Acting Assistant Secretary Diana Furchtgott-Roth Economy Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

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Over the first three quarters of 2018, the U.S. economy grew at an annualized rate of 3.2 percent, the fastest pace for the first three quarters of a year since 2005. Initial data for the fourth quarter indicate the economy continued to perform well, although slowing global growth and the housing sector could present headwinds. Private forecasters now estimate that real GDP growth slowed to around 2.7 percent in the fourth quarter, and will slow further to 2.2 percent in the first quarter of 2019.

Strong private consumption, robust business investment, and a solid build in private inventory were the main drivers of healthy economic performance experienced in the first three quarters of 2018, followed by a positive contribution from government spending. For the first time since 2010, residential investment declined in the first three quarters of the year. Real net exports also subtracted from growth, though the latter partly reflected strong domestic demand for imports in the U.S., a reflection of higher growth in the U.S. relative to trading partners.

Labor markets remain very tight, with the number of job openings remaining above the number of job seekers for seven of the past eight months. The pace of job creation accelerated in 2018, exceeding monthly averages seen during the previous two years, and in the latter half of 2018, growth of nominal and real wages accelerated on a more sustained basis. After falling to a 50-year low of 3.7 percent during the fall of 2018, the unemployment rate rose to 3.9 percent in December, the result of an increase in labor force participation. Manufacturing activity slowed and business sentiment pulled back a bit during the fourth quarter, each from very high levels, however.

GDP GROWTH

Over the first three quarters of 2018, real GDP grew at an annualized rate of 3.2 percent. Private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – grew at an annualized rate of 2.8 percent over that same period. On a

quarterly basis, private domestic final demand grew at an annual rate of 1.0 percent in the third quarter.

Growth in real personal consumption expenditures continued at a solid pace of 3.5 percent at an annual rate in the third quarter, building on the second quarter's strong 3.8 percent advance. Outlays on consumer services drove consumption, rising 3.7 percent at an annual rate and accounting for almost two-thirds of consumers' contribution to GDP growth. Spending on durables increased 3.7 percent in Q3 while nondurables expenditures were up 4.6 percent in the third quarter. On balance, real personal consumption expenditures added 2.4 percentage points to growth in the third quarter.

Business fixed investment increased 2.5 percent at an annual rate in the third quarter after increasing 8.7 percent in the second quarter, and added 0.4 percentage point to overall growth. Since the end of 2017, real private nonresidential fixed investment has grown 7.5 percent at an annual rate, indicating a healthy environment for business investment that has been aided by deregulation and the Tax Cuts and Jobs Act. Fixed investment in intellectual property products and equipment increased in the third quarter, rising 5.6 percent and 3.4 percent, respectively. Intellectual property investment has grown 10.0 percent since the end of 2017, the strongest pace through the third quarter since 1999, while equipment investment has risen 5.5 percent through the third quarter. Although investment in structures declined 3.4 percent in the third quarter after growing at double-digit paces in each of the previous two quarters, the level of investment in structures remains 8.0 percent above its level at the end of 2017. Meanwhile, the cycle of inventory accumulation turned strongly positive in the third quarter, adding 2.3 percentage points to real GDP growth.

Residential investment retrenched for the third consecutive quarter, declining 3.5 percent at an annual rate and down 2.8 percent since the end of 2017. Signs of slowing in the housing sector persist against a backdrop of low inventories and rising mortgage rates. Existing home sales, which account for 90 percent of all home sales, declined in 8 of the past 12 months, including a 6.4 percent drop in December, and were down 10.3 percent since the end of 2017. Similarly, new home sales have fallen six times in 2018 and as of October were down 14.5 percent since the end of 2017. Meanwhile, total housing starts increased 3.2 percent in November and were up 3.8 percent since the end of 2017. However, the gain solely reflected growth in the volatile multi-family sector. Single-family units decreased 4.6 percent in November and were down 2.7 percent since December 2017. The story is similar for building permits. Total building permits rose 5.0 percent in November and were 0.6 percent higher since December 2017, but

permits for single-family homes have fallen 3.3 percent since the end of 2017. Confidence for builders of single-family homes softened toward the end of 2018: the NAHB's home builder confidence index was down 18 points in December over the year. However, the index picked up 2 points to 58 in January 2019, indicating a positive outlook for the year, even as demand has moderated. House price appreciation remains relatively strong, exceeding core inflation and income measures, although the pace has slowed relative to a year ago, likely due to notably higher mortgage rates in recent months.

