DALLASFED Economic Update U.S.

National Economy on Solid Footing Before Arrival of Hurricanes Harvey and Irma

September 25, 2017

Hurricanes Harvey and Irma, if taken together, would rank among the costliest weather-related disasters in U.S. history based on the estimated value of destroyed or damaged property and infrastructure. Moreover, the back-to-back storms in late August and early September have introduced substantial uncertainty into the economy's near-term outlook.

Previous natural disasters suggest that despite interruption of economic activity in the immediate term and hardship for those living in affected areas, the impact on the national economy—an impact that includes subsequent boosts to activity from rebuilding—tends to be modest.

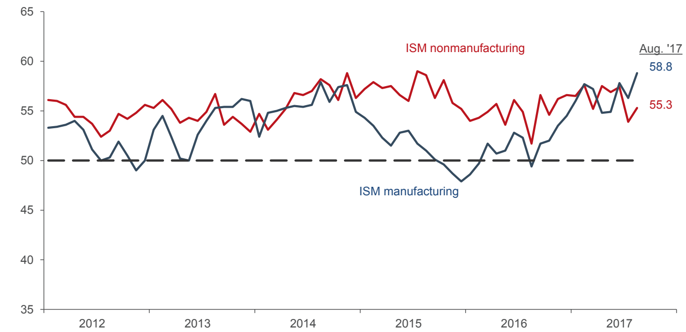
Whether past experience will be a good guide to the recent hurricanes will depend, among other factors, on the strength of the economy before the storms. To that end, this report examines the health of the national economy just before the hurricanes and the storms' likely impact on the outlook.

GDP Growth Revised Higher

Real (inflation-adjusted) gross domestic product (GDP) grew at a 3.0 percent annual rate during the second quarter, a 0.4 percent upward revision of the first estimate. The increase followed weak first-quarter growth of 1.2 percent. The latest result reflected a pickup in real personal consumption spending growth and a smaller drag from inventory investment.

The Institute for Supply Management (ISM) manufacturing index increased to 58.8 in August from 56.3 in July. The ISM nonmanufacturing index also rose in August, to 55.3 from 53.9 in July (*Chart 1*). Readings above 50 indicate general expansion; those below 50 indicate general contraction. The manufacturing index is at its highest level since 2011. The nonmanufacturing index, though below recent highs, suggests moderate growth in services.

Chart 1
August ISM Indexes Point to Solid Growth

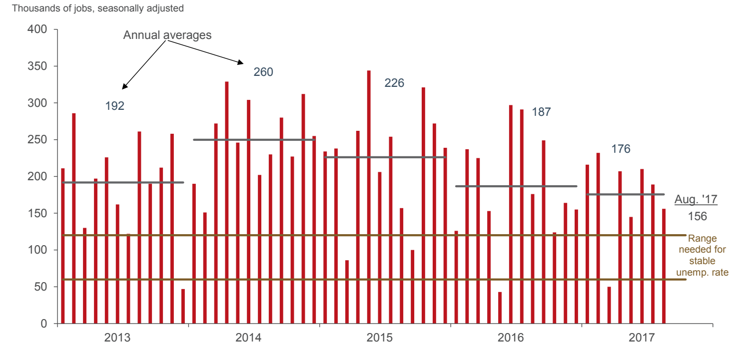


*Values above 50 indicate expansion.
SOURCE: Institute for Supply Management (ISM).

Hiring Slows, Unemployment Near Prerecession Low

Nonfarm payrolls increased by 156,000 in August, below the consensus forecast and less than the downwardly revised July number of 189,000. Payroll gains have averaged roughly 176,000 per month in 2017, a slower pace than during the three prior years (*Chart 2*). While hiring has slowed, it remains above the range estimated to be consistent with stable unemployment.

Chart 2
Payroll Growth Continues Slowing in 2017



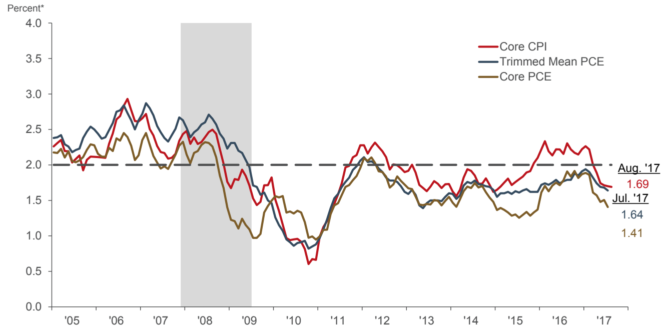
SOURCES: Bureau of Labor Statistics; authors' calculations.

