Research @ Citi Episode 52: Government Shutdown vs. the U.S. Economy

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Transcript:

Rob Rowe (00:00)

Hi, everyone. I'm Rob Rowe, U.S. Regional Director of Research. Welcome to the Research @ Citi podcast. Joining me today is Veronica Clark, Senior U.S. Economist on our U.S. Economics team.

We're here to discuss a number of topics, but most importantly, the U.S. government shutdown and how this may affect the U.S. economy, as well as what may be the Fed reactions. Veronica, thanks for being on the podcast today.

Veronica Clark (00:25)

Yeah, thank you for having me.

Rob Rowe (00:27)

In terms of the current government shutdown, we've been through a couple of these, but what do market participants, what do we all need to know? What are the things that you think are critical for us to understand and know about the government shutdown?

Veronica Clark (00:41)

We have certainly experienced these before, but maybe one not quite like this in a while. So the last government shutdown we had in 2018, 2019, some of the government was actually funded. So we had a partial government shutdown then, but that meant it was a bit less disruptive to markets.

One agency that was still funded then was the Bureau of Labor Statistics. It meant that we still got the jobs data, we still got inflation data. We have not had a full government shutdown since October of 2013. And that unfortunately, in this instance, means that we don't get any of that data.

So that's the first, most important element of this shutdown. The most immediate impact for markets is that we're not getting economic data that is released by the government, by essentially any government agency. We will still get data that's released from the Fed and private-sector data providers, but we have already missed a pretty crucial September Non-Farm Payrolls report that was supposed to come out last Friday.

At the time I'm talking, it's been eight days of this shutdown. It does seem pretty likely that the shutdown is going to continue at least through this week. As we get into next week, October 15th, that's next Wednesday, we are getting into a time where federal employees, maybe the military, are going to start missing their first paycheck from the shutdown.

Maybe that adds a bit more impetus to get the government reopened. So maybe we're hopeful for reopening later this month, but we will also probably miss all of the economic data that is supposed to come out next week. That includes Retail Sales, the CPI report for September, so it does seem like we could be going through a lot of this month without the important official economic data.

I'm not so worried about the quality of that September data yet, but we do get into issues of data collection and data quality for some of this October data. So that definitely means when the data eventually come out, they could be more volatile than we're used to. And certainly markets will be reacting to that.

And then the longer this lasts, the shutdown itself could have economic impacts. And of course that can impact markets. We could see more job loss, maybe some threat of permanent job loss from the shutdown. And certainly if that shows up in the data, markets will react to that whenever we get that data.

Rob Rowe (02:49)

Veronica, before we segue into the impact of the government shutdown, what I would like to ask you is, "How do you see the state of the U.S. economy right now?" There's a lot of argument and back and forth about where it may be — soft landing etc., recession. I think we're in the soft-landing camp. And so how are you seeing the U.S. economy if we pretended that the government shutdown didn't happen? What was the trajectory there?

Veronica Clark (03:13)

It's a confusing time, and not a time where you want to be missing data because there are a lot of stories you can tell. I'd say we're not expecting a recession. So yeah, in that sense, that is not in our forecast.

But we do see more weakness in the labor market ahead, more weakness on that employment side of things. So I think there's essentially two schools of thought right now. One group of investors maybe who see the slowdown that we've seen in the labor-market data the last couple of months as maybe just temporary. The fundamentals are still strong. We've still had resilient consumer spending.

But maybe part of that is later in the year we can get a resurgence of investment. There were some business tax provisions passed over the summer as part of the fiscal bill. Obviously, AI investment related to computers and building data centers, that can stay pretty strong. So maybe we're still in this very resilient, strong growth situation as we head into next year.

I'd say this could be a more structural slowdown side of things because this weakening that we've seen in the labor market, we don't see the big layoffs. That's not in our forecast, but this is a very low-hiring labor market.

That is not unique to this year. That's been happening for about two years already. We would see that as a consequence of rates have been high and fiscal stimulus from the pandemic in 2022 has been fading. You do see contraction in sectors that are more rate-sensitive, like manufacturing and housing. Yes, we might have some more support for investment through tax breaks, but we do have the tariffs to deal with. That is, in a sense, a tax increase. So we do expect more softening in the labor market and would think that that means consumption would be slowing also.

Rob Rowe (04:56)

How should I square a softening labor market with consistent consumption and actual growth still remaining somewhat strong?

Veronica Clark (05:08)

Yeah, we have still seen that resilience to consumption. Consumption was pretty weak to start the year, but then Q2 data was stronger. Q3 data looks like it's been stronger. I think it's a fair story, and one that gets more attention, that a lot of the consumption is probably coming from higher-income earners, maybe people who are feeling the wealth effect from asset prices going up, your home price has gone up 20% in the last couple of years. So more of the consumption really is coming from that side.

