Economy Statement by Benjamin Harris, Assistant Secretary for Economy Policy, for the Treasury Borrowing Advisory Committee January 31, 2022

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Real GDP growth accelerated in the fourth quarter of 2021, returning to a pace consistent with that seen in the first half of the year. Economic growth this quarter was driven primarily by inventory investment—as firms restocked depleted inventories—as well as strong export growth and robust consumer spending on services. By the end of 2021, household balance sheets were exceptionally health due in part to the American Rescue Plan (ARP), other government pandemic assistance, and brisk wage growth. The pace of GDP growth in the fourth quarter ended 2021 on a historic note: over the four quarters of 2021, real GDP grew 5.5 percent, the fastest annual pace in 37 years.

Over the course of 2021, the labor market approached full employment. Over the twelve months ending December 2021, the economy enjoyed the greatest number of job gains on record and the fastest calendar year drop in the unemployment rate.. In this environment, workers were able to leverage a high degree of job mobility to achieve strong wage gains—most notably in low-wage sectors.

A mismatch between supply and demand led inflation to rise substantially in 2021 as energy demand recovered to pre-pandemic levels, goods demand remained high, and supply chains experienced disruptions due to the rapid recovery in demand and Covid impacts on manufacturing supply chains. By the end of the year, principal measures of total and core inflation climbed to multi-year highs. While the inflation outlook is uncertain, a receding pandemic, weaker demand for goods, and easing supply bottlenecks can be expected to reduce inflationary pressure throughout the year.

GDP GROWTH

According to the advance estimate released last week, real GDP growth accelerated sharply to 6.9 percent at an annual rate in the final quarter of 2021, following a 2.3 percent gain in the

third quarter. Given the robust pace of growth in the fourth quarter, GDP at the end of 2021 was 5.5 percent higher on a year-over-year basis, the strongest annual pace since 1984.

Real private domestic final purchases (PDFP)—the sum of personal consumption, business fixed investment, and residential investment—grew 2.8 percent at an annual rate in the fourth quarter, after increasing 1.4 percent in the third quarter. PDFP growth in the second half of 2021 was slower than in the first half—in the first quarter, PDFP surged by 11.8 percent and by 10.1 percent in the second. By this measure, demand has returned to pre-pandemic trend.

Real personal consumption expenditures (PCE)—the largest component of PDFP and roughly two-thirds of real GDP—rose by 3.3 percent in the fourth quarter on an annualized basis, accelerating from the 2.0 percent gain in the third quarter. The fourth-quarter print reflected continued rotation of consumption from goods to services. Real purchases of durable goods increased just 1.6 percent in the fourth quarter—held down by reduced purchases of motor vehicles and household durable items – while nondurable goods PCE ticked down by 0.1 percent. Expenditures on services increased by 4.7 percent in the fourth quarter, propelled by higher spending on health care and strong recovery in pandemic-sensitive sectors, such as recreation and transportation services. Despite the rotation toward pre-pandemic consumption patterns, the composition of PCE remains weighted more heavily toward goods than services—as of the fourth quarter of 2021, PCE goods was still 15.4 percent higher than just before the pandemic while PCE services was 0.4 percent lower.

Business fixed investment (BFI) increased by 2.0 percent at an annual rate in the fourth quarter, following a 1.6 percent gain in the third quarter. Investment in structures continued to be a drag on BFI growth, dropping by 11.4 percent in the third quarter. Investment in mining-related structures, including oil and gas wells, rose in the fourth quarter as rising oil prices made domestic rigs more profitable. Meanwhile, both equipment investment and investment in intellectual property products increased in the fourth quarter—by 0.8 percent and 10.6 percent, respectively.

Real residential investment—the third and final component of PDFP—slipped by 0.8 percent at an annual rate in the fourth quarter, the third consecutive quarterly decrease. Rising construction prices were partly responsible for the decrease in real investment. Although nominal residential spending rose 8.6 percent on an annualized basis, the price index for residential construction jumped by 9.5 percent. Higher construction costs have been driven in part by shortages of materials and labor. However, residential investment remains well above pre-pandemic trend.