The labor force participation rate of 62.9 percent and broad U-6 unemployment rate of 8.6 percent were unchanged in August (the U-6 rate includes discouraged workers, other marginally attached workers and those working part time for economic reasons). The headline, or U-3, unemployment rate ticked up 0.1 percent in August to 4.4 percent. The U-3 rate matched its prerecession low, in May 2007, while the U-6 rate remained about 0.7 percentage points above its prerecession low. U-3 unemployment remains below the Congressional Budget Office's estimate of its natural rate, roughly 4.7 percent.

Inflation Remains Low

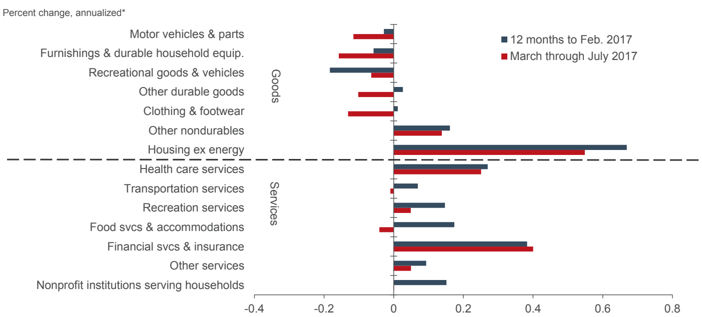
Measures of core consumer price inflation trended lower in June, July and August and remain below levels consistent with the Federal Reserve's long-run goal of 2 percent (*Chart 3*). Measured on a 12-month basis, the price index for personal consumption expenditures (PCE) excluding food and energy ticked down 0.1 percent in July to 1.4 percent. The Federal Reserve Bank of Dallas' Trimmed Mean PCE inflation rate edged down 0.1 percent in July to 1.6 percent. The Consumer Price Index (CPI) excluding food and energy—for

Chart 3
12-month Core Inflation Rates Trending Lower



*Year over year, seasonally adjusted.
NOTES: Shaded area indicates recession. Dashed line indicates 2 percent personal consumption expenditures (PCE) inflation target.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Chart 4
Inflation Deceleration is Broad Based



*Contributions to core personal consumption expenditures inflation.
SOURCES: Bureau of Economic Analysis; authors' calculations.

which there is an additional month of data—was unchanged at 1.7 percent in June, July and August.

Inflation has slowed noticeably since early 2017. Monthly rates were soft across a range of core measures from March through July. August's one-month core CPI rate of an annualized 3 percent may represent a break with this trend.

A few items' price movement contributed to the March-to-July deceleration—for example, cellular telephone services, which fell 7 percent in March in the PCE, and hotel and motel services, which fell a combined 7 percent over June and July.

Chart 4 breaks down inflation in PCE excluding food and energy into its broad components; the bars show each component's contribution to core PCE inflation for the 12 months through February 2017 (blue) and for March-July (red). With two exceptions, the broad components of core PCE contributed less from March to July than during the prior 12 months. Despite the recent low readings, professional forecasters still anticipate inflation to be anchored around the Fed's long-run goal of 2 percent, suggesting price strength in coming quarters.

Hurricanes' Impact on the Outlook

Natural disasters such as Hurricanes Harvey and Irma destroy physical capital and disrupt economic activity. They also displace some amount of production, consumption and investment that would have otherwise occurred. Some of these foregone activities are simply postponed, while others are permanently lost. The disruption effect by itself would lead to an immediate dip and subsequent partial recovery in the level of economic activity. Indeed, industrial production slipped in August.

In subsequent months and quarters, the rebuilding of lost capital plus the realization of some amount of postponed consumption and investment tend to raise the level of economic activity above what otherwise would have been the case. Rebuilding is typically a very gradual process, spread out over many quarters.

In terms of GDP, these patterns lead to an expectation of slower growth in the third quarter relative to the pre-disaster outlook, followed by slightly more rapid growth over the next several quarters. A similar pattern is expected in the labor market, with slower job gains for a couple of months, followed by slightly greater increases later in the year and into 2018. Indeed, initial claims for unemployment insurance jumped by 62,000 in the week following Harvey; further increases over the next few weeks seem likely.

Given Hurricane Harvey's impact on the nation's oil refining capacity, a temporary jump in headline inflation from higher gasoline prices is likely. Some inflation may already have been present in August's CPI data, but the bulk will likely show up in data for September. Whether the hurricanes will affect core measures of inflation is less clear, though prices for vehicles, shelter and energy-intensive services such as airlines represent potential channels for transitory core inflation pressures.

—Jim Dolmas and Laton Russell

About the Authors

Dolmas is a senior research economist and advisor and Russell is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.