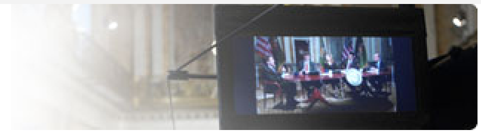

Statement by Assistant Secretary for Economic Policy Karen Dynan for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

8/3/2015

Economic activity has strengthened in recent months after a number of transitory factors weighed on growth early this year. The Commerce Department reported last week that real GDP increased at an annual rate of 2.3 percent in the second quarter of 2015 following a tepid 0.6 percent increase in the first quarter. The pickup was driven by an upturn in exports coupled with slower import growth, a stronger pace of consumer spending, and a rebound in state and local government outlays. Looking ahead, growth is expected to strengthen further in the second half of 2015, propelled in part by robust gains in consumer spending.

In the second quarter, real consumer spending rose at a solid 2.9 percent annual rate, up from a 1.8 percent pace in the first quarter. Payroll gains have helped support nominal earnings, and the considerable decline in gasoline prices over the past year has boosted the purchasing power associated with those earnings. All told, real disposable personal income has risen 3.1 percent over the past year, accelerating from a 2.4 percent gain posted during the year-earlier period. In addition, household balance sheets are in increasingly good repair, benefiting from low debt servicing costs, home price appreciation and stock market gains. With consumer confidence now back in its pre-recession range, the outlook for stronger consumption growth going forward is favorable.

Business spending on equipment and structures has weakened recently. According to the advance second-quarter GDP report, business fixed investment declined at an annual rate of 0.6 percent in the second quarter after a weak 1.6 percent advance in the first quarter. Both equipment investment and structures investment fell in the second quarter, more than offsetting further solid growth in investment in intellectual property products. A pullback in drilling and mining activity after oil prices dropped is partly responsible for the recent weakness in business investment. During the first half of 2015, the drop in business outlays for mining and oil exploration reduced GDP growth by an estimated 1¼ percentage points. There are tentative signs that investment in the mining sector is stabilizing, with the steep plunge in the number of rigs actively drilling for oil abating in recent weeks.

Housing activity has stepped up over the past year. Residential investment rose at an annual rate of 6.6 percent in the second quarter and is 7.5 percent above its year-earlier level. Employment in residential construction has moved higher, as have home sales. Home prices are still rising, but appreciation has moderated considerably from the double-digit pace seen in 2013. Housing demand is expected to improve further given the ongoing strengthening of the labor market and other favorable household fundamentals. Notably, household formation—a key determinant of the demand for new housing—has risen to a much stronger level in recent quarters, reaching 1.62 million for the year ended in the second quarter—well above the historical average of 1.2 million.

Last week's advance second-quarter GDP report was accompanied by revisions to historical data going back to 2012. The average annualized pace of real GDP growth over the period was revised down by 0.2 percentage point to 2.0 percent, with the downward revision largely reflecting the incorporation of newly available and revised source data for personal consumption expenditures and government spending. The bulk of the revision occurred in 2013, with real GDP growth over the four quarters of the year marked down from 3.1 percent to 2.5 percent. Growth during 2012 was revised down 0.3 percentage point to 1.3 percent, while growth over the four quarters of 2014 was revised up 0.1 percentage point to 2.5 percent.

The Commerce Department also released a new supplemental measure of the economy's performance last week: the average of GDP and gross domestic income (GDI). While GDP is the sum of final expenditures associated with domestic production, GDI is the sum of income associated with production. In principle, the two measures should be equal, but in practice they differ due to timing differences and measurement challenges. This new measure is a valuable addition to the GDP release and is expected to facilitate analysis of macroeconomic trends. Over the year through the first quarter, the new measure grew 3.1 percent. During the same period, real GDP increased 2.9 percent. Both measures point to steady improvement in the economy.

Labor market conditions continue to strengthen at a pace that exceeds that seen in the early years of the recovery. The U.S. economy added an average of 221,000 jobs per month in the second quarter, compared with an average of 195,000 jobs in the first quarter. The unemployment rate has dropped 0.8 percentage point over the past year. At 5.3 percent in June, the unemployment rate is close to its pre-recession average. Broader measures of underemployment have also returned to more normal levels, including those that include marginally attached workers and part-time workers. The long-term unemployment rate, which declined to 1.4 percent in June, is still elevated but closing in on its 2001-2007 average of 1.0 percent. The rate of involuntary part-time employment declined to 4.1 percent in June but still remains well above its 2001-2007 average of 2.9 percent. The employment report for July 2015 will be released at the end of this week.

Inflation measures remain relatively low and stable, due in part to low energy prices. Oil prices rose somewhat this past spring but have fallen back more recently and are now approaching the six-year lows reached in March. The one-month futures price of West Texas Intermediate crude oil is currently trading around $48 per barrel, down nearly $10 over the past three months and about $50 lower than a year ago. The average retail price for regular gasoline has been hovering around $2.80 per gallon for the past two months, about 80 cents lower than a year ago, and dipped to $2.75 in the latest week.

During the most recent 12-month period ending in June, the consumer price index edged up 0.1 percent, a considerable slowing from the 2.1 percent rise in the year-earlier period. Core consumer prices (excluding food and energy) rose 1.8 percent over this period, decelerating slightly from the 1.9 percent year-earlier pace. Core services price inflation continues to run at a moderate pace, but core goods price inflation has remained in negative territory for more than two years. Labor market slack still appears to be weighing on growth in worker compensation, with the Employment Cost Index for private-industry workers having risen 1.9 percent over the past year. This pace of increase is in line with that of recent years and well below the 3½ percent average annual pace recorded in the decade prior to the recession.

Last month, the Office of Management and Budget released the FY 2016 Mid-Session Review (MSR), which updates the Administration's estimates for outlays, receipts, and the budget deficit for developments since the President's FY 2016 Budget was released last February. For FY 2015, the MSR projects a $455 billion deficit (2.6 percent of GDP), nearly $30 billion (0.2 percent of GDP) lower than last year's deficit and $128 billion lower (0.6 percent of GDP) than estimated in the FY 2016 Budget. The deficit is projected to continue to narrow as a share of the economy over the next two fiscal years, falling to 2.2 percent of GDP by FY 2017. Over the longer term (FY 2018 to FY 2025), the Administration estimates that the deficit will average 2.6 percent of GDP, well below the 40-year average of 3.2 percent of GDP. The debt-to-GDP ratio is projected to peak at 75.3 percent of GDP in FY 2015 and FY 2016 and then edge down over the next two years, stabilizing at 74.6 percent of GDP in FY 2018.

In sum, U.S. economic activity continues to be on a solid uptrend, with low and stable inflation and continued strengthening of the labor market. A consensus of private forecasters is projecting growth at an annual rate of 3 percent over the second half of 2015 and 2.7 percent over the four quarters of 2016. These estimates are roughly in line with the Administration's forecast published in the MSR last month. The Administration projects that the economy will expand at an above-trend rate of 2¾ percent on average from 2016 through 2018 before moderating to 2.3 percent on average from 2019-2025.

###