Economic Update

UNITED STATES

Federal Reserve Bank of Dallas

Data Point to Momentum in GDP Growth as Year Begins

February 2, 2018

U.S. economic growth slowed in fourth quarter 2017 following two strong quarters. While real gross domestic product (GDP) growth came in below consensus expectations, due in part to drags from inventories and trade, it showed strength in consumption and investment. Overall, the report indicated real GDP has positive momentum entering 2018.

The labor market continues to tighten, and there are recent signs of wage pressure. Inflationary pressures remain modest, with core inflation below the Federal Reserve's 2 percent target.

Strong Consumer Spending

Real (inflation-adjusted) GDP grew at a 2.6 percent annualized rate during the fourth quarter (*Chart 1*) and 2.5 percent year over year. The main driver of growth in the quarter was consumer spending, which contributed 2.6 percentage points, followed by nonresidential investment, which contributed 0.8 percentage points. On the downside, inventories and net exports depressed real GDP growth as they subtracted 0.7 and 1.1 percentage points, respectively.

Output Gap Continues to Widen

The latest GDP measure showed that the output gap—the difference in the level of GDP and the Congressional Budget Office's potential level of real GDP, divided by the level of potential output—is widening. The output gap is now 0.5 percent, up from 0.2 percent in the third quarter (*Chart 2*). This is consistent with an economy operating above potential and with a continuous tightening of the labor market. The U.S. economy is currently estimated to be above full employment.

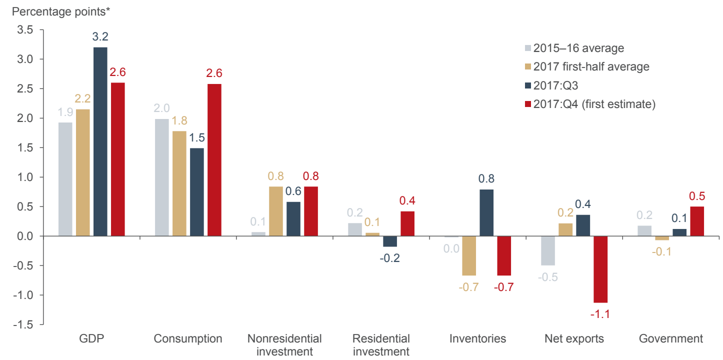
Labor Market Remains Tight

January's employment report shows that the labor market continues to tighten. The U.S. economy added 200,000 jobs in January, bringing the three-month job creation average to 192,000.

Unemployment was little changed from December's employment report. The headline unemployment (U-3) rate remained at 4.1 percent in January, the lowest level since the Great Recession (*Chart 3*).

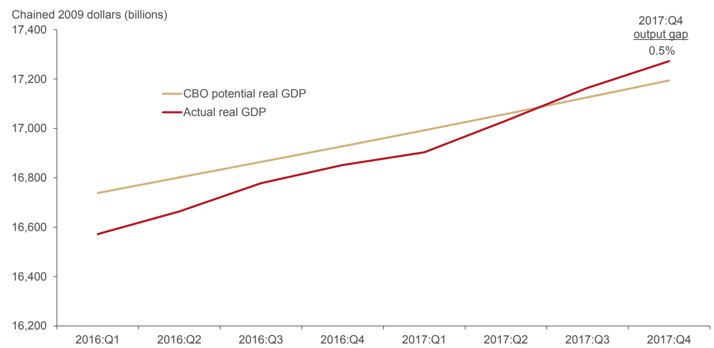
The unemployment rate is presently overshooting its long-run level of 4.7 percent, estimated by the Congressional Budget Office. Given the recent sustained pace of economic growth and the widening of the output gap, the unemployment rate is expected to decline even further. Economic projections from December's Federal Open Market Committee (FOMC) meeting forecast that the unemployment rate will fall to 3.9 percent by year-end 2018.

Chart 1
Strong Increases in Consumer Spending Boost Fourth-Quarter Output Growth



*Contribution to total real gross domestic product (GDP) growth, quarter over quarter; annualized and seasonally adjusted.
SOURCE: Bureau of Economic Analysis.

Chart 2
Output Gap Widens Further



SOURCES: Bureau of Economic Analysis; Congressional Budget Office (CBO).

The labor force participation rate was unchanged at 62.7 percent, while the average workweek decreased by 0.2 hours to 34.3. Over the past year, average hourly earnings have advanced 2.9 percent. During the expansion, earnings have been subdued compared with the strength of the recovery observed in other measures of the labor market.

Wage Pressures Seen at Lower End of Wage Distribution

Wage growth has begun to pick up the past few years, largely due to persistent improvements in the labor market. A recent development has been the pace of wage growth for low-wage workers, which has been lagging behind growth for medium- and high-wage workers.

Chart 4 shows the annual change in the three-month average (August–October) between 2017 and 2016, along with the same three-month average annualized wage growth over the previous five years. The chart presents evidence of wage pressures across the wage distribution, but in the 12 months ending in October 2017, low-wage workers (those in the 10th to 30th percentile) have seen a larger increase in wage growth compared with middle- and high-wage workers. The rationale for this development stems from recent increases in the minimum wage across states and municipalities as well as the higher sensitivity of low-wage workers compared with medium- and high-wage earners to persistent improvements in the labor market.

