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

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WASHINGTON - Real GDP growth declined in the first quarter of 2022, following a rapid acceleration of 6.9 percent in last year's final quarter. The outright decline in real GDP was driven by sharp swings in the contributions of net exports and inventory investment, two components which had added strongly to growth in the fourth quarter. However, underlying private demand grew accelerated in the first quarter relative to the second half of 2021. Private demand grew at a healthy rate despite a backdrop which included a resurgence of COVID-19 cases from the Omicron variant, expectations of tightening monetary policy, and Russia's invasion of Ukraine and its impacts on sentiment and prices for oil and food.

Labor market conditions improved further during the first quarter of 2022, after making record gains in 2021—including the largest advance in payroll job creation, and the largest drops in the headline and the U-6 (broadest) unemployment rates in a calendar year. With jobs plentiful and workers in short supply, strong nominal wage gains are drawing more workers back into the labor force.

However, supply-demand mismatches in the economy have driven headline—as well as core—inflation higher thus far in 2022. Rising inflation in 2021 reflected supply-demand imbalances, partly due to elevated demand from high household savings and partly related to supply-chain disruptions. These factors continue to influence prices this year, and headline inflation has been further elevated by rising prices for energy and grains related to Russia's invasion of Ukraine. Still, core inflation may have peaked in spring 2022 and started to ebb, given a further waning of the pandemic, government efforts to contain energy prices, and an easing of supply bottlenecks in some markets.

GDP GROWTH

According to the advance estimate released last Thursday, real GDP declined by 1.4 percent at an annual rate in the first quarter of 2022, following an unusually rapid 6.9 percent jump in the final quarter of 2021. The slowdown in the first quarter reflected greater domestic demand for imports, higher prices and weaker demand for U.S. exports, slower growth of private inventories, and higher prices for government spending.

By contrast, private domestic demand strengthened in early 2022. Real private domestic final purchases (PDFP)—the sum of personal consumption, business fixed investment, and residential investment—accelerated to 3.7 percent at an annual rate during the first quarter, following a 2.6 percent advance in the fourth quarter. By stripping out international trade, government spending, and the volatile inventory component, PDFP is typically a stronger indicator of future GDP increases and represents the private sector's capacity to generate self-sustaining growth.

Real personal consumption expenditures (PCE)—the largest component of PDFP and roughly two-thirds of real GDP—rose by 2.7 percent in the first quarter on an annualized basis, up slightly from the 2.5 percent increase in the fourth quarter. The first-quarter advance reflected an acceleration in consumption of services, which grew by 4.3 percent and more than offset a 0.1 percent decline in goods purchases. The negligible decline in goods consumption reflected higher purchases of durable goods (particularly of motor vehicles and parts) being fully offset by lower spending on real nondurables—notably gasoline as demand adjusted to the sharp jump in gas prices during the first quarter.

Meanwhile, the continued recovery in services PCE was led by spending on health care services but also reflected strong growth in imputed categories such as shelter and financial services. In addition, consumers returned to pandemic-sensitive sectors, such as travel and recreation services, as the Omicron wave faded throughout the quarter. However, despite the strong growth in services PCE in the first quarter, the composition of total PCE remains weighted more heavily toward goods than services: as of the first quarter of 2022, goods PCE was still over 6 percent higher than the pandemic (2015-2019) trend. By contrast, PCE services was still 4 percent below trend.

Business fixed investment (BFI) jumped up by 9.2 percent at an annual rate in the first quarter, following a 2.9 percent gain in the fourth quarter. Investment in structures remained a drag on growth—albeit a negligible drag—as it slipped just 0.9 percent in the first quarter after dropping by 8.3 percent in the fourth quarter. Investment in mining-related structures, including oil and gas wells, continued to rise due to rising energy prices. Meanwhile, surging investment in business equipment and intellectual property products outweighed the slight decline in structures. Equipment investment rose 15.3 percent at an annual rate in the first quarter, and investment in intellectual property products increased 8.1 percent at an annual rate in the first quarter.

