

Economy Statement by Catherine Wolfram, Acting Assistant Secretary for Economy Policy, for the Treasury Borrowing Advisory Committee

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WASHINGTON - Last week, the Bureau of Economic Analysis confirmed that the U.S. economy has now expanded for three consecutive quarters, after the pandemic caused GDP to plummet 19.2 percent at an annual rate in the first half of 2020. In the first quarter of 2021, economic growth was bolstered by two additional rounds of Economic Impact Payments (EIPs), extensive vaccination of the population, the easing of COVID-19 restrictions, and continuing progress reopening the economy. Indeed, significant progress has been made in revitalizing many sectors, and the economy has proven its resilience in the face of multiple headwinds. Nonetheless, a full recovery continues to depend upon vaccinating enough of the population for effective herd immunity and ensuring individuals and businesses can thrive, despite the challenges posed by the global pandemic.

The first quarter GDP report, as well as recent monthly data on employment and personal income, show rapid improvements in production and employment—largely due to vaccine distribution and unprecedented fiscal support. Nevertheless, the effects of the pandemic on economic activity remain highly uneven. While GDP looks likely to reach pre-pandemic levels in the current quarter, employment remains well below pre-pandemic levels, particularly in as lower-wage, labor-intensive sectors like leisure and hospitality. Disruptions to these and other pandemic-sensitive sectors have disproportionately impacted women and minorities and have distorted aggregate measures of wage growth, productivity growth, and average hours worked. That is, drastic changes in the composition of the labor force have made aggregate indicators a less reliable measure of the health of the labor market.

The American Rescue Plan (ARP), along with prior relief efforts, have helped bridge many households through the pandemic. As vaccinations proceed and cases fall, we expect some of the hardest-hit industries to recover, benefiting women and minorities. The ARP, through programs like Emergency Rental Assistance and targeted grants to businesses, can fill the gap for households that were not able to receive unemployment insurance benefits or

stimulus payments. Bringing the pandemic under control, reopening schools, and fostering a tight labor market will bring about inclusive growth for communities impacted the most by the pandemic.

GDP GROWTH

According to the advance estimate released last week, real GDP advanced 6.4 percent at an annual rate in the first quarter of 2021, following annualized growth of 4.3 percent in the final quarter of 2020. The advance estimate is based on incomplete source data and will be revised in coming months.

Three major components of GDP – private consumption, private business fixed investment, and residential investment – grew at, or close to, a double-digit pace. Growth of private domestic final purchases – the sum of personal consumption, business fixed investment, and residential investment – nearly doubled in the first quarter, to 10.6 percent at an annual rate. This measure attests to a significant acceleration in the underlying upward momentum in private demand during the first quarter.

Real personal consumer expenditures (PCE), which accounts for about two-thirds of overall GDP, grew 10.7 percent at an annual rate in the first quarter, accelerating smartly from the 2.3 percent pace of the previous quarter. Purchases of durable goods – a category that includes motor vehicles, household equipment and furnishings, among other items – soared 41.4 percent in the first quarter, boosted by two rounds of Federal Economic Impact Payments. Purchases of durable goods declined 1.1 percent in the fourth quarter. Spending on nondurable goods – such as food and beverages purchased for off-premises consumption, gasoline and other energy goods, clothing, footwear, and other goods – jumped 14.4 percent in the first quarter, following a decline of 1.6 percent in the fourth quarter. Household expenditures on services – the component of PCE most severely affected by the pandemic and related measures – grew 4.6 percent in the first quarter, picking up a bit from the 4.3 percent pace registered in the fourth quarter. As of the first quarter, the level of PCE overall stood at well over 99 percent of its level at the end of 2019. However, services account for roughly two-thirds of economic activity in the U.S., so more telling for the economy's progress is the fact that as of the first quarter, PCE of services had only recouped about 62 percent of the spending lost during the first half of 2020. Real PCE contributed just over 7 percentage points to the rise in total GDP in Q1.