Core Inflation Measures Show Signs of Firming

Recent inflation data show that measures of core inflation remain below the FOMC’s 2 percent target but seem to be slightly advancing (*Chart 5*). The 12-month core Consumer Price Index (CPI), which measures all items excluding food and energy, rose to 1.8 percent in December from 1.7 percent in November. Core personal consumption expenditures (PCE) inflation in December remained the same as it was in November at 1.5 percent on a year-over-year basis. Likewise, the Dallas Fed’s Trimmed Mean PCE inflation measure in December was unchanged from November at 1.7 percent year over year. But recent measures of core inflation, both CPI and PCE, have begun to tick upward and close in on the 2 percent target. The Survey of Professional Forecasters projects that core PCE inflation will reach 2 percent by 2019.

Long-Term Inflation Expectations Well-Anchored

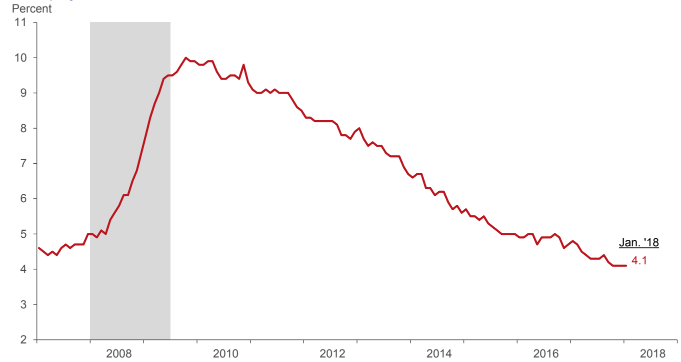
Long-term inflation expectations have remained stable (*Chart 6*). The Survey of Professional Forecasters’ implied five-year/five-year-forward CPI inflation expectations (expected average inflation over the five-year period that begins five years from now) have dipped to 2.2 percent from 2.3. They have been hovering around 2.2 to 2.3 percent for a long time and seem largely unaffected by recent changes in both fiscal and monetary policies. The five-year/five-year-forward Treasury Inflation-Protected Securities-implied breakeven inflation rate is at 2.2 percent, little changed since early December.

—Laton Russell

About the Author

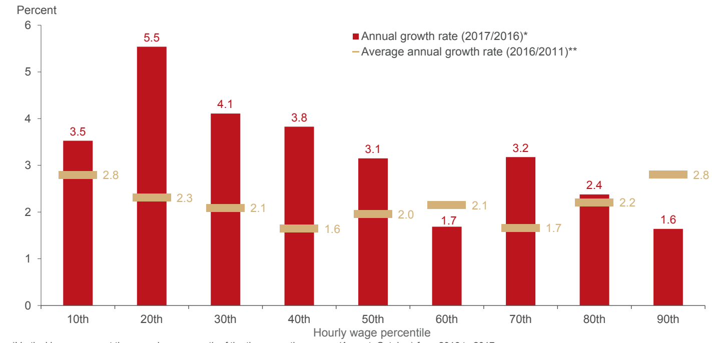
Russell is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.

Chart 3
Unemployment Rate at Postrecession Low



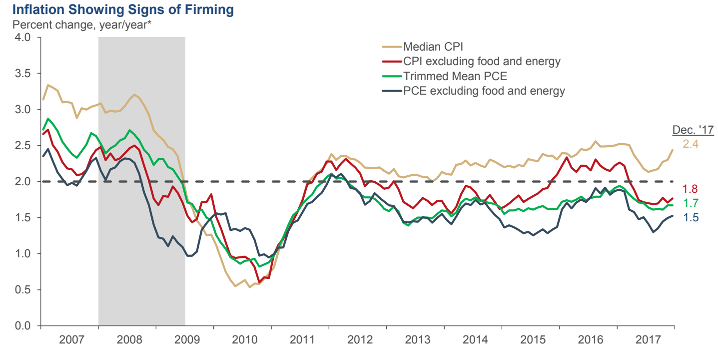
NOTE: Shaded area indicates NBER recession.
SOURCES: Bureau of Labor Statistics; National Bureau of Economic Research (NBER).

Chart 4
Wage Growth Higher at Low End of Wage Distribution



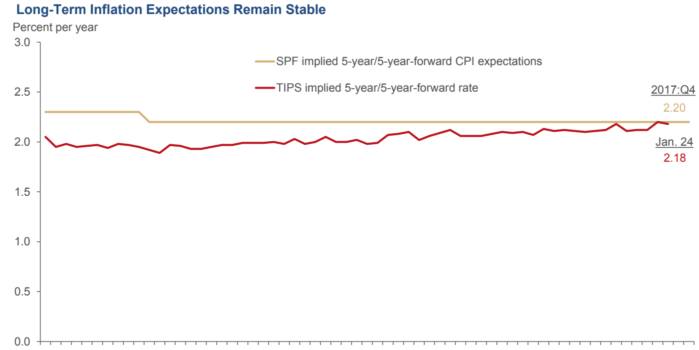
*Vertical bars represent the annual wage growth of the three-month average (August–October) from 2016 to 2017.
**Horizontal lines represent the average annual wage growth over the previous five years (August–October 2011 to August–October 2016).
NOTE: The series frequency (three-month average) is used to smooth the data.
SOURCES: IPUMS CPS; author's calculations.

Chart 5
Inflation Showing Signs of Firming



*Seasonally adjusted.
NOTES: The shaded area indicates NBER recession. The dashed line represents the Federal Reserve's 2 percent inflation target. CPI refers to the Consumer Price Index and PCE to personal consumption expenditures.
SOURCES: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Bank of Cleveland; Federal Reserve Bank of Dallas; National Bureau of Economic Research (NBER).

Chart 6
Long-Term Inflation Expectations Remain Stable



NOTES: SPF refers to the Survey of Professional Forecasters; TIPS refers to Treasury Inflation-Protected Securities. The five-year, five-year-forward rate is the 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.