EconomicUpdate NATIONAL
Federal Reserve Bank of Dallas

The National Economy: More of the Same

June 19, 2012

Some of the uncertainty clouding the economic outlook earlier in the year has lifted, revealing less improvement than winter reports suggested. Indicators of both output and employment countered earlier hopes of breakout expansion. Other indicators have also been somewhat soft, pointing to modest growth in the near future.

Output Growth Remains Tepid

Real gross domestic product (GDP) grew at a disappointing 1.9 percent annualized rate in the first quarter after a more robust 3 percent rate in fourth quarter 2011. The two-quarter average—2.45 percent—exactly matches the pace of growth since the recovery began in third quarter 2009 (*Chart 1*).

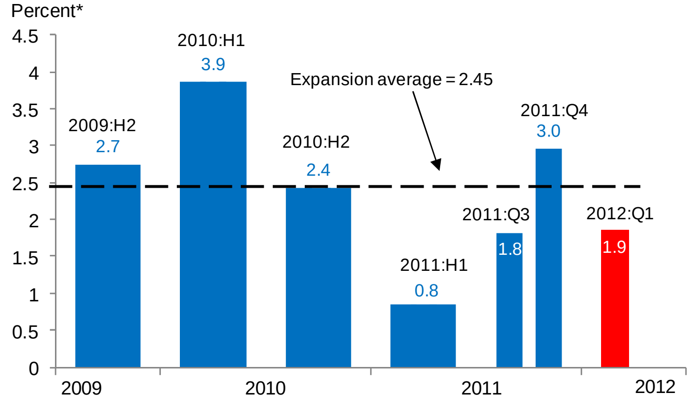
If the volatile inventory investment component of GDP is dropped (leaving final sales of domestic product), growth has held steady at about 1.7 percent over the recovery (*Chart 2*). Changes in consumption of nondurable goods and services can entirely account for variation around that average rate. Changes to the contributions from business fixed investment and consumption of durable goods offset one another—combining for a constant contribution of 1.3 percentage points. The negative impact of government purchases offset the positive combination of a stronger contribution from residential investment and the diminished drag from net exports.

Acceleration in Job Gains Proves Fleeting

Employment increases failed to reach expectations for a third straight month. Nonfarm payrolls rose by 69,000 in May and 77,000 in April, bringing the three-month moving average to 96,000—considerably less than the 141,000-job average gain seen since payrolls began rising again in March 2010. It is possible that some of this weakness was a payback effect from elevated hiring during the unseasonably warm winter. Over the last 12 months—a span that should smooth over any weather effects—employment growth has averaged 149,000.

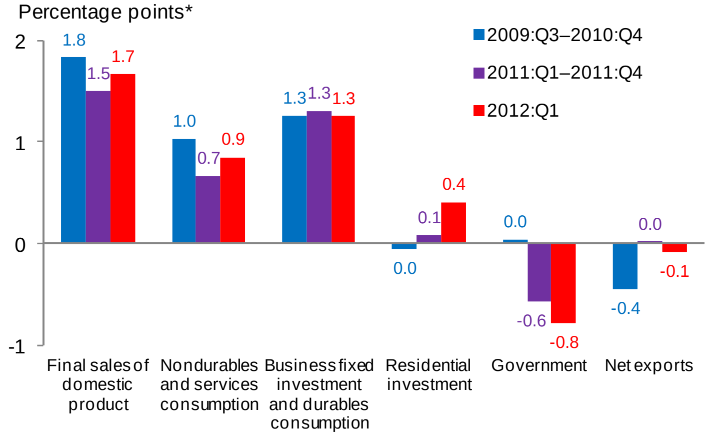
The four-week average of initial unemployment insurance claims rose from 363,000 at the end of March to 384,000 at month-end April, where it has largely remained. Increases of this magnitude in initial jobless claims are a fairly reliable indicator of future upward bumps in the unemployment rate (*Chart 3*). Unemployment did, in fact, increase from 8.1 percent in April to 8.2 percent in May, although the rise was driven by an expansion of the labor force rather than weak employment growth in the household survey.

Chart 1
GDP Growth Drops Back Below Its Expansion Average



*Seasonally adjusted, annualized rate.
SOURCES: Bureau of Economic Analysis; authors' calculations.