Business fixed investment (BFI) rose 10.1 percent at an annual rate in the first quarter, reflecting gains in equipment investment and intellectual property products (IPP). The first-quarter double-digit gain followed jumps of 31.3 percent and 18.6 percent in the third and fourth quarters of 2020, respectively. Equipment investment rose 16.7 percent in the first quarter, slowing from outsized advances in the previous two quarters. Investment in IPP grew 10.1 percent, similar to the fourth quarter's 10.5 percent advance. Investment in structures declined for the sixth consecutive quarter, falling 4.8 percent, after a 6.2 percent decline in the fourth quarter. The ongoing pull-back in this type of BFI has been linked to a variety of factors, including less oil exploration (particularly when oil prices were low last year), perceptions of less oil demand in the future and less need for commercial buildings with the continued use of telework, and an ongoing shift in spending patterns towards online, rather than on-site, retailing. During the first quarter, however, investment in mining structures increased (high and rising energy prices prompted more spending on oil and gas wells) and the decline mainly reflected lower business construction of office space, commercial buildings, and lodging. Overall, the contribution of total BFI to growth was relatively stable, adding 1.3 percentage points to real GDP growth in the first quarter, after contributing 1.7 percentage points in the fourth quarter. Moreover, as of the first quarter, total BFI was 0.9 percent higher than its pre-pandemic level.

The private inventory component of real GDP registered a considerable drawdown in the first quarter, after returning to a more normal pace of accumulation in last year's final quarter. The inventory drawdown may reflect supply chain constraints and bottlenecks as demand for consumer goods has risen well above pre-pandemic levels. Of course, depletion of inventories in one quarter can mean a significant restocking by businesses in the following quarter – hence the volatility of this component, and the need to strip it out of measures designed to look at the underlying pace of the economy's growth. In the first quarter, the change in private inventories subtracted 2.6 percentage points from economic growth, after contributing 1.4 percentage points to the expansion in the fourth quarter.

In four of the past five 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 36.6 percent in the fourth quarter and grew 10.8 percent in the first quarter. This component added 0.5 percentage points to growth, after contributing 1.4 percentage points in the fourth quarter and 2.2 percentage points in the third quarter. As of the first quarter, residential investment was 17.3 percent above its pre-pandemic level. Taking a broader view, this sector has contributed to growth in six of the last eight quarters.

While there has been some retracement from the record low mortgage rates seen earlier this year and the record highs in builder confidence posted late last year, relatively low mortgage rates and very positive views among builders continue to support the sector. But, builders have yet to increase supply by enough to meet demand, and the imbalance continues to feed a strong acceleration in home price growth. The upside of higher home prices is an attendant increase in housing wealth for homeowners, but limited supply and diminishing affordability could ultimately weigh on demand.

Data on specific aspects of activity in the housing market have been generally positive over the past several months, notwithstanding a weather-related lull in February. Single-family housing starts and permits grew strongly between May and December last year, then retreated early this year due to weather. In March, however, single-family starts jumped by 15.3 percent and single-family permits rose 4.7 percent; both measures are now about 20 percent above pre-pandemic levels as well. Existing home sales, which account for 90 percent of all home sales, rose to a 14-year high in October 2020, but in each of the last two months, have declined. Still, existing home sales were 12.3 percent higher over the year through March and 5.4 percent higher than pre-pandemic levels. New single-family home sales, although fluctuating in recent months, reached a 14-year high in March, and were 42.6 percent above their pre-pandemic level. In November 2020, the National Association of Home Builder's confidence index rose to a record high of 90. Despite moderating to 83 by April, the index remains at a historically high level – well above the average level of 66 in 2019 – and continues to signal an unequivocally positive outlook about market conditions in the housing sector. In early January 2021, average rates for 30-year mortgages fell to a record low of 2.65 percent, or 2¼ percentage points below the most recent peak in November 2018. Since January, mortgage rates have trended higher, holding around 3 percent as of the end of April.

