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Federal Reserve Bank of Dallas

Recovery Remains Resilient

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Indicators of real economic activity for the U.S. have held up surprisingly well given the lack of confidence signaled through surveys and financial markets. Real gross domestic product (GDP) grew at an annualized pace of 2.5 percent in third quarter 2011. Inflationary pressures were subdued and show signs of converging to 2 percent.

Consumers Rattled but Keep Opening Their Wallets

After the financial turbulence in August, many expected slower, or even negative, growth in the third quarter. Surveys of consumer confidence reflected this pessimism, falling to levels not seen outside of recession. Since then, "hard"—not survey-based—indicators of real economic activity have generally surprised on the upside. Retail sales have held up remarkably well, rising 1.1 percent in September (*Chart 1*). Real personal consumption expenditures (PCE) grew 0.6 percent in September and contributed 1.7 percent annualized to real GDP growth in the third quarter. This was a welcome development, although doubts remain about consumers' ability to fuel recovery-like growth.

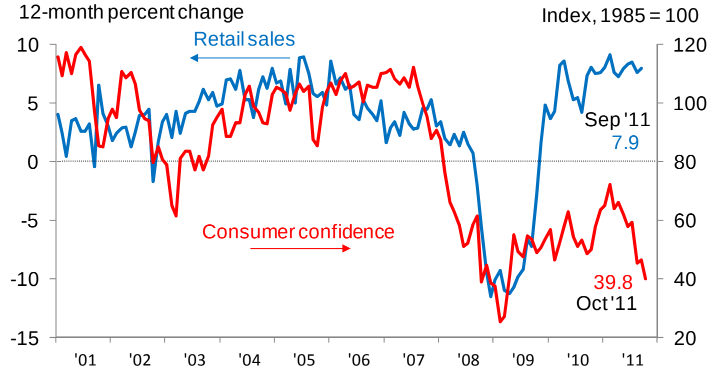
Output Growth Improved

Real GDP grew at a 2.5 percent annualized rate in the third quarter after a sluggish 0.8 in the first half of the year, putting to rest fears of impending recession. The improvement was broad based, with every major category besides inventory investment contributing more to growth than its first half average (*Chart 2*). Business investment was very strong, mostly in equipment and software. Behind PCE, nonresidential fixed investment contributed the second most to growth, 1.5 percentage points. Businesses still have plenty of cash to invest, but to continue investing at this rate they would likely need to expect stronger demand elsewhere. Real government consumption and investment did not change, after three consecutive quarters of being a drag on growth. Net exports were a small positive and remain a possible sustainable driver of recovery. However, slower growth in Europe should continue to dampen export growth.

Housing Still Bouncing Along the Bottom

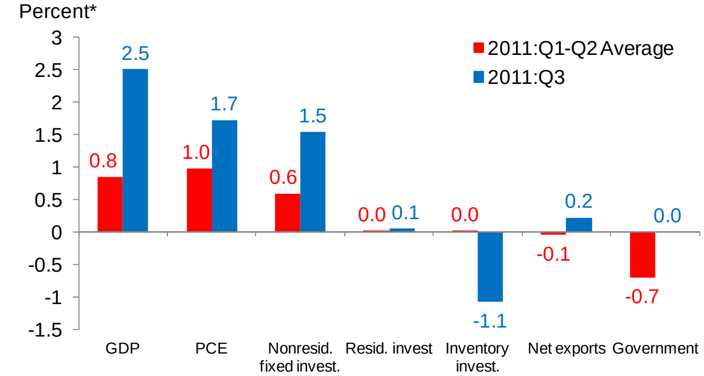
Residential investment has traditionally led economic growth and has been a substantial driver of past recover-