And ultimately, I think it still would be that if labor income — that's the ultimate driver of total consumption — is slowing with job growth slowing, we would think consumption can slow more. But we've certainly seen strength in business investment, first half of the year. That looks like it can stay strong. And yeah, that might be somewhat separate from what's happening in the labor market related to the AI story.

Ultimately, for the economy as a whole though, consumption, labor-dependent types of growth are still 70% of GDP. If the employment market, if the labor market is slowing, we would think that you would see an aggregate slowdown in growth, too.

Rob Rowe (06:14)

And so now let's reintroduce the government shutdown. First of all, it seems to me that most people's gut feeling is that this one's going to go a little longer than the others. And I'm not so sure why, because most of these have been brinkmanship, and at some point somebody gives, and maybe it doesn't go that long. But everybody has a gut feeling that this one's going to go for a while.

I did see a headline that suggested that the president would consider some health-care provisions that he could potentially put into the reconciliation or whatever. But I mean, how are we looking at that over time? In other words, what would you estimate the current job losses to be? What would they be over time? And how would that affect the growth of this economy, do you think?

Veronica Clark (07:03)

So usually what happens in government shutdowns — and yeah, usually they are shorter, maybe just a week or two, even just a couple days — is you do have a group of federal workers who are still working. They're deemed essential. This is the TSA, airport security, things like that. But then you have another group of federal workers who are furloughed and not working during this period. But importantly, no federal worker is getting paid. And if it's just a couple days, a week or so, that doesn't tend to matter. You haven't actually missed a pay period yet. Nothing in your paycheck has necessarily changed. So very short, normal government shutdowns, you really don't get much of an economic impact or labor-market impact.

Obviously, if they last after next week, people will miss a pay period. Usually what happens is all of those workers furloughed, or still working, will be back-paid when the government reopens. Legislation is passed to back-pay all those workers, and so you end up not actually missing any pay. You just maybe receive it later than usual.

There is a risk this time, though: The administration has threatened some more permanent layoffs, maybe some actual funding cuts, related to the shutdown. Maybe some of these workers would not be back-paid or would lose their jobs going forward. There's nothing concrete that's been determined on that. So as far as we know right now, yes, there are 750,000 federal workers who are furloughed right now and not working, but we're assuming that they will ultimately be back-paid.

But the issue is, even if they end up receiving pay for this period, they might receive it a lot later than usual. And not everyone is going to be able to maintain their same level of consumption if you're missing a paycheck or two. So yeah, the longer this lasts — certainly if it lasts beyond the middle of the month, if it lasts the whole month — we would think that the economic drag can get greater. And then especially it's a lot more if any of these layoffs are made permanent.

Rob Rowe (08:52)

Does anything trip your estimation into a recession, depending on how long this goes? Does it have that sort of significance?

Veronica Clark (09:00)

Probably not. We might be getting into uncharted territory, though. A full government shutdown — I believe 2013 was maybe the longest one, and that was three weeks, something like that — for a month or more in a labor market that is already pretty vulnerable, in an economy that we think is already slowing, does not help certainly. And so, yeah, you do get into issues of “What is the straw that breaks the camel's back?” I don't think it would necessarily be the shutdown, but we've already seen issues of government funding affecting certain sectors and what-not.

But we will also, regardless of the shutdown itself, have a bunch of federal workers out of work in October. This is the DOGE buyouts, people who took the DOGE buyout offers in the spring. Those people are dropping off of payrolls in October anyway. So, there will already be some more federal layoffs happening next month, I guess this month when the data comes out next month.

Rob Rowe (09:55)

Does that sort of overemphasize the data? In other words, does it get overdone because of these furloughed workers? Even for some period will affect that data when we do get it.

Veronica Clark (10:07)

So what should happen is when we eventually get that October jobs data, we're expecting there to be a big drop in government employment. That's because of the people who took the DOGE worker buyouts. They stopped being paid at the end of September. And there might be a slight increase to unemployment from those people too.

The federal workers on furlough from the shutdown ultimately should not drop off of payrolls. They should be back-paid. So they should still count as on payroll, as having received pay for October, but those workers actually might increase the unemployment rate.

So those people would be counted on temporary layoff in October. That would, of course, then come back down once they went back to work. But yeah, that October data all around, there are risks that it could look a lot softer.

Rob Rowe (10:53)

I don't envy your job of having to estimate what the unemployment rate's going to be.

Veronica Clark (10:57)

Yes, it's a tricky one. But of course, it's the most important number for the Fed, probably.

Rob Rowe (11:03)

That's right. Well, let's talk about the Fed here. That's a good segue. How does the Fed react to this? I mean, obviously they've sort of entered an easing cycle, if you will. We've had one cut. I think you and your team are estimating another cut for this year and then two more in the first quarter. Are you standing by that? Do you think they feel compelled under these circumstances then to accelerate this easing?