Total government spending rose 2.6 percent at an annual rate in the third quarter, accelerating from a 2.5 percent pace in the previous quarter. After making an essentially neutral contribution to growth in most of 2016 and 2017, government spending has added 0.4 percentage points on average to GDP growth in each of the past three quarters. Federal outlays grew 3.5 percent in the third quarter after a 3.6 percent rise in the previous quarter, while state and local government spending growth stepped up to a 2.0 percent rate in the third quarter – the fastest pace in more than two years.

The U.S. trade deficit widened in the third quarter, as imports grew at an annual rate of 9.3 percent and export growth declined 4.9 percent. As a result, net exports subtracted 2.0 percentage points from growth in the third quarter, after adding 1.2 percentage points to growth in the second quarter.

LABOR MARKETS AND WAGES

The December labor market report included calendar year-end revisions using updated seasonal adjustment factors to data going back to January 2014. Revisions to unemployment rates from January through November 2018 resulted in readings that were on net 0.1 percentage point lower. In December, the unemployment rate rose to 3.9 percent from the 50-year low of 3.7 percent reached in September and again in November. The increase was due entirely to a rise in the labor force participation rate, which reached 63.1 percent, its highest level since September 2013. The most comprehensive measure of labor market slack, which includes those marginally attached to the labor force and those working part-time for economic reasons, declined to a 17-year low of 7.4 percent in August 2018, but since then, has edged up slightly, and stood at 7.6 percent in December 2018, still 1.7 percentage points below the pre-recession average of 9.1 percent. During 2018, monthly job growth averaged 220,000, well above the 182,000 monthly average for 2017 as well as the 195,000 monthly average in 2016.

Payroll job creation surged to 312,000 in December, the second-highest gain in 2018. The employment report for January will be released this Friday, February 1.

The pace of nominal wage growth resumed an accelerating trend towards the end of 2018 after leveling off for several months. Slower inflation combined with faster nominal wage growth resulted in notably stronger gains in real wages as well. Nominal average hourly earnings for private-sector production and nonsupervisory employees rose 3.3 percent over the year ending in December, the fastest pace since April 2009. Real average hourly earnings advanced 1.5 percent over the same period, the fastest rate since August 2016. And, for the first time since early 2009, the 12-month growth rate of wages and salaries for all private industry workers has held above 3 percent for three consecutive months through December. Using the Personal Consumption Expenditures (PCE) price index, which reflects substitution of lower-priced goods, real average hourly earnings likely grew by at least 1.6 percent over the past year through December. Another measure of wage and salary growth, the Employment Cost Index, showed that private wages and salaries grew by 2.9 percent in the third quarter, the fastest pace since March 2008. Data for the Employment Cost Index for the fourth quarter will be released this Thursday, January 31.

PRICES

Declining energy prices over the past several months have contributed to a slowing in headline inflation by several measures, while core inflation, which excludes the volatile food and energy components, has stabilized. During 2018, the increase in the consumer price index (CPI) for all items peaked at 2.9 percent over the 12 months through June and July, but slowed by a full percentage point to 1.9 percent over the year through December, a rate 0.2 percentage point below the year-earlier pace. Notably, energy price inflation slowed markedly from 12-month rates of 12 percent or more last June and July to a decline of 0.3 percent over the year through December 2018. Food price inflation was stable through most of 2018 but accelerated to 1.6 percent over the 12 months through December, albeit equal to the year-earlier pace. Excluding food and energy, the CPI increased 2.2 percent over the year through December 2018, above the 1.8 percent rate through December 2017.

Twelve-month readings of the headline PCE price index held at or above 2.0 percent through most of 2018, but slowed to 1.8 percent over the year through December 2018, matching the year-earlier rate. Core PCE price inflation also picked up during most of 2018, and in December

its yearly pace stood at 1.9 percent, accelerating from the 1.6 percent pace observed a year earlier.

CONCLUSION

The economy performed strongly during the first three quarters of 2018, benefitting from tax reform, deregulation, and other measures to boost investment, incomes, and labor force participation. Starting in Q2 2017, wage growth—a formerly missing piece of the current economic recovery—began to show both nominal and real growth. Nonetheless, we need to be aware that the slowdown in global growth has the potential to affect GDP. Private sector forecasts suggest a slowing of GDP growth in the fourth quarter and a further slowing in the first quarter of 2019. Recent sharp declines in manufacturing growth as well as business and consumer sentiment have nonetheless been from a very high level. For example, the Institute of Supply Manufacturers index reached a 14-year high of 60.8 in August, and has declined 6.5 points since, which still indicates expansion. In October 2018, the Conference Board Consumer Confidence index hit an 18-year high of 137.9, but over the next two months, fell by 9.8 points in total, reaching 128.1 in December, a high level. Overall, private domestic demand has remained strong, labor markets have tightened further, and labor force participation continues to trend higher.

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