U.S. DEPARTMENT OF THE TREASURY

Economy Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association

February 1, 2021

In the final quarter of 2020, the U.S. economy expanded further, with growth in real GDP of 4.0 percent, according to the advance estimate released last Thursday. Despite this second consecutive quarter of growth, real GDP still declined 2.5 percent over the four quarters of 2020, given the severity of the contraction in the first half of the year. The economy's recovery slackened by the end of the year. Payroll job creation slowed noticeably from September through November, before declining outright in December, largely due to losses in leisure and hospitality service industries—such as restaurants and bars, hotels, performing arts venues, and other establishments that are particularly vulnerable to stay-at-home orders and other measures implemented to combat the pandemic. While real personal consumption rose in the fourth quarter, the pace of growth was constrained in part by renewed lockdowns and reduced capacity in key service industries. Though the second Federal economic aid package passed in December 2020 should boost growth in the first half of 2021, a full recovery nonetheless depends on effectively resolving the pandemic – the efficacy of public health measures and the rapid vaccination of the population – while ensuring that households and businesses can cope with the variety of headwinds presented by the pandemic.

GDP GROWTH

Real GDP grew 4.0 percent at an annual rate in the fourth quarter of 2020, following a surge of 33.4 percent in the third quarter. Two major components of GDP – private fixed investment and residential investment – grew at double-digit paces, but private consumption also made healthy positive contribution to growth in the fourth quarter. Private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – increased 5.6 percent at an annual rate in the fourth quarter, extending the 39.0 percent advance in the third quarter. This measure captures the economy's capacity for a self-sustaining recovery, and also attests to an underlying upward momentum in private demand.

Real personal consumer expenditures (PCE), which accounts for about two-thirds of overall GDP, grew 2.5 percent at an annual rate in the fourth quarter. This followed a surge of 41.0 percent in the third quarter; by the fourth quarter, PCE had recovered 77 percent of what was lost in the first half of 2020. Purchases of durable goods – a category that includes motor vehicles, household equipment and furnishings, among other items – were unchanged in the fourth quarter, after spiking 82.7 percent in the third quarter. Purchases of nondurable goods – such as food and beverages purchased for off-premises consumption, gasoline and other energy goods, clothing, footwear, and other goods – declined 0.7 percent in the fourth quarter, following a gain of 31.1 percent in the third quarter. Meanwhile, household expenditures on services – the component of PCE most severely affected by the pandemic and related measures – grew 4.0 percent in the fourth quarter, after rebounding by 38.0 percent in the third quarter. With two consecutive quarters of gains in most categories, consumer spending was 2.6 percent below its level at the end of 2019. Overall, real personal consumption expenditures added 1.7 percentage points to the rise in total GDP in Q4.

Business fixed investment (BFI) rose 13.8 percent at an annual rate in the fourth quarter, driven by gains in all three major components, and following a jump of 22.9 percent in the third quarter. Equipment investment showed the most rapid and broad-based growth in the fourth quarter, rising 24.9 percent overall – with gains in each sub-component – after surging 68.2 percent in the third quarter. Investment in intellectual property products grew 7.5 percent, roughly comparable to the 8.4 percent increase in the third quarter. Meanwhile, investment in structures was up 3.0 percent in the fourth quarter. This represented a sharp swing from the 17.4 percent drop in the third quarter, when appetite for such investment was diminished due to lower oil prices and less oil exploration, continued use of telework, and a shift in consumption patterns away from brick-and-mortar to online retail sites. While the latter two factors were still present in the fourth quarter, oil prices have trended up since late October, prompting more investment in oil-drilling structures; according to private sources, the average rig count rose 21 percent from the third to the fourth quarters. The fourth quarter rebound in investment for mining-related structures partially offset annualized declines of 82.1 percent and 67.0 percent in the second and third quarters, respectively. Overall, total business fixed investment added 1.7 percentage points to real GDP growth in the fourth quarter, after contributing 3.2 percentage points in the third quarter.

Inventory accumulation, albeit a volatile component, returned to a more normal pace in the fourth quarter, after a significant buildup in the third quarter. In the fourth quarter, the change in private inventories added 1.0 percentage points to economic growth, after contributing 6.6 percentage points in the third quarter.

