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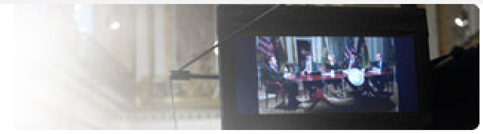

Statement of Assistant Secretary for Economic Policy Karen Dynan for the Treasury Borrowing Advisory Committee (TBAC) of the Securities Industry and Financial Markets Association (SIFMA)

11/3/2014

Economic conditions continued to strengthen in the third quarter, led by healthy private-sector demand. The labor market improved further, with the unemployment rate declining to a six-year low of 5.9 percent in September. A consensus of private-sector forecasters expects the economy to expand at a solid pace through the end of next year amid continued recovery in the labor market, higher household wealth and income, increased lending, and ongoing recovery in the housing market.

Last week, the Commerce Department reported that real GDP increased at an annual rate of 3.5 percent in the third quarter following a strong 4.6 percent advance in the previous quarter. The composition of growth in the third quarter was favorable, with real final sales up 4.2 percent, a considerably stronger gain than in the second quarter. Consumer spending rose at a 1.8 percent pace, slowing a bit from the previous quarter’s 2.5 percent pace. Residential investment increased 1.8 percent, building on an 8.8 percent advance in the previous quarter. Business investment increased 5.5 percent, with growth of equipment investment maintaining a healthy gait of 7.2 percent. The pace of inventory accumulation slowed following a large build-up in the second quarter, and the change in private inventories subtracted 0.6 percentage point from GDP growth during the quarter.

The trade deficit narrowed sharply in the third quarter. Exports rose and imports fell, with net exports adding 1.3 percentage points to real GDP growth after subtracting from growth in the prior two quarters. Government spending accelerated in the third quarter, with federal spending jumping 10 percent, reflecting a large increase in defense outlays, and state and local expenditures increasing 1.3 percent.

The pace of improvement in the job market has shifted into higher gear this year. Job creation has picked up to an average monthly pace of 227,000 from 194,000 last year. The unemployment rate’s sharp decline over the past several months has been particularly noteworthy: In September, the unemployment rate dropped to 5.9 percent, the lowest reading since July 2008. Meanwhile, the labor force participation rate has been relatively stable. Initial jobless claims have fallen further, and aggregate weekly hours and the number of job openings are on the rise. Most measures of labor utilization have not yet returned to their pre-recession levels, but there has been broad-based improvement. For example, the U-6 measure of unemployment, which includes workers who are marginally attached to the labor force and those working part-time for economic reasons, has fallen 1.8 percentage points over the past year and, at 11.8 percent, is nearly 5½ percentage points lower than its April 2010 peak. The long-term unemployment rate has fallen 0.8 percentage point over the past year, accounting for two-thirds of the decline in the overall unemployment rate.

Stronger housing activity contributed to overall economic growth in the second and third quarters after being a drag on growth in late 2013 and early 2014. The outlook for housing remains generally favorable. Mortgage interest rates have eased by roughly 60 basis points since the start of the year and recently dipped below 4 percent for the first time since mid-2013. Substantial home price gains have eroded housing affordability but price growth has slowed in recent months and affordability for the typical household remains higher than its historical norm. While a still-restricted supply of mortgage credit continues to dampen housing demand, lending should increase as the economy continues to recover. Higher employment and incomes should help bolster home buyers’ standing with lenders and boost housing demand more generally going forward. The stronger economy has also helped reduce mortgage delinquency and foreclosure rates further, and they are now at their lowest levels in more than four years.

Consumer price inflation remains moderate and wage pressures still appear to be subdued. During the year ending in September, the consumer price index rose 1.7 percent, and core consumer prices—which exclude the volatile food and energy components—also rose 1.7 percent. While core services price inflation has been relatively stable, there has been a noteworthy slowing in some components, including medical care services inflation, which is currently at its lowest level since 1950. As yet, there is little upward pressure on inflation coming from compensation costs, which continue to be held down by labor market slack. Over the year ending in September, growth in the Employment Cost Index for private-industry workers picked up to 2.3 percent but growth remains well below the average pace of around 3½ percent in the decade prior to the recession.

The strengthening of economic conditions in recent years has occurred alongside a faster-than-expected reduction in the federal government budget deficit. During the fiscal year that ended in September 2014, the budget deficit declined $197 billion to $483 billion,

$100 billion lower than projected in the July Mid-Session Review. The FY 2014 deficit was equivalent to 2.8 percent of GDP, the lowest share since 2007. A combination of fiscal retrenchment and faster economic growth have lowered the deficit as a share of the economy by 7 percentage points from a peak of 9.8 percent in FY 2009 – the most rapid improvement in any five-year period since the demobilization after World War II.

While domestic economic fundamentals point toward continued healthy growth, we are mindful of the risks to the U.S. economy if global growth were to slow more than expected. Concerns about global growth prospects and geopolitical developments also have the potential to weigh on U.S. financial markets. However, these factors have not had a material impact on most private-sector analysts' outlooks for the U.S. economy.

In sum, the U.S. economic recovery continues to move solidly forward. Real GDP posted a strong gain in the third quarter following a robust increase in the second quarter, and the pace of improvement in labor markets has accelerated this year. Inflation remains low, and the federal budget deficit is narrowing. The near-term outlook is favorable, with the headwinds from the financial crisis having abated: Household debt is down, home prices have recovered, financial markets have strengthened, bank balance sheets have improved, lending is increasing, and companies are holding considerable amounts of cash. In addition, the drag coming from the public sector has diminished considerably. Federal fiscal drag is down to an estimated ¼ percentage point this year from an estimated 1½ to 1¾ percentage points in 2013. A consensus of private forecasters is currently projecting real GDP growth of 3 percent in the final quarter of this year and 2.9 percent over the four quarters of next year.

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