Assistant Secretary for Economic Policy Michael Faulkender Economy Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association October 28, 2019

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The U.S. economy continues to grow at a steady pace, propelling further job creation and wage gains. Inflationary pressures remain at bay, even with labor markets at or near full employment. The recovery's record longevity – now 124 months and counting - reflects benefits from pro-growth measures like the Tax Cuts and Jobs Act of 2017 (TCJA) and regulatory relief that have boosted growth and have delivered structural reforms to bolster the economy's resilience.

Although slowing global growth and trade uncertainties have impacted business investment and confidence, the effects on the broader economy have proved limited thus far. Labor markets show continued strength. The September headline unemployment rate declined to a fresh 49-year low and Hispanic and African-American unemployment rates stand at record lows. Job creation – at an average 161,000 per month thus far in 2019 – remains more than sufficient to keep the economy at or near full employment, and the total number of payroll jobs added since the November 2016 election has climbed to 6.5 million. Moreover, job openings continue to exceed the number of unemployed, and labor force participation rates have climbed back to multi-year highs.

Following robust growth of 8.3 percent in the second quarter, core retail sales rose 6.8 percent in the third quarter, indicating continued, strong household consumption. Indeed, the underlying fundamentals of consumption are solid: nominal nonsupervisory wage gains have accelerated to a higher and tighter range over the past seven months, and consumer sentiment remains at elevated levels. Stable job creation, substantial nominal and real wage gains, and high confidence are all signals that bode well for consumer spending in the near term.

The advance estimate for real GDP growth in 2019 Q3 will be released this Wednesday, October 30.

GDP GROWTH

According to the third estimate for Q2, real GDP grew at an annualized rate of 2.0 percent, bringing the average growth rate over the past 2 ½ years to 2.6 percent. Second-quarter growth was led by a 4.6 percent surge in personal consumption expenditures, more than four times the pace recorded in the first quarter and matching 2017 Q4's robust pace. Growth was also supported by a strong increase in government expenditures, as well as further investment in equipment and intellectual property. A drawdown of inventories built up in previous quarters, a pullback in structures investment related to declining oil prices, a modest drag from residential investment, and a widening of the trade deficit contributed to the slowing of GDP growth in the second quarter from 3.1 percent in the first quarter. Nonetheless, the pace of private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – more than doubled to an annualized rate of 3.3 percent in the second quarter.

Consumer spending in the second quarter grew at the fastest pace since 2017 Q4, as the annualized rate more than quadrupled from Q1 to 4.6 percent. This significant acceleration was driven by an 8.6 percent increase in goods, including a 13.0 percent increase in spending on durables, the fastest pace in five years, and a 6.5 percent advance in consumption of nondurables, the fastest rate in nearly 16 years. Expenditures on services rose 2.8 percent in the second quarter. Altogether, total consumer spending made the largest contribution to second-quarter growth, 3.0 percentage points, of any component of GDP. Turning to the third quarter, a full three months of retail sales data is in hand. Nominal core retail sales, a key component of consumer spending in the national accounts, appear to have grown at an annual rate of 6.8 percent in the third quarter, slowing modestly from the 8.3 percent pace in the second quarter. This rate of growth suggests that real consumption of goods could make a more moderate, though still quite solid, contribution to real GDP growth in the third quarter.

After 12 consecutive quarters of positive growth, the third estimate of GDP indicated that business fixed investment declined a full percentage point in the second quarter, a retreat that mainly reflected an outsized 11.1 percent decline in spending on structures, which was partly related to weak oil prices. Intellectual property products investment rose 3.6 percent and spending on equipment was up 0.8 percent. Slower equipment investment in Q2 was linked in part to the grounding of the Boeing 737 MAX airplane. Looking at available data for the third quarter, spending on structures has declined sharply in July and August, and the continued grounding of the Boeing 737 MAX as well as the strike by the United Auto Workers union at General Motors have dampened activity in the manufacturing sector. However, the latter factors should resolve soon in the manufacturing sector. With respect to the service sector, which accounts for 70 percent of U.S. economic activity, the ISM non-manufacturing survey for

September reported that most U.S. service industries remain sanguine about the near-term outlook, even in the face of global economic headwinds. After three consecutive quarters of positive contributions to growth, the cycle of inventory accumulation turned negative in the second quarter, subtracting 0.9 percentage point from real GDP growth as businesses drew down inventories in response to strong demand.

Residential investment declined 3.0 percent in 2019 Q2, the sixth consecutive quarterly decline in this sector, although the pullback was smaller than those seen last year and primarily reflected a sharp reduction in the value of construction put in place since spring 2018. Looking at other and more recent data, a variety of conditions in the housing market continue to improve. For example, existing home sales (which account for 90 percent of all home sales) are almost 8 percent higher this year through September, and new single-family home sales (roughly 10 percent of home sales and considered a more timely measure) have grown by more than 24 percent over the first nine months of 2019. Single-family housing starts are up 4.3 percent over the 12 months through September, and over the same period, total housing starts rose 1.6 percent. Significantly, for eight of the past nine months, total building permits have remained above total housing starts, pointing to a further pickup in homebuilding. These developments reflect ongoing improvements in home affordability and mortgage rates: over the year through August, the FHFA home price index rose at its slowest pace in four years, and as of late October, mortgage rates had declined 119 basis points since last fall. These conditions are also reflected in a reviving of homebuilder sentiment: the National Association of Home Builder's home builder confidence index has trended higher this year to reach a 20-month high in October, more than retracing last year's decline.