The change in private inventories (CIPI) was the strongest contributor to real GDP growth in the fourth quarter, adding 4.9 percentage points. Unlike in the third quarter, the impetus to GDP growth from CIPI was due to inventory build-up, rather than slower inventory draw down. During the pandemic, inventories have been depleted to historically-low levels. Between the first quarter of 2020 and the third quarter of 2021, total real private inventories were drawn down by over $81 billion (not annualized). The increase in the fourth quarter recovered only about half of the loss. However, inventories for some industries remain very lean despite buildup in the fourth quarter, such as retail motor vehicle inventories which recovered only 7 percent of the net drawdown since the beginning of the pandemic. That is, inventories are stretched and restocking needs have extended into the current year.

The trade deficit widened by $21.4 billion to $1338.0 billion in the fourth quarter; a change that neither added nor subtracted from GDP growth. Total imports of goods and services jumped 17.7 percent at an annualized rate, while total exports of goods and services jumped 24.5 percent. Over 60 percent of the increase in services exports was due to the return of international travel to the United States.

Total government spending declined 2.9 percent at an annual rate in the fourth quarter, after rising 0.9 percent in the third quarter. A 4.0 percent decline in federal spending drove the overall pull-back, largely reflecting fewer purchases of defense-related intermediate goods. State and local government consumption was down 2.2 percent at an annual rate in the fourth quarter; the decrease reflected lower real spending on compensation for state and local government salaries as well as less real investment in structures—which was significantly affected by rising construction costs.

In sum, real GDP accelerated to 6.9 percent in the fourth quarter on an annualized basis. The acceleration primarily reflected sizeable contributions from a private inventory build (4.9 percentage points) as well as increased consumer spending (2.3 percentage points) and business fixed investment (0.3 percentage points). Government consumption and investment was the sole significant drag on fourth quarter growth (-0.5 percentage points). =

LABOR MARKETS AND WAGES

The economy made impressive strides in 2021 in generating payroll jobs and in reducing headline as well as broader measures of unemployment. Over the twelve months ending December 2021, the economy generated 6.5 million payroll jobs, the largest number of jobs added in a single year on record. Over the same period, the headline unemployment rate

dropped 2.8 percentage points to 3.9 percent as of December. The broadest measure of labor market slack, the U-6 unemployment rate, fell by 4.4 percentage points over the year to 7.3 percent in December 2021—also the sharpest decrease on record and ending the year only 0.3 percentage points above the pre-pandemic level in February 2020. The long-term (27 or more weeks) unemployment rate has declined rapidly to 1.2 percent of the labor force in December 2021, falling by half over the previous 12 months.

These rapid improvements have translated into tight labor market conditions, which have put upward pressure on nominal wages. Nominal average hourly earnings for production and non-supervisory workers increased 5.5 percent over the year through December 2021. The Employment Cost Index (ECI), which better controls for changes in labor composition and is a more comprehensive measure of total compensation, showed private sector wages increasing 5.0 percent over the four quarters ending in December 2021, roughly double the 2.8 percent gain over the four quarters ending December 2020, and the fastest four-quarter wage gain since the first quarter of 1984. Lower wage occupations and industries continue to see the fastest growth in wages. In leisure and hospitality industries, the ECI for private wage growth jumped 8.9 percent over the year ending in the fourth quarter of 2021, while the retail trade ECI was 7.0 percent higher.

Unlike in 2020 and early 2021, wage gains in the past several months have been driven by tight labor markets and churn rather than compositional effects. Recovery in the prime-age (ages 25 to 54) labor force participation rate has been incomplete, with the participation rate ranging between 81.6 percent and 81.9 percent—well below the pre-pandemic participation rate around 83 percent. At the same time, the participation rate for those older than 55 years may have shifted lower permanently. Population growth has also stalled in the last two years with substantially lower immigration and significant Covid mortality impacts.

These factors have left labor supply constrained and increased the ability of workers to negotiate for wage gains or move to higher-paying jobs. As evidence, the Job Openings and Labor Market Turnover Survey (JOLTS), typically thought to convey worker confidence in finding employment, showed quits rising to a record-high 4.5 million in November, equivalent to 3.0 percent of employment. Prior to the pandemic, the series' high quits rate was 2.4 percent.