Chart 1
Retail Sales Hold Up Despite Falling Confidence



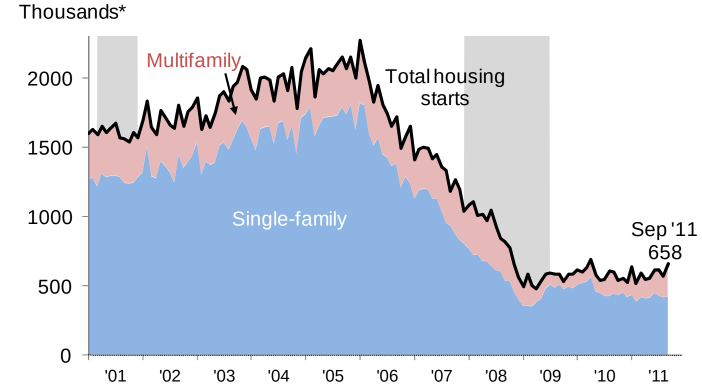
SOURCES: Census Bureau; Conference Board.

Chart 2
Third Quarter GDP Sees Broad-Based Improvement



*Contribution to real GDP growth, seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

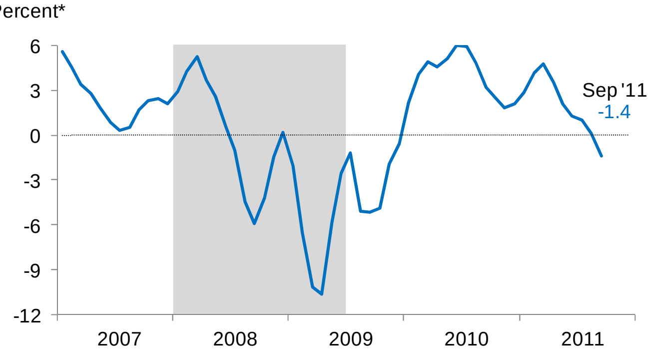
Chart 3
Housing Starts Have Been Moving Sideways



*Seasonally adjusted, annualized rate.
NOTE: Gray shaded areas represent recession.
SOURCE: Census Bureau.

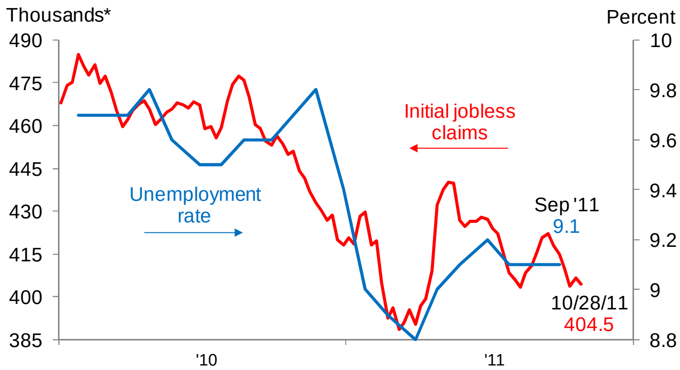
ies. This recovery has had to do without a boost from residential investment, as home building stopped falling in 2009 and has moved sideways ever since (*Chart 3*). Housing starts increased to 658,000 in September, driven by a 51 percent increase in multifamily starts. The rent-of-primary-residency component of PCE inflation has ticked up to 2.1 percent over the past 12 months ending in September, indicating tightening in the rental market. With construction languished at historic lows for several years, any substantial increase in employment could spur household formation and some contribution from residential investment, even if it is from new apartments rather than single-family homes.

