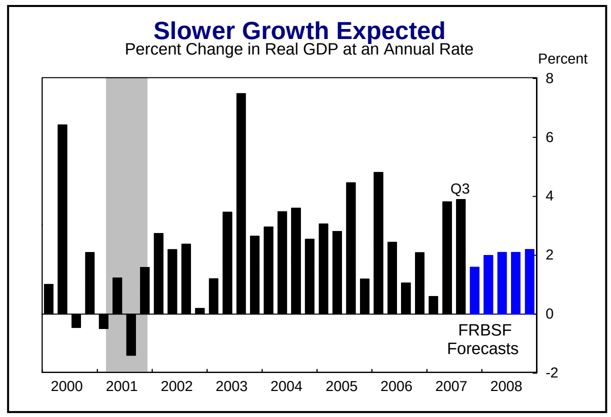
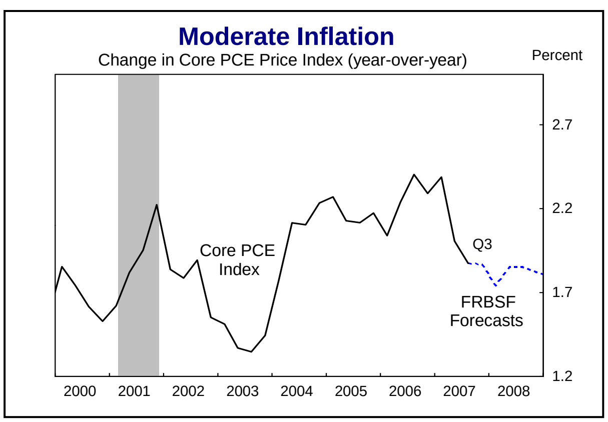
National Scene: Slower Growth Ahead

The economy posted a strong performance in the second and third quarters of this year; the preliminary estimate of third quarter real GDP growth was 3.9% following a second quarter growth rate of 3.8%. Growth in the third quarter was bolstered by a number of forces, perhaps the most important being consumer spending, which contributed 2.1 percentage points to overall growth. Consumer spending has been supported by strength in the labor market, as witnessed by employment gains averaging over 100,000 per month in the third quarter. Other sectors that contributed to growth were net exports, business investment, government spending, and inventories. The largest drag to output growth was residential investment, which posted a 20% contraction and reduced GDP growth by 1.1 percentage points. Over the past year, residential investment has directly lowered GDP growth by 0.9 percentage points. One measure of just how much residential investment has declined is housing starts. In 2005, monthly new housing starts averaged 2.1 million units at an annual rate. By October 2007, new housing starts had fallen almost in half to 1.2 million units at an annual rate.



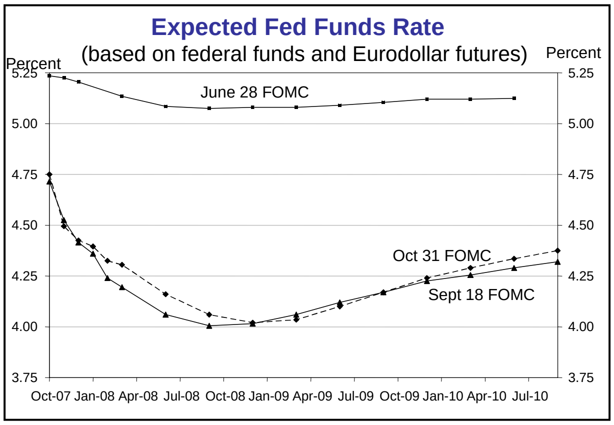
Going forward, the Federal Reserve Bank of San Francisco's *Fedviews* of October 12, 2007, forecasts that growth will slow in the fourth quarter of 2007 and then increase in 2008, but remain below potential. Factors contributing to the expected near-term slowdown include higher energy prices (which will increase the trade deficit), firms no longer boosting their inventories (or not boosting their inventories as much as they did in the third quarter), and a potential slowing in consumer spending. The softening in consumer spending may result from elevated energy prices, an increase in debt obligations connected to resets to mortgage rates, and a decline in home equity wealth due to flat or declining home prices. Another factor contributing to slower growth is residential investment, which is expected to decline further.