In three of the past four quarters, residential investment has grown at double-digit paces. After surging by 63.0 percent in the third quarter – its largest advance since 1983 – residential investment increased 33.5 percent in the fourth quarter. This component added 1.3 percentage points to growth, after contributing 2.2 percentage points in the third quarter. Prior to the pandemic, residential investment had contributed to GDP growth for two quarters, and growth in this sector was solid in the first quarter of 2020. The pandemic led to a steep but temporary decline in the second quarter. Yet since last May, this sector has gained considerable strength, supported by record-low interest rates and record highs in builder confidence. Demand for homes has far outstripped available supply, which has led to the recent, strong acceleration in home price growth—as well as strong gains in housing wealth among homeowners. High house prices should eventually draw in more supply to help redress the current imbalance; until then, the rise in prices is making owner-occupied housing somewhat less affordable.

Single-family housing starts and permits have grown strongly each month since May. As of December, single-family housing starts were nearly 30 percent above their February level and single-family building permits – a leading indicator for starts – were 23 percent above pre-pandemic levels. Existing home sales, which account for 90 percent of all home sales, rose to a fourteen-year high in October and were up more than 22 percent over the year through December. New single-family home sales reached a 13-year high last August; though pulling back since, new home sales were still 15.2 percent higher over the year through December. In November, the National Association of Home Builder's home builder confidence index rose to a record high of 90; though declining a combined 7 points over the two subsequent months, the home builder confidence index in January was still at an elevated level, conveying a significantly positive outlook about market conditions in the housing sector. In early January, average rates for 30-year mortgages set a record low that was 2¼ percentage points below the levels since in November 2018. In the intervening weeks, rates have risen only modestly above the record low.

Government spending declined 1.2 percent at an annual rate in the fourth quarter, reflecting a 0.5 percent decline in Federal spending and a 1.7 percent decline in state and local government expenditures. Total government spending pared 0.2 percentage points from GDP growth in the fourth quarter, mostly due to the state and local government component. State and local government consumption has fallen for three consecutive quarters, partially owing to the reduction in employees as these governments struggled to meet balanced-budget requirements. The pandemic increased health care costs for these governments but social distancing restrictions lowered revenue, creating budget shortfalls.

The net export deficit increased $102.1 billion at an annual rate during the fourth quarter to $1.12 trillion, as recovering domestic demand fueled another surge in imports. Exports grew strongly, if less so than imports. Total exports of goods and services grew by 22.0 percent, while imports advanced 29.5 percent. The widening of the trade deficit subtracted 1.5 percentage points from fourth quarter GDP growth, though this was less than one-half the 3.2 percentage points of drag posed by net exports in the third quarter.

LABOR MARKETS AND WAGES

Due to measures taken to control the spread of the virus, the economy lost 22.2 million jobs last March and April, 21.1 million of which were in the private sector. Payroll job growth resumed last May: through December, the economy had recovered nearly 56 percent of all jobs lost and 60 percent of the private sector's job losses. Nonetheless, the pace of job growth slowed in more recent months and the labor market recovery stalled in December, with the economy losing 140,000 jobs, including 95,000 jobs in the private sector. In all, the number of unemployed persons stood at 10.7 million in December, and weekly initial unemployment claims continue to run about four times the average levels seen prior to the pandemic's onset.

The headline unemployment rate remained at 6.7 percent in December for the second consecutive month, nearly double its pre-pandemic level but more than 8 percentage points below the 14.8 percent, post-World War II high reached in April 2020. The broadest measure of labor market slack, the U-6 unemployment rate, has also declined noticeably over the past several months yet remains above pre-pandemic levels. By December, the U-6 had been cut to 11.7 percent, roughly half its level in April 2020. But it remains nearly 5 percentage points above the pre-pandemic low of 6.8 percent observed in in December 2019. Moreover, long-term unemployment continues to rise: the share of the labor force who were unemployed 27 weeks or more reached 2.46 percent in December, or roughly four times the 0.68 percent rate seen in February 2020.

