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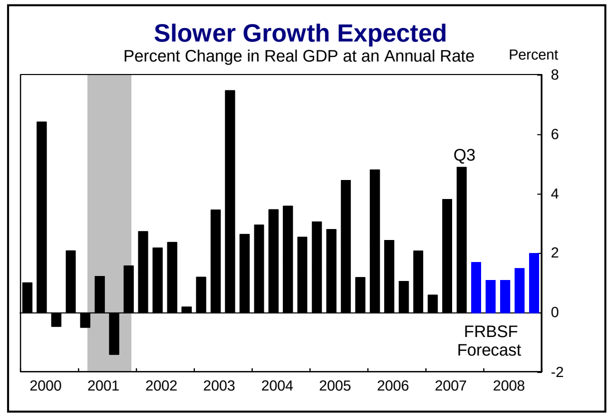
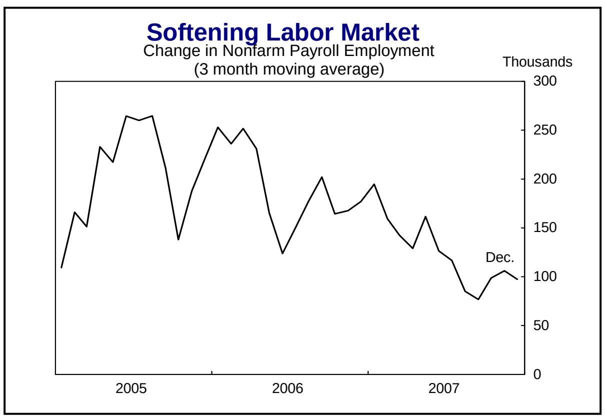
National Scene: Slow Growth Ahead

The Federal Reserve Bank of San Francisco's *FedViews* of January 10, 2008 forecasts that growth will slow sharply in the fourth quarter (to 1.7%) and grow at only a 1.1% rate in the first two quarters of 2008. Growth is not expected to pick up significantly until late 2008. Consistent with this somber outlook, recent data releases on the labor market, housing market, consumer spending, and manufacturing production, have been weak.

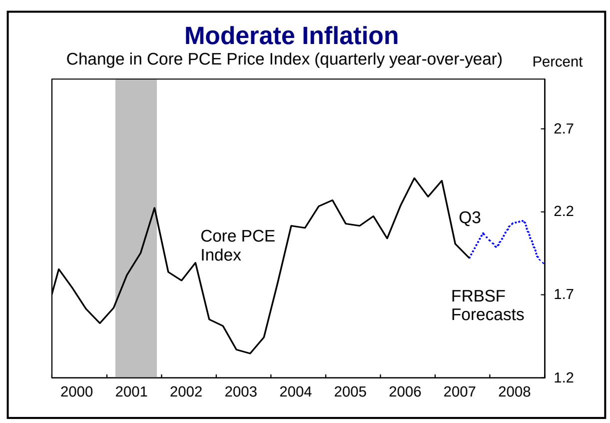


According to a number of data sources, the labor market has softened. New job growth has been trending down through the last half of 2007 (see figure). In fact, in December, total nonfarm payrolls increased by only 18,000, the smallest monthly increase in over four years. In another sign of a softening labor market, the unemployment rate has also moved up; after hovering around 4-1/2% in late 2006 and through the first half of 2007, the unemployment rate had risen to 5.0% by December.



On the residential housing front, the number of new housing starts continues to plummet. Smoothing through the month-to-month swings, new housing starts near the end of 2007 fell over 40% from their peak in 2005. Additionally, sales of existing homes have fallen 20% over the past year. This weakness in housing is also reflected in prices: the Case-Shiller ten-city house price index fell 7.3% from its peak in July 2006 to October 2007. Looking ahead, futures markets and many analysts expect house prices to fall further.

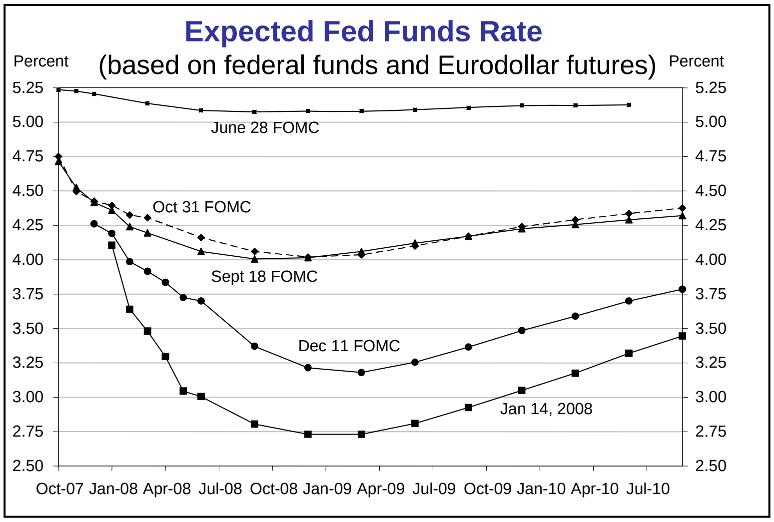
One area of economic activity that might be adversely affected by the slump in the housing market is consumer spending. Another factor that impinges on consumer spending is the labor market; if job growth continues to slow, then personal income (one of the most important drivers of consumer spending) will also slow. Perhaps surprisingly though, consumer spending through November had yet to show noticeable signs of slowing. More recently, however, retail sales, a volatile month-to-month measure that is subject to revision, fell in December by 0.4%.