Overall, government spending increased 6.3 percent at an annual rate in the first quarter, after declining 0.8 percent in the fourth quarter. Federal spending surged 13.9 percent, following two consecutive quarters of declines, while state and local spending increased 1.7 percent, after three consecutive quarterly declines. The surge in Federal spending reflects one-time items: lender fees from a second round of PPP loans and purchases of Covid-19 vaccines. Given balanced budget requirements for states and localities, the increase in spending at this level attests to an improving fiscal picture, after three quarters of rising health care costs, cuts in employment, and lower revenues. Total government spending added 1.1 percentage points to GDP growth in the first quarter, including a 0.9 percentage

point contribution at the federal level and a 0.2 percentage point addition from state and local governments.

The net export deficit widened to a lesser degree in the first quarter, increasing \$53.5 billion at an annual rate to \$1.18 trillion, as an outright decline in exports combined with a moderate increase in imports. These movements followed double-digit increases in exports and imports during the previous two quarters. Total exports of goods and services declined 1.1 percent, while imports advanced 5.7 percent. The widening of the trade deficit pared 0.9 percentage points from first quarter GDP growth, posing a relatively modest drag compared with subtractions of 1.5 percentage points in the fourth quarter and 3.2 percentage points in the third quarter of last year. Imports are well above pre-pandemic levels while exports lag, reflecting the relatively faster recovery in the US and the effects of larger fiscal support.

LABOR MARKETS AND WAGES

Although measures taken to prevent the spread of the virus triggered the loss of 22.4 million jobs over March and April 2020, including 21.4 million in the private sector, the economy has since made significant strides in restoring payrolls. As of March 2021, 14 million jobs had been added, or 62 percent of the total lost, including more than 66 percent of the jobs lost in the private sector. However, payroll employment is still 8.4 million below the level in February 2020.

The headline unemployment rate declined to 6.0 percent in March 2021, or nearly nine 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 March, the U-6 had been cut to 10.7 percent, less than half the 22.9 percent high reached in April 2020. This measure is now within 4 percentage points of the pre-pandemic low of 6.8 percent observed in December 2019. Moreover, long-term unemployment continues to rise: the share of the labor force who were unemployed 27 weeks or more reached 2.63 percent in March, or nearly four times the 0.68 percent rate seen in February 2020.

The headline labor force participation rate (LFPR) – as well as prime-age (ages 25-54) LFPR – have begun to recover from the lows seen in April 2020. The headline rate has plateaued over the past six months, and as of March 2021, stood at 61.5 percent, or almost 2 percentage points below the six-year high seen in January 2020. The prime-age LFPR was

81.3 percent in March, or 1.7 percentage points below the eleven-year high seen in January 2020.

At the beginning of this year, weekly initial unemployment claims were still running about four times the average levels seen prior to the pandemic's onset, but these filings have trended lower during the first quarter. In each of the last three weeks, weekly claims have been running about double the pre-pandemic average level. The extent of this improvement bodes well for the employment report for April, which will be released this Friday, May 7.

Twelve-month growth rates of nominal average hourly earnings for production and nonsupervisory workers have averaged 5.2 percent over the past thirteen months of the pandemic, considerably higher than the 3.5 percent average over the previous thirteen months. Job losses among lower-wage workers tended to push average wages much higher for a few months last year, but more recently, wage gains have remained elevated despite the rehiring of many of these workers. Even before the pandemic there were shortages of skilled labor, and now, there may be additional constraints on labor supply due to changed worker circumstances during the pandemic, which would keep upward pressure on wages. Nominal average hourly earnings for production and non-supervisory workers rose 4.4 percent over the year through March 2021. As labor force participation rises and the composition of the labor force returns to normal, these outsized gains in nominal wages are expected to recede. A much slower pace of inflation contributed to stronger gains in real wages: twelve-month growth rates of real wages have averaged 3.9 percent over the past thirteen months, compared with an average of 1.7 percent over the preceding thirteen months. However, rising inflation over the past three months has contributed to a decline in real wages in each of the last three months; over the year through March 2021, average hourly earnings grew 1.4 percent in real terms, the slowest twelve-month pace since just before the onset of the pandemic.

Likewise, growth in wages and salaries for private industry workers, as measured by the Employment Cost Index, has slowed modestly over the year. This measure advanced 3.0 percent over the four quarters ending in March 2021, decelerating from the 3.3 percent gain over the four quarters through March 2020. Aside from some volatility associated with the pandemic in 2020, year-over-year growth in the Employment Cost index held around 3 percent since mid-2018. This measure of labor cost has fewer issues adjusting for compositional changes of the labor force than do other measures.