Although the headline labor force participation rate (LFPR) – as well as prime-age (ages 25-54) LFPR – have recovered from the lows seen in April, they have yet to return to their pre-pandemic levels and in recent months, progress has slowed. As of December, the headline LFPR stood at 61.5 percent, or almost 2 percentage points below the six-year high seen in January 2020, and the prime-age LFPR was 81.0 percent, 2 percentage points below the eleven-year high seen in January 2020. The employment report for January 2021 will be released this Friday, February 5.

Nominal average hourly earnings for production and nonsupervisory workers rose 5.2 percent over the year ending in December 2020, faster than the 3.2 percent pace over the 12 months through December 2019. December marked the 29th month that this measure of wage growth has remained above 3 percent, a consistency not seen since the mid-2000s. Job losses among lower-wage workers tended to push average wages much higher for a time, but even with the rehiring of many of these workers, wage gains remain elevated, possibly pointing to the continued shortage of skilled workers. Relatively low inflation has also boosted purchasing power: real average hourly earnings rose 3.8 percent over the year through December 2020, accelerating sharply from the year-earlier pace of 0.9 percent. In contrast, growth in wages and salaries for private industry workers, as measured by the Employment Cost Index, has slowed a bit. This measure advanced 2.8 percent over the four quarters ending in December 2020, slowing from the 3.0 percent gain over the four quarters through December 2019.

PRICES

Inflationary pressures remain subdued, even with the recent, moderate climb in oil prices, and still-sizeable gaps remain relative to year-ago rates. The Consumer Price Index (CPI) for all items accelerated to 0.4 percent in December, reflecting a 4.0 percent jump in energy prices, but over the 12 months through December, CPI inflation was 1.4 percent, almost a full percentage point below its year-earlier pace. Despite recent gains, energy prices were still 7.0 percent lower than a year ago, versus a 3.4 percent gain over the previous 12-month period. After tapering in recent months, food price inflation accelerated again in December, as the re-imposition of dining-out restrictions boosted demand for food consumed at home. It bears noting that 12-month food price inflation rates have remained in the range of 3.5 percent to 4.5 percent since April 2020. Over the year through December, food prices rose 3.9 percent, more than double the 1.8 percent pace over the 12 months through December 2019. Meanwhile, core CPI inflation edged down to 0.1 percent in the month of December. Over the past 12 months, core inflation was 1.6 percent, or 0.7 percentage points below its pace over the year through December 2019.

The headline Personal Consumption Expenditures (PCE) Price Index (the preferred measure for the FOMC's inflation target) also shows a restrained pace of inflation; in contrast to CPI inflation, however, current rates remain nearer to year-ago levels. The 12-month headline PCE inflation rate was 1.3 percent through December 2020, within range of the 1.6 percent pace over the previous year. Core PCE inflation was 1.5 percent over the year through December 2020, close to the 1.6 percent, year-earlier rate. Inflation as measured by the PCE price index has held below the FOMC's target since November 2018. The FOMC's target for inflation is an average of 2 percent over time as measured by the PCE price index. Due to the significant drop in prices during the March to May lockdowns, there may be a spike in inflation in late-winter and early-spring, but it should prove transitory.

CONCLUSION

After two consecutive quarters of growth, real GDP is nearing the level of economic activity achieved in the fourth quarter of 2019. Yet, 10.7 million workers remain unemployed, and many businesses have closed. A variety of headwinds and uncertainties persist, all presenting considerable downside risks to growth. On the domestic front, the possibility that consumer mood simply levels off, or even deteriorates, could weigh on private consumption in the future. In addition, there is considerable uncertainty about the reach of existing vaccines vis-à-vis the emergence of mutated forms of the virus, mutations which appear to be significantly more contagious. Given the difficulties in distributing the virus to date, slower-than-expected attainment of so-called "herd immunity" could hamper the return to normal operation of the businesses most affected by the pandemic. Finally, slower recovery in overseas markets could also adversely affect U.S. economic recovery. To address some of these challenges, the Administration has presented a plan for rapid vaccination of the population and has proposed $1.9 trillion in additional fiscal support the economy more broadly. Private forecasters currently project a growth rate in real GDP of 2.3 percent in the first quarter of 2021, and of 3.9 percent for the year as a whole.