Chart 4
Personal Income Contracts in Third Quarter



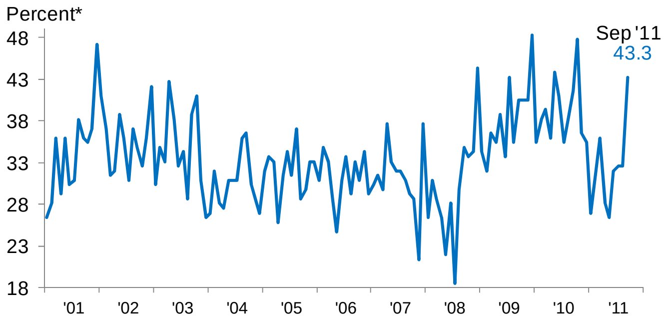
*3-month percent change annualized, in the 3-month moving average.
NOTE: Gray shaded area represents recession.
SOURCE: Bureau of Economic Analysis

Chart 5
Initial Claims Consistent with Stalled Unemployment



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

Chart 6
Number of Items with Falling Prices Jumps in September



*Of 178 PCE components with falling prices.
SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

Personal Income Paints a Bleaker Picture than GDP

Aggregate economic activity is measured in two ways: gross domestic product, the more commonly referenced measure, and gross domestic income (GDI). In theory these should be the same, as expenditures equal income, but in practice they are often different due to measurement methods. Since the most recent downturn, GDI has been a more accurate indicator of economic activity than its more heavily revised counterpart, GDP. GDP has generally been revised toward the earlier estimates of GDI.[1] While the third quarter GDP report is encouraging, GDI should also be carefully considered, given its recent tendency to better withstand revision. Unfortunately, it is not released until a month after the initial release of GDP. Personal income, which makes up 65 percent of GDI, is released earlier with a monthly frequency. Real personal income fell 1.4 percent annualized in the third quarter, making it unlikely that GDI kept up with GDP (*Chart 4*).

Employment Still Growing

Nonfarm payroll employment increased by 103,000 in September, and August and July were revised up to 57,000 and 127,000, from 0 and 85,000. This eased fears of a potentially contracting labor market. These numbers were distorted by 45,000 Verizon Communication Inc. workers on strike. In absence of the strike, August would have been stronger and September weaker. This brought employment growth in the third quarter to 0.7 percent, half the second quarter rate and below what is necessary to bring down the jobless rate. The household survey showed employment increasing by 398,000 in September, offset by the labor force increasing by 423,000, leaving the unemployment rate at 9.1 percent. Initial claims for unemployment insurance in October hovered near 400,000, consistent with a flat unemployment rate (*Chart 5*).

Inflationary Pressures Soften

The headline PCE price index increased by 2.0 percent annualized in September, down from 3.2 percent in August. This was unusual in that the sharp change was not driven by food or energy. The core PCE price index, excluding food and energy, decreased by 0.03 percent annualized, down from an increase of 2.04 percent in August. The fraction of components in the PCE basket experiencing price declines jumped to 43 percent, a level comparable to 2010 when inflationary pressures were consistently softening (*Chart 6*).[2] The core 12-month rate of inflation fell to 1.65 percent from 1.68 percent, and the headline rate rose to 2.95 from 2.89. The core price decrease is surprising, but one month is not a trend. The smoother trimmed mean PCE rate, which excludes the largest price increases and decreases, was at 1.6 percent annualized in September and 2.1 percent annualized over six months. This is in line with expectations for inflation to converge to around 2 percent as energy price increases from earlier in the year pass through the system.

Despite volatile financial markets, third quarter 2011 generally saw improvement over an anemic first half. The economy is not weak enough to fall into a downturn without an external push, and it may even be gaining momentum. However, it is telling that 2.5 percent output growth—considered by some to be the economy's long-run potential growth rate—during a recovery is received as good news. If the U.S. economy is to return to its pre-recession trend and the unemployment rate is to fall quickly, stronger growth will be required.

—Tyler Atkinson

About the Author

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

Notes

1. "The Income- and Expenditure-Side Estimates of U.S. Output Growth," by Jeremy J. Nalewaik, Brookings Papers on Economic Activity, Spring 2010, pp. 71–106.
2. "Behind the Numbers: PCE Inflation Update, September 2011," by Jim Dolmas, Federal Reserve Bank of Dallas, October 28, 2011, www.dallasfed.org/data/pce/2011/pce1109.cfm.