PRICES

Inflation picked up markedly in 2021. Some of the factors were largely anticipated. Given the sharp drop in energy prices at the beginning of the pandemic in 2020, any recovery of global prices would spur headline inflation in 2021. Similarly, rising house prices due to high demand were likely to filter into shelter inflation; the re-opening of pandemic-sensitive services would mean higher sector-specific prices.

However, other factors were unanticipated. Energy inflation was further exacerbated by a global energy shortage due to cutbacks in production at the start of the pandemic. High household savings and the slow re-opening of services due to new variants delayed the rotation of demand from goods to services. In addition, the pandemic constrained supply chains as international ports shuttered with outbreaks and domestic labor supply was unable to fully meet high demand.

In the fourth quarter of 2021, the Consumer Price Index (CPI) for all items rose 0.9 percent in October before slowing to 0.5 percent growth in December. Over the 12 months through December 2021, headline CPI rose 7.1 percent while core CPI inflation—which excludes food and energy prices—registered 5.5 percent. Energy price growth accounted for 1.5 percentage points of headline CPI inflation, while food inflation added 0.9 percentage points. Inflation from durable goods was led by motor vehicles, which added 1.2 percentage points to growth as high demand and a shortage of semiconductors for motor vehicles reduced production and pushed up prices. For core services, shelter costs contributed 1.2 percentage points to year-over-year inflation. Re-opening effects from pandemic-sensitive services were relatively mild, contributing only 0.3 percentage points to headline inflation in 2021.

Over the same period, the PCE price index rose 5.8 percent while core PCE inflation was 4.9 percent in 2021. Although the CPI and PCE indices have different methodologies and weighting for components, the PCE price index showed similar drivers of inflation.

HOUSING MARKETS

Throughout 2021, housing markets were marked by an imbalance between supply and demand, driving rapid home price growth and eroding affordability. The Case-Shiller national house price index—which measures sales prices of existing homes—was up 18.8 percent over the year ending in November 2021, a sharp acceleration from the 9.5 percent and 3.4 percent rates seen in November 2020 and November 2019, respectively. Moreover, in each of the past seven months, year-over-year increases in both of these indices have run between 17 percent and 20 percent.

In the fourth quarter, however, there were positive signs for housing supply in coming quarters. Single-family housing starts rose by a combined 9.8 percent from September to December 2021, and single-family permits, which signal future starts, have increased by 8.4 percent over the same period. In 2019 and 2020, construction of a new single-family home took about eight months from authorization to completion (the estimated time-to-completion is not yet available from the Census Bureau), suggesting fresh supply will come on to the market in 2022 and ease some house price pressures. Indeed, the number of homes under construction at the end of 2021 is the highest since 2007. Moreover, surveys of homebuilders reflect optimism about the state of the housing market. The National Association of Home Builder's confidence index rose for the fourth consecutive month in December, ending the year at 84, just 6 points shy of record high reached in November 2020.

Meanwhile, sales of homes trended lower at the end of 2021. In December, existing home sales—which account for 90 percent of all home sales—declined 4.6 percent over the month and were down 7.1 percent over the year. Although new single-family home sales rose by 11.9 percent in December, the level of sales was still down by 14.0 percent over the year. One net, existing and new home sales were lower by around 600,000 over the year ending December 2012. The downtrend of existing home sales reflected in part very lean inventories. At the end of December 2021, existing home inventories dropped to an all-time low of 910,000, dropping by 14.7 percent over the year and equivalent to 1.8 months of sales. (Realtors consider a seven-month supply to be a balanced market.) By contrast, the inventory of new single-family homes available for sale has moved closer to a balanced market. Inventories of new homes rose by 34.8 percent over the year to 403,000, equivalent to a 6.0-month supply.

RISKS TO THE OUTLOOK –

There are multiple downside and upside risks to the economic outlook. Primary among the downside risks are concerns about the pandemic, supply chains, energy prices, and shelter costs.