Total government spending has stepped up over the past six quarters, after making an essentially neutral contribution to growth in 2016 and 2017. Overall, government spending rose 4.8 percent in the second quarter, reflecting a surge of 8.3 percent in federal spending (the fastest pace since 2009 Q2) and a 2.7 percent advance in state and local outlays. Altogether, government spending added 0.8 percentage point to real GDP growth in the second quarter.

The third estimate of Q2 GDP showed that export growth turned more sharply negative than initially thought, declining 5.7 percent. Import growth was revised down slightly to a flat reading, and on balance, net exports subtracted nearly 0.7 percentage point from real GDP growth, after adding more than 0.7 percentage point to growth in the first quarter. The trend of trade data for July and August, if maintained through September, suggest that net exports could be neutral for GDP growth in the third quarter.

LABOR MARKETS AND WAGES

The unemployment rate fell to a fresh 49-year low of 3.5 percent in September, even as labor force participation rates rose. In addition, selected unemployment rates set or remained at historic lows: the unemployment rate for Hispanic-Americans fell to a series low of 3.9 percent in September (series dates from 1973) and for African-Americans, the unemployment rate remained at the record low of 5.5 percent (series data from 1972). Furthermore, the unemployment rate for adult men (age 20 and over) declined to 3.2 percent in September, matching the lowest rate since June 2000. The most comprehensive measure of labor market slack, which includes those marginally attached to the labor force as well as those working part-time for economic reasons (the U-6 rate), declined 0.3 percentage point to 6.9 percent, the lowest reading since December 2000 (and 2.2 percentage points below the pre-recession average of 9.1 percent).

Labor force participation rates continue to defy demographic trends: workers are responding to the various incentives of the TCJA, as well as rising wage rates and plentiful job openings. Indeed, another labor market record is the greater availability of job openings over the number of unemployed persons to fill them – a characteristic that has persisted for the past 18 months. The overall labor force participation rate (LFPR) remained at 63.2 percent in September, matching the five-year high reached in January, February, and August. The LFPR for prime-age workers remained at 82.6 percent in September, matching the nine-year high reached in January and August. From the employer's perspective, of course, labor shortages remain a significant challenge in general, and shortages of skilled or qualified workers has also been a persistent problem, as reported in employer surveys since early 2018. The National Federation of Independent Business's small business optimism index for August showed a record high of 57 percent of firms reporting serious difficulties in finding qualified workers, a percentage which declined only moderately to 50 percent in the NFIB's September survey. The employment report for October will be released this Friday, November 1.

It bears repeating that rapid wage gains have been a consistent feature of the economy for well over a year and, more recently, have ramped to a sustained 3½ percent pace for nearly a half year. Private-sector production and nonsupervisory workers have seen nominal wage growth at or above 3 percent for the past 14 months, and for the past five months, nominal wage gains have fluctuated between 3.4 percent and 3.6 percent. Over the 12 months through September, nominal wages for these workers grew 3.5 percent, a marked pick up from the 3.0 percent pace a year earlier. The combination of strong nominal gains and modest inflation has also boosted real purchasing power on a consistent basis: thus far in 2019, real average hourly earnings for private-sector production and nonsupervisory workers have grown between 1.4 percent and 2.1 percent, including a gain of 1.9 percent over the 12 months through September. Another measure of wage and salary growth, the Employment Cost Index (ECI), has also shown rapid growth in private wages and salaries for several quarters; the ECI for the third quarter will be released on Thursday, October 31.

PRICES

Consumer price inflation has been slowing at the headline level since July 2018, mainly reflecting lower energy prices. Over the 12 months through September 2019, the Consumer Price Index (CPI) for all items rose 1.7 percent, well below the 2.3 percent pace a year earlier. Energy prices have fallen significantly since last summer; over the year through September 2019, energy prices dropped 4.8 percent, compared to a 4.8 percent advance a year earlier. On the other hand, food price inflation has picked up from last year, rising 1.8 percent over the 12 months through September, roughly half percentage point faster than the 12-month pace through September 2018. In contrast, core inflation, which excludes food and energy, held relatively steady during the first half of 2019, but has accelerated recently. Core CPI was 2.4 percent over the year through September, accelerating from the 2.2 percent, year-earlier pace.

Headline inflation, as measured by the Personal Consumption Expenditures (PCE) Price Index (the measure in which the FOMC's 2 percent inflation target is expressed), has remained below the target since November 2018. The 12-month headline PCE inflation rate stood at 1.4 percent over the 12-months through August 2019, nearly a full percentage point slower than the 2.3 percent pace through August 2018. Core PCE inflation was 1.8 percent over the year through August 2019, decelerating from the 2.0 percent pace over the year-earlier period. The PCE Price Index for September will be released this Thursday, October 31.

CONCLUSION

The second quarter saw a more than quadrupling of growth in private consumption and a doubling of growth in private final domestic demand. The economy's resilience in the past few months to such influences as slowing global growth and domestic difficulties at Boeing and General Motors is evident across a variety of sectors. High consumer sentiment and solid spending, demography-defying labor force participation and low unemployment rates, nominal and real wage growth, and low inflation in the face of these headwinds is noteworthy. The

Administration's deregulatory measures and TCJA have contributed to the current expansion's record-breaking length and have laid the foundation for strong future economic growth. Moreover, the reduction of fiscal uncertainty and the apparent aversion of a hard exit by Britain from the European Union should also help bolster business confidence and economic activity in coming quarters. Private forecasters predict real GDP growth of 2.2 percent in 2019 on a Q4-over-Q4 basis and 1.6 percent in 2020. The Administration has a strong belief in the resilience of the American economy and the pro-growth nature of its policies. In its latest projection, it expects that after temporary headwinds fade, economic growth will return to near 3 percent as investment recovers and productivity accelerates.