PRICES

Inflationary pressures have been building in very recent months due to a recovery in energy prices, non-energy base effects – that is the mechanical increase in measures of year-over-year inflation due to the sharp drop in prices for many goods and services at the onset of the pandemic – and strengthening demand as the economy reopens and personal income increases.

The Consumer Price Index (CPI) for all items accelerated to 0.6 percent in March, largely due to a 5.0 percent jump in energy prices. Over the 12 months through March, CPI inflation stepped up to 2.6 percent, rising above its year-earlier reading by more than a full percentage point. Energy prices were 13.2 percent higher than a year ago, reversing sharply from the 5.7 percent decline a year ago when low global oil demand and high supply – particularly due to a production dispute between Saudi Arabia and Russia – pushed down oil prices to historic lows. On a twelve-month basis, food price inflation has remained in the range of 3.5 percent to 4.5 percent since April 2020 – as the pandemic induced more cooking at home – but has begun to taper in recent months. Meanwhile, core CPI inflation has accelerated, but to a lesser degree than headline inflation. In March, the core CPI rose 0.3 percent. Over the past twelve months, core inflation was 1.6 percent, well below the 2.1 percent pace over the year through March 2020.

The headline Personal Consumption Expenditures (PCE) Price Index (the preferred measure for the FOMC's inflation target) had shown a more restrained pace of inflation until very recently, when it moved above year-ago levels. The 12-month headline PCE inflation rate was 2.3 percent through March 2021, a full percentage point above the 1.3 percent pace over the previous year. Core PCE inflation was 1.8 percent over the year through March 2021, edging up from the 1.7 percent, year-earlier rate. The acceleration in the headline PCE inflation rate is notable because it rose in March above the FOMC's 2 percent inflation target for the first time since November 2018. However, the gain was largely due to rising energy prices and base effects from the decline in the price level at the start of the pandemic. In addition, the FOMC has indicated that it seeks an average of 2 percent inflation over time.

RISKS TO THE OUTLOOK

Despite strong economic reports recently, downside risks remain to the economic outlook: 8.4 million workers are still unemployed and a substantial portion of the services sector – which alone accounted for 43 percent of U.S. economy activity in 2019 – has yet to recover fully. Conversely, labor markets could be tighter than estimated as some workers may have

permanently exited the labor force. Although current inflationary pressures are likely transitory, such tightness could create wage pressures for inflation and cause stronger inflation to persist beyond the next few months if labor force participation fails to recover.

There are also downside risks to the public-health outlook, which in turn poses risks to the economic outlook. In the United States, significant numbers of people are hesitant to receive – or have chosen not to receive – the vaccine, and there continues to be concern about the efficacy of existing vaccines in the face of mutated forms of the virus. Globally, testing and vaccinations have diverged by country, leading to the risk of an uneven global recovery and the chance for new vaccine-resistant mutations. Addressing these global inequalities would help expedite a return to normal.

CONCLUSION

Nonetheless, there appears to be momentum building in the economy. After three consecutive quarters of growth, real GDP has nearly returned to the level of activity achieved just before the onset of the global pandemic. Underlying domestic demand by consumers, businesses, and builders – buttressed by fiscal policy– has proved resilient in the face of multiple headwinds. Moreover, at this time, inflation expectations appear well-anchored, with many in the private sector forecasting a return to pre-pandemic price trends later this year or early next, as base and reopening effects wear off.

The near-term health outlook for the United States is also favorable: in April, the number of new COVID-19 cases fell to its lowest level since October 2020 and over 104 million Americans (31.6 percent of the population) were fully vaccinated as of May 2. These developments have all contributed to forecasts of robust growth this year. In early April, prior to the release of the advance estimate for Q1 GDP, private forecasters projected growth in real GDP of 8.7 percent in the second quarter of this year and of 6.6 percent on a Q4/Q4 basis at the end of 2021.

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