Pandemic: Since the previous Economy Statement to the Treasury Borrowing Advisory Committee, the Omicron variant was identified in South Africa and quickly spread to the United States. Although symptoms and deaths from Omicron appear to be less severe than from previous variants, it also appears to be more effective than previous variants at evading the immunity from vaccination or previous infection. According to the most recent data, the seven-day average of COVID infections due to Omicron peaked in mid-January above 800,000

cases, causing significant labor absences as sick workers stayed home. Future variants may have worse symptoms and fatality rates or may be fully resistant to current vaccines and present a significant risk to the economic outlook. On the other hand, given the level of vaccinations and prior infection, the US population may be nearing herd immunity.

The persistence of the pandemic endangers the recovery of supply-chains, which poses risk to production and inflation. Continued lockdowns in China or southeast Asia may result in delays or further reducing production, keeping goods prices elevated. Omicron could further disrupt shipping or transportation chains, resulting in price pressures.

The pandemic has also negatively affected labor supply and population growth. To date, labor supply from the elderly has likely permanently shifted lower due to pandemic-related early retirements. Some people's work preferences may have changed due the new normal of pandemic-era work, while others may have stepped away from work due to other factors, such as limited availability of childcare. If these losses in labor supply are permanently lost due to the pandemic, then potential economic growth has been shifted lower.

Energy prices: Energy producers—including the United States—have been slow to recover the production lost in 2020. Members of OPEC+ have fallen behind production targets and the Energy Information Agency expects that domestic production in 2022 will trail pre-pandemic production by roughly 500,000 barrels per day. Currently, it is expected that energy prices will stabilize in 2022, but geopolitical instability could result in higher energy prices.

Shelter costs: House prices and rents are out of sync. Since owning a home and renting an apartment are imperfect substitutes, prices and rents tend to be in long-run equilibrium. Yet given current house valuations, the price-to-rent ratio has risen sharply to 1.5, an historically high ratio, up from suggesting an imbalance between types of shelter.

While there is the potential for negative shocks to the economy, some developments imply the potential for strong GDP growth, an easing of labor market tightness, or decreased inflationary pressures.

Household finances: In 2021, household balance sheets were in healthy positions. Even as pandemic assistance waned in the second half of the year, personal income continued to rise largely due to strong wage and salary growth. By the third quarter of 2021 (last available data), households' net worth stood at a record-high of 796 percent of disposable personal income (DPI), nearly 40 percentages from the end of 2020. At the same time, debt service as a share of DPI remained about 70 basis points below pre-pandemic norms.

Structures investment: Energy, commercial, and residential investment all have upside potential. High energy prices would continue to spur structures investment in oil- and gas-related mining structures, while a quicker return to in-person work may help relieve the overhang in commercial properties and speed re-investment in the sector. Meanwhile in housing markets, the high number of units permitted, units authorized but not yet started, and units under construction bode well for residential investment in the coming year.

State and local governments: At the beginning of the pandemic and heading into 2021, state and local governments reportedly worried about their finances following the wide-spread stay-at-home orders. Due to the ARP and stronger-than-expected recovery in revenues, fiscal balances are in solid shape. At the end of the 2021 fiscal year (ending June for the majority of state governments), state budget officers preliminarily reported that state general funds roughly tripled to $153 billion while rainy day funds rose by 47 percent to $113 billion. They also projected that general fund spending will increase by 9.5 percent from fiscal years 2021 to 2022, indicating the potential for state and local spending to be a key contributor to GDP growth, in stark contrast to the experience after the 2008 recession.

CONCLUSION

As of December 2021, the economic expansion is in its twentieth month. Real GDP growth accelerated in the fourth quarter to 6.9 percent at an annual rate, bringing growth over the four quarters of 2021 to a historically strong 5.5 percent. At the start of 2022, key investment sectors are poised for strong growth, despite ongoing supply chain difficulties and the specter of new COVID variants. Private forecasts of GDP growth predict a return to trend GDP late this year, whereby the level of GDP reaches the level it would have been absent the pandemic-induced recession. As of early January, before the release of the advance estimate for Q4 GDP, private forecasters projected growth in real GDP of 3.3 percent in the first quarter of this year. On a fourth-quarter over fourth-quarter basis, private projections put real GDP growth at the end of 2022 at 3.3 percent.