Chart 2
Shifting Growth Contributions Largely Offset One Another

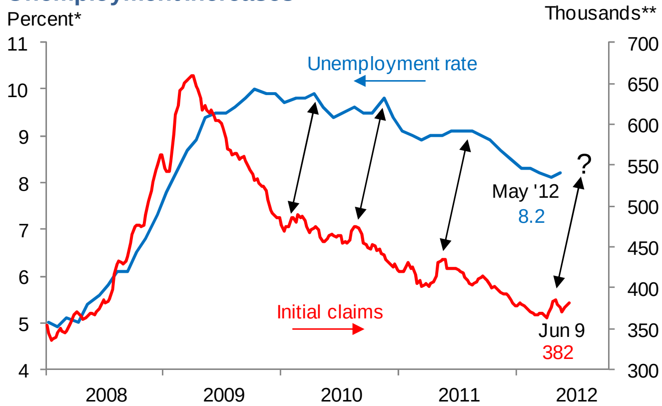


*Average contribution to percent growth in GDP, seasonally adjusted, annualized rate.
SOURCES: Bureau of Economic Analysis; authors' calculations.

Any Catch-Up Left?

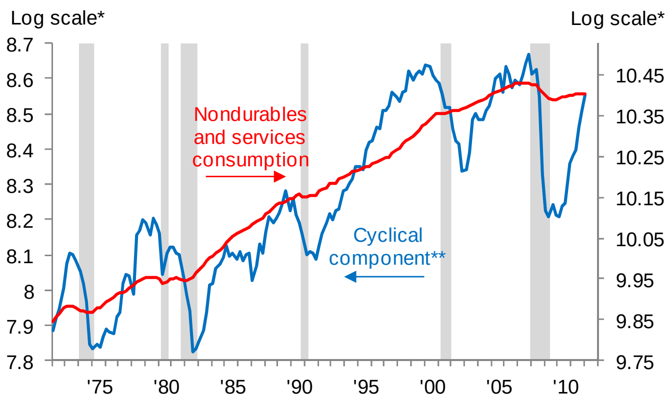
Economic theory says that consumption of nondurable goods and services should be determined almost exclu-

Chart 3
Upticks in Initial Claims Often Foreshadow Unemployment Increases



*Seasonally adjusted.
**Four-week moving average, seasonally adjusted.
SOURCES: Bureau of Labor Statistics; Department of Labor.

Chart 4
'Bounce-Back' Could Be Over



NOTE: Gray bars represent recessions.
*Chained 2005 dollars, seasonally adjusted annualized rate.
**Fixed investment + household durables purchases + net exports.
SOURCES: Bureau of Economic Analysis; authors' calculations.

sively by households' assessment of their long-term income prospects, and that the growth rate ought to be unpredictable. This series serves as a good measure around which the cyclical component of output fluctuates (*Chart 4*). The cyclical component tends to revert to the nondurables and services consumption trend, producing a bounce-back effect after recessions. If declining consumption of nondurable goods and services during 2008–09 represents households' diminished expectations of future income, the bounce-back effect in this recovery could be over—the blue line has caught back up to the red line. This would imply that continued tepid, trend-rate growth is more likely ahead than robust catch-up growth. Alternatively, the fall in the red line could be caused by some households' impaired access to credit and inability to smooth consumption across time. If this is the case, growth could accelerate as credit markets fully heal.

Inflation Above Unemployment-Based Forecast

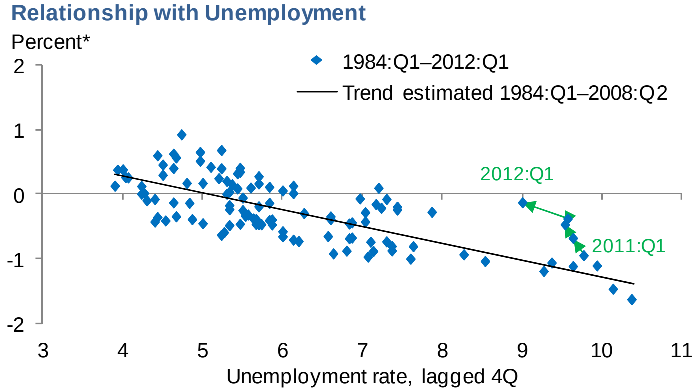
Personal consumption expenditures (PCE) inflation was 1.8 percent over the 12 months ended in April, as was Trimmed Mean PCE inflation. While this is below the Federal Reserve's mandate consistent rate of 2 percent, it exceeds anticipated levels using only long-forward inflation expectations and the unemployment rate one-year previous, a measure that has had a fairly successful track record (*Chart 5A*).[1] This unexpectedly high inflation has led some analysts to conclude that recent unemployment is mostly due to structural problems in the labor force and, thus, should not be counted as slack. However, wage growth relative to long-forward inflation expectations has been at expected levels given the unemployment rate—a finding that runs counter to the idea that unemployment is high for structural reasons (*Chart 5B*).