Veronica Clark (11:24)

So we're expecting them to cut at the meeting later this month in October, again in December, then again January and March of next year.

I think this October cut, the market is fully priced for it. Unclear if we will have any official data released before they meet at the end of the month. I think if they don't have any data, there's a couple of things. One, you are probably just stuck reacting to what you last knew. And what you last knew, as of September, was that the labor market was weakening a bit more. The risks there were a bit greater. And if anything, the upside inflation risk had looked a little bit less. And the median, an official we know in September, wanted to cut two more times this year. So that's obviously cutting in October and then also December.

But there is this camp of Fed officials who are uncomfortable with cutting too quickly, who don't want to cut at all the rest of the year. So there certainly will be more of that debate.

But then the second thing I think is, if it is the case that the shutdown is lasting the whole month of October and we don't have any data, well, that in itself is weighing on growth and weighing on the labor market. And so that just adds to the downside risk. Maybe that could be reason to get some of these more hesitant officials on board for a cut in October.

After October, I think the labor-market data is, of course, the most important. We could have that much softer October payrolls report, more evidence that the labor market is weakening. It will, of course, be very data-dependent.

After this year, the market's a bit more split. The market thinks that maybe we're not getting quite as quick cuts as we have. And there are issues of residual seasonality with stronger inflation in Q1. But I think it comes back to that weakening employment story that will probably be the most important for the Fed.

Rob Rowe (13:04)

Is that a seasonal uptick in inflation that we're anticipating?

Veronica Clark (13:07)

Yeah. So this happens every Q1 now, or at least it has for the last couple of years. It's essentially a consequence of inflation still being a bit stronger. You get more of that strength at the start of the year, just because that's a natural time to raise prices and the seasonal adjustment hasn't quite accurately accounted for that. So yeah, we've seen this pattern of stronger inflation data in Q1, and then it slows throughout the rest of the year.

I would think that some of that could repeat this year. Maybe start of the year is a natural time to pass on more tariff costs. You're changing prices anyway. So maybe we see goods prices that are a bit stronger in Q1.

But in general, if the labor market is loosening? You, number one, care more about the risks on the employment side of the mandate. But then, number two, that should make you less concerned about the persistence of inflation, because two-thirds of core inflation is still services. And that's going to be very dependent on the labor market.

Rob Rowe (14:01)

Veronica, are there secondary effects to this that we need to think about? I'm thinking, OK, maybe we have flight delays etc. Does this affect tourism? Does it affect other industries that could then have a kicking effect on growth?

Veronica Clark (14:16)

I mean, certainly, some of the knock-on effects can get worse the later that you go. I'm thinking even the National Zoo in D.C. is still open this week. They had enough funds from another funding source to stay open a bit longer. But that's limited, right? So you will get more closures, I think, as time goes on.

You will also have some private-sector spillover. Back in previous shutdowns, you do see government contractors who are technically private-sector employers, they have to furlough workers or lay workers off temporarily. And it's especially more of that knock-on effect, the more paychecks that these people miss. And then you cut back on spending and that has effects. You're not going out to eat at a restaurant, or you're not buying something that you otherwise would have. So, yeah, this does get bigger the longer it goes on.

Rob Rowe (15:03)

And in regard to the Fed again, is there a point at which they're going to be flying blind on the data? I mean, you were mentioning the next cut may be data-dependent. We'll have to see how the labor market's doing. It's going to be October data that is in relation to September. That could be overdone, but also it may not be delivered, depending on how long this goes.

Veronica Clark (15:23)

So we do have some data points and they'll just have to rely like we are more on some of these third-party data providers. So any private-sector survey data, we've gotten the ISM surveys for September: They were on the softer side, but nothing dramatic. We did get ADP Employment, which is never a great indicator for payrolls in any specific month, but the trend is still correlated, and that was weaker in September. That was a loss of 32,000 jobs.

But we also will fortunately get one of the most important data points that comes out every week anyway, which is the weekly claims data. So the official numbers for jobless claims, initial and continuing claims each week, are not being released, but the states release their own data. So we're able to aggregate up all the states. So the Fed will have some data to look at.

But again, in itself, the shutdown, if it's really lasting the whole month, that's an added drag on demand and the labor market. Probably a reason that they would err on the side of cutting anyway.

Rob Rowe (16:22)

Veronica, thank you so much for all of your insights. I found it very insightful. Thanks again.

Veronica Clark (16:27)

Thanks.

Rob Rowe (16:28)

This podcast was recorded on October 8th, 2025. Be sure to join us for our next Research @ Citi podcast, which will feature Johanna Chua, our head of Emerging Markets Economics, our Chief Asia Economist, who will provide an update and overview of the economic landscape in Asia.

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Thanks so much, everyone.

Disclaimer (17:07)