Turning to inflation, large increases in energy and food prices have boosted overall prices. In December, the Consumer Price Index (CPI) increased 4.1% from a year ago. Another measure of inflation that lags the CPI in terms of when it becomes available, the overall personal consumption expenditures (PCE) price index, increased 3.6% from November 2006 to November 2007. Excluding food and energy, core PCE prices were up 2.2%. According to *FedViews*, the softness in labor markets is expected to ease pressures on inflation going forward.

Policy Pointers: **Fed Lowers Rates Again**

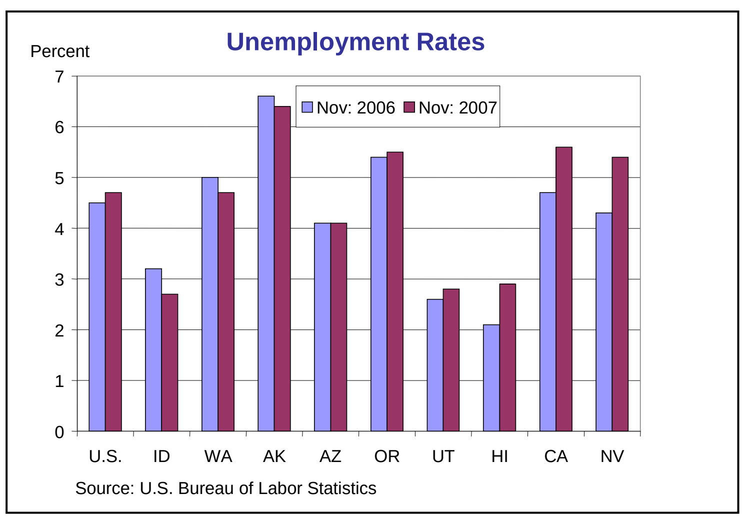
At its December 11, 2007 meeting, the Federal Open Market Committee (FOMC) lowered the target federal funds rate by 25 basis points, following an equivalent reduction at its October meeting and a 50 basis-point reduction at its September meeting. As in the October post-meeting statement, the FOMC in December emphasized that its present rate reduction, in conjunction with the actions previously taken, should help ease financial market disturbances and promote continued economic growth going forward. However, as a notable change in the December statement, the Committee said that economic growth "is slowing" compared with October's wording, that economic growth "was solid."



Since the December 11 meeting, concerns over a weakening economy have increased. Based on incoming data and the interpretation markets have placed on remarks by Fed officials, futures markets are now expecting the FOMC to be much more aggressive in its easing of the Federal funds rate than they did immediately after the December statement was released. Markets are now expecting at least a 50 basis-point reduction in the fed funds rate at the upcoming January meeting, followed by another 25 basis-point cut at the March meeting. Looking further ahead, market participants are expecting the federal funds rate to reach 2-3/4% in the second half of 2008.

Around the District: **Changes in Unemployment Rates**

As discussed previously, the national unemployment rate has been increasing. However, the picture is a bit more mixed looking at states within the 12th District; from November 2006 to November 2007 (the most recent data available), the unemployment rate decreased in three District states (Idaho, Washington, and Alaska), was unchanged in one (Arizona), and increased in five (Oregon, Utah, Hawaii, California, and Nevada). Although the unemployment rate has moved up in Utah and Hawaii, those states still rank among the lowest in the nation.



Given the size of the California economy, the increase in its unemployment rate warrants closer scrutiny. One possible reason for the increase in California's unemployment rate is that overall job growth in California has lagged behind the nation; from November 2006 to November 2007, California's payrolls increased by 0.6%, nearly half of the 1.1% gain recorded for the nation. One factor that could underlie California's lackluster job growth is the change of fortunes in the housing market, especially in the Central Valley. One possible consequence of a slower housing market is decreased construction activity. For California, construction employment fell by 3.8%, twice the rate of the national average of 1.9%.

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