Economic Update
UNITED STATES
Federal Reserve Bank of Dallas

High Growth and Steady Inflation Mark End of 2017

December 20, 2017

The general economic picture at year-end 2017 is little changed from earlier in the year, with growth, employment and business confidence remaining strong. Forecasts for fourth-quarter gross domestic product (GDP) point to continued growth of about 2.5 percent. Headline and core inflation measures have either leveled off or increased in recent months. Most forecasters still project inflation will reach the target rate of 2 percent by 2018 or 2019.

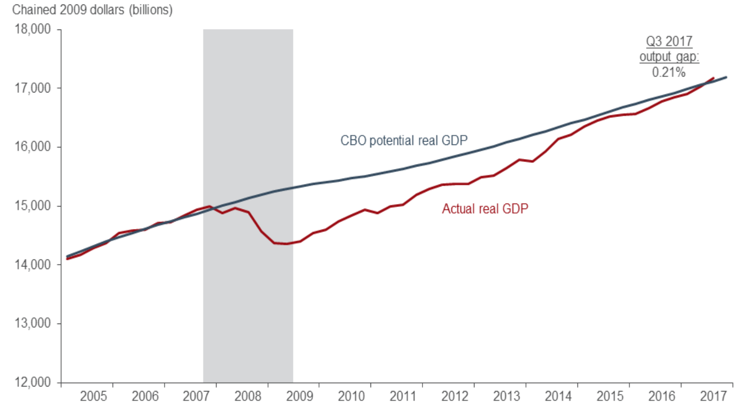
Real GDP Maintains Growth

The second release of real (inflation-adjusted) GDP growth in third quarter 2017 stood at 3.3 percent, up from the initial release of 3.0 percent. The majority of this revision came from positive movements in nonresidential fixed investment (up 10 basis points, or 0.1 percentage point) and government spending (up 9 basis points).

With the latest GDP release, the output gap—the difference between actual output and the Congressional Budget Office's potential real GDP measure—has closed. The output gap crossed into positive territory in the third quarter and reached 0.21 percent, indicating that real growth has finally outpaced potential growth (*Chart 1*).

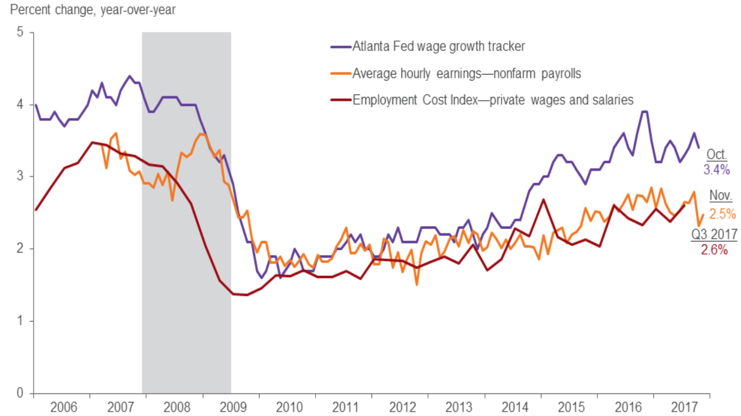
Looking forward, the latest Survey of Professional Forecasters (SPF) report in November predicts real GDP growth will reach 2.6 percent in fourth quarter 2017 and 2.4 percent in first quarter 2018. In contrast, the Federal Reserve Bank of Atlanta's GDP Nowcast forecasting model projects higher growth of 3.3 percent in the fourth quarter, while the New York Fed's Nowcast anticipates a 4.0 percent rate. The Federal Reserve Board's Summary of Economic Projections, released Dec. 13, anticipates real GDP growth of 2.5 percent in 2017 and 2018, reflecting upward revisions from September's release of 2.4 and 2.1 percent for the same years.

Chart 1
GDP Output Gap Now Positive



NOTE: Shaded area indicates recession.
SOURCES: Bureau of Economic Analysis; National Bureau of Economic Research; Congressional Budget Office.

Chart 2
Wage Growth Remains Steady



NOTE: Shaded area indicates recession.
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Atlanta.

Solid Employment Growth

Employment remains strong, with payrolls increasing by 228,000 in November, above consensus estimates, and headline unemployment (the U-3 rate) remaining at 4.1 percent. The broader U-6 rate, which includes discouraged workers, other marginally attached workers and those working part time for economic reasons, ticked up to 8.0 percent from 7.9 percent in October. Labor force participation has moved sideways this year, with the rate remaining at 62.7 percent in November, compared with 62.9 percent in January.

If GDP growth continues at around 2 to 3 percent, unemployment will dip, possibly to below 4 percent, assuming that productivity and labor force growth continue at similar rates found in past years. The latest SPF report expects unemployment to stay at 4.1 percent in first quarter 2018 and drop to 4.0 percent in 2019.

In the second half of 2017, wage growth measures either largely remained the same or accelerated slightly. The Employment Cost Index increased from 2.4 percent in second quarter 2017 to 2.6 percent in the third quarter on a year-over-year basis (*Chart 2*). While the Atlanta Fed's Wage Growth Tracker and the Bureau of Labor Statistics' average hourly earnings measures have been volatile, on average, all three wage growth indicators have grown steadily this year.