The most recent readings on core inflation have been moderate of late. Core personal consumption expenditure (PCE) prices increased at a 1.8% annual pace in the third quarter following a 1.4% pace in the second. On a year-over-year basis, core PCE prices have increased less than 2% each month since June. According to *FedViews*, these moderate inflation readings are expected to continue throughout the remainder of 2007 and through 2008. Factors contributing to this projected moderate inflation path include the expected softening in economic growth. However, there are several upside risks to inflation, including the effects from higher energy and commodity prices, a falling dollar, and lower productivity growth. Oil prices have been volatile as of late, increasing sharply in October (about 15%, by one measure) and remaining at elevated levels through early November.

Policy Pointers: The Fed Cuts Rates

On October 31, the Federal Open Market Committee (FOMC) reduced the target for the federal funds rate by 25 basis points to 4.5%; this action followed a 50 basis point reduction at the September meeting. In its post-meeting statement, the FOMC stated that economic growth in the third quarter was "solid." In contrast, the September statement said that economic growth was "moderate" during the first half of the year. The October statement also emphasized inflation risks, adding "recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation." In another substantative change in language relative to the September statement, the October statement presented the case that risks to the economic outlook, after taking into account the reduction in the federal funds rate, became more balanced, stating "the upside risks to inflation roughly balance the downside risks to growth."



One factor behind recent FOMC actions has been the turmoil that hit financial markets beginning this past summer and that has carried on through the fall. Although there are still areas where strains exist, the October 31 statement notes that "strains in financial markets have eased somewhat on balance."

Immediately after the September FOMC meeting, federal funds futures markets expected the federal funds rate to fall a further 50 basis points to 4% by the summer of 2008. Immediately after the October meeting, expectations in the futures markets had shifted to believing the FOMC would be slightly less aggressive, though the market expects some further easing of monetary policy.

Around the District: Mortgage Delinquency Rates on the Rise

Stories covering the increase in mortgage delinquencies and foreclosures have been pervasive, especially in light of developments in the subprime mortgage market. An interesting feature of the data on mortgage delinquencies is the large variation across metropolitan statistical areas (MSAs) in terms of the percent of first mortgages that are delinquent and also in terms of the changes in first mortgage delinquency rates. Within the 12th District, the MSAs with the highest delinquency rates and the largest increases in delinquency rates tend to be in California, and, more specifically, in the central valley of California. According to data from Equifax/Moody's, and as shown in the accompanying table, the 12th District harbored 10 of the top 20 MSAs in terms of the increase in first mortgage delinquency rates over the past year (as measured by 2006:Q2 to 2007:Q2). Other than MSAs located in the central valley, Las Vegas is the other MSA in the 12th District where mortgage delinquencies have shot up notably. Several MSAs in Florida also witnessed significant increases in mortgage delinquencies.

10 Largest Changes in Delinquency Rates Among 12th District MSAs

National Ranking	MSA	Change in Delinquency Rate, 2006Q2-2007Q2	Delinquency Rate, 2007Q2
1	Merced, CA	5.44	8.08
2	Stockton, CA	3.57	6.30
8	Riverside, CA	2.49	5.21
9	Modesto, CA	2.46	5.09
11	Las Vegas, NV	2.30	4.72
13	Bakersfield, CA	1.91	4.10
14	Sacramento, CA	1.86	3.76
15	Fresno, CA	1.74	3.77
16	Oakland, CA	1.69	2.91
18	Vallejo, CA	1.68	3.83

Source: Equifax/Moody's
Note: Rankings reflect data from 200 MSAs

FedViews, Beige Book, and *FRBSF Economic Letter* are available at http://www.frbsf.org/economics/index.html#pubs
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