Okun's Law: Reports of Its Death Greatly Exaggerated

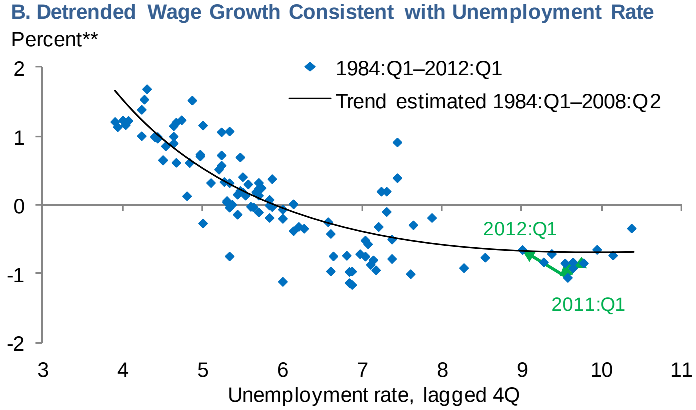
Okun's Law says that when output is disappointingly low, the unemployment rate tends to be disappointingly high, and vice versa. Moreover, it asserts that this linkage is stable over time: It is reliably true that for each 1 percent that output runs below trend or "potential," the unemployment rate runs (approximately) 0.5 percentage points

Chart 5
Wage Growth Not Driving Higher-than-Expected Inflation

A. Detrended Trimmed Mean PCE Inflation Above Historical Relationship with Unemployment



B. Detrended Wage Growth Consistent with Unemployment Rate



*Trimmed Mean PCE inflation (four-quarter percent change)–Survey of Professional Forecasters nine-year, one-year-forward CPI inflation expectations + 0.3.
**Employment Cost Index: Wages and Salaries growth (four-quarter percent change)–Survey of Professional Forecasters nine-year, one-year-forward CPI inflation expectations.
SOURCES: Federal Reserve Bank of Dallas; Federal Reserve Bank of Philadelphia; Bureau of Labor Statistics; authors' calculations.

above normal. Over the past five quarters, real GDP has grown at a 1.7 percent annualized rate, matching most estimates of potential growth, while the unemployment rate has fallen an average of 0.3 percentage points a quarter. Some analysts view this as a breakdown in Okun's Law because the output gap (the difference between actual and potential output) has at best been constant while the unemployment gap has declined steadily. However, the relationship between the output and unemployment gaps often exhibits loops during recession and recovery. Chart 6 shows an Okun's Law line fitted through a scatterplot of output-gap–unemployment-gap combinations. This line has a slope of -0.6, rather than -0.5, which is commonly assumed. The chart shows that the recent decline in the unemployment rate simply moved the economy from somewhat above to somewhat below the Okun's Law line, without ever straying far from it. Because first quarter 2012 is on the lower boundary of normal experience, further declines in the unemployment rate should not be expected without accompanying above-potential GDP growth.

—Tyler Atkinson and Evan F. Koenig

Note

1. "Inflation, Slack, and Fed Credibility," by Evan. F. Koenig and Tyler Atkinson, Federal Reserve Bank of Dallas Staff Papers, no. 16, 2012, www.dallasfed.org/assets/documents/research/staff/staff1201.pdf.

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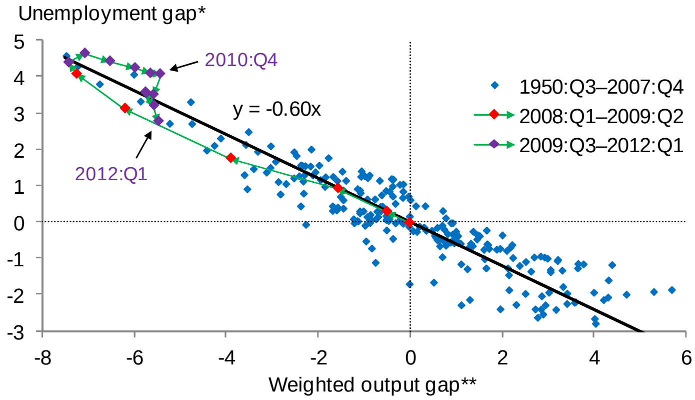
Chart 6
Unemployment Gap Not Out of Line with Output Gap



*Unemployment rate minus its natural rate estimated by the Congressional Budget Office (CBO).
**Real GDP as a percent of its potential estimated by the CBO; 0.8 times the contemporaneous gap plus 0.2 times the previous quarter's gap.
SOURCES: Bureau of Economic Analysis; Congressional Budget Office; Bureau of Labor Statistics; authors' calculations.