As a result of the high employment growth this year, many industries are experiencing labor market tightness, indicating that employers are experiencing more difficulty in filling open positions. Chart 3 displays one measure of tightness—the number of openings per unemployed individual—for total private industry from January 2001 to September 2017. The latest value, 1.1, is a 17-year high and confirms industry reports of hiring challenges.

Inflation Stable but Shows Signs of Turning Up

Inflation has stabilized over the past couple of months and shows signs of future acceleration. Core Consumer Price Index (CPI) inflation ticked down from 1.8 percent in October to 1.7 percent on year-over-year basis in November. Core personal consumption expenditures (PCE) inflation, which excludes food and energy, increased slightly to 1.45 percent in October on a year-over-year basis from September's 1.36 percent, while headline PCE declined to 1.6 percent from September's 1.7 percent. Meanwhile, the Dallas Fed's Trimmed Mean PCE year-over-year inflation measure was unchanged at 1.6 percent. Chart 4 shows that trimmed mean and core PCE, the Atlanta Fed's sticky CPI measure, the Cleveland Fed's median CPI, and core CPI inflation have either stayed roughly the same or begun increasing.

Inflation expectations remain largely unchanged since earlier this year. The SPF forecasts core PCE inflation to reach the Federal Reserve's 2 percent target by 2019, while the implied five-year/five-year-forward (expected average inflation over the five-year period that begins five years from now) CPI inflation rate stands at 2.2 percent. Similarly, the five-year/five-year-forward Treasury Inflation-Protected Securities (TIPS) breakeven inflation rate stood at 2 percent as of Dec. 12 (*Chart 5*).

Business and Consumer Confidence Decline but Remain Positive

The Institute for Supply Management's manufacturing composite index declined slightly from 58.7 in October to 58.2 in November, while the nonmanufacturing composite index declined from 60.1 to 57.4. A reading above 50 indicates growth.

The Conference Board's Consumer Confidence Index climbed further from 126.2 in October to 129.5 in November, its highest reading since late 2000. The University of Michigan's Consumer Sentiment Index cooled from November's 98.5 to 96.8 in December, though both readings are relatively high. Overall, these indicators point to continued optimism about growth next year.

—Daniel Chapman

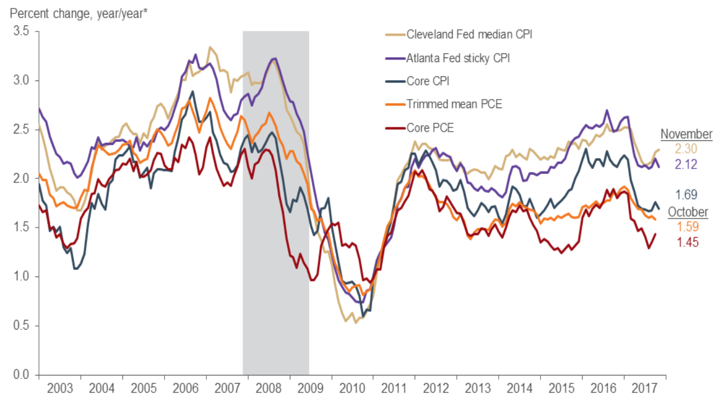
About the Author

Chapman is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.

Chart 3
Labor Market Tightens to Highest Level Since 2001

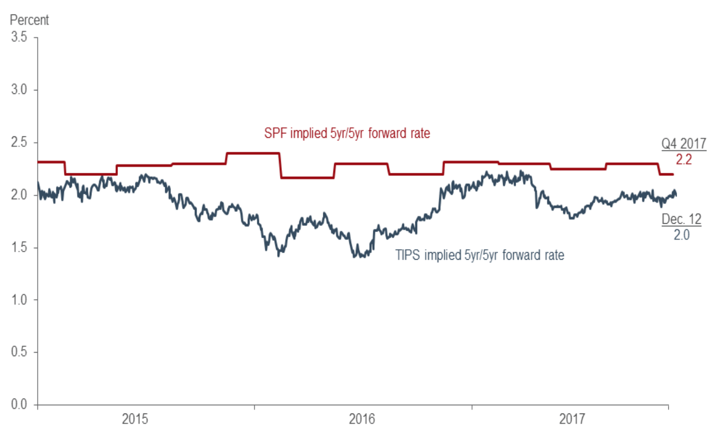
NOTE: Shaded areas indicate recessions.
SOURCES: Bureau of Labor Statistics; author's calculations.

Chart 4
Inflation Either Flattening or Slowly Rising



*Seasonally adjusted.
NOTE: Shaded area indicates recession.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Banks of Atlanta, Cleveland and Dallas; author's calculations.

Chart 5
Long-Term Inflation Expectations Unchanged



NOTE: SPF refers to the Survey of Professional Forecasters; TIPS refers to Treasury Inflation-Protected Securities. The five-year, five-year forward rate is expected average inflation over the five-year period that begins five years from now.
SOURCES: Federal Reserve Board; Federal Reserve Bank of Philadelphia; author's calculations.