Real residential investment—the third and final component of PDFP—rose by 2.1 percent at an annual rate in the first quarter, following a 2.2 percent increase in the previous quarter. As of the early 2022, residential investment was nearly 7 percent above its pre-pandemic trend—even as construction prices have risen sharply since mid-2020. Higher construction costs have been driven in part by disruptions in supply chains for materials as well as shortages of labor.

The change in private inventories (CIPI), a volatile component, posed the second-largest drag on real GDP growth in the first quarter, subtracting 0.8 percentage points, a sharp contrast with the 5.3 percentage-point addition made in the fourth quarter. Although businesses continued to build inventories in the first quarter at a healthy clip, it was at a slower pace than in the fourth quarter. Inventories tend to be a volatile component of GDP; in the first quarter, the slowdown was led by decreases in inventories of wholesale durables trade and other retail stores, which was partly offset by stronger buildup in manufacturers' inventories.

The trade deficit widened by $191.6 billion to $1,541.7 billion in the first quarter, which imposed the largest drag (3.2 percentage points) of any component on GDP growth. Total exports of goods and services dropped by 5.9 percent at an annual rate, while total imports of goods and services jumped 17.7 percent. Nominal exports rose in the quarter, but real exports fell on a sharp increase in the export price index.

Total government spending declined 2.7 percent at an annual rate in the first quarter, nearly matching the decline in the previous quarter. Federal government consumption and investment accounted for about 80% of the decrease, largely concentrated in national defense purchases—defense spending contracted by 5.9 percent, the fourth consecutive quarterly loss. State and local government consumption declined 0.8 percent in the first quarter, half the decline in the fourth quarter. Like exports, these real declines reflected large increases in price index for government consumption and investment.

LABOR MARKETS AND WAGES

In 2021, U.S. labor markets realized robust employment gains and the largest calendar-year drop in the unemployment rate on record; labor market improvement continued during the first quarter of 2022. After generating a record 6.74 million payroll jobs in 2021, the economy added another 1.69 million during the first quarter of 2022. As of March, a total of 20.4 million jobs have been recovered during the current recovery, or 93 percent of those lost during the two-month recession in early 2020. Meanwhile, the headline unemployment rate dropped by a record 2.8 percentage points over 2021 to 3.9 percent. By March, it had fallen further to 3.6 percent, just one-tenth above the half-century low of 3.5 percent registered before the pandemic. The broadest measure of unemployment—the U-6 rate, a measure of labor underutilization that includes underemployment and discouraged workers in addition to the unemployed—also dropped by a record amount (-4.4 percentage points) last year. In the first quarter, the U-6 fell an additional 0.3 percentage points to 6.9 percent and, by March, was just one-tenth above its pre-pandemic low of 6.8 percent. The long-term (27 or more weeks) unemployment rate, expressed as a percentage of the labor force, also declined sharply last year. As of March 2022, this rate was 0.9 percent, or just 0.2 percentage points above the pre-pandemic low.

Recovery in the overall labor force participation rate (LFPR) was somewhat restrained in 2021, related in part to the multiple COVID-19 variants that arose during the year and slower population growth due to increased mortality rates and lower immigration. During the first half of 2021, total LFPR increased by only 0.1 percentage points and by another 0.3 percentage points during the latter half. Yet recovery in the LFPR picked up again in this year's first quarter. As of March 2022, the headline LFPR had climbed another 0.5 percentage points to 62.4 percent, or 1.0 percentage point below the 63.4 percent rate reached in early 2020. For prime-age (ages 25 to 54) workers, the LFPR saw much of its 2021 growth in the first half of the year, rising by 0.7 percentage points to 81.7 percent. Thereafter, it was rangebound between 81.6 percent and 81.9 for six months. However, the prime-age LFPR saw a remarkable recovery in the just the first quarter of this year. As of March 2022, this measure had climbed 0.6 percentage points to 82.5 percent, matching the rate in March 2020 and just 0.6 percentage points below the high of 83.1 percent reached in January 2020.

Progress in participation for older workers has been slower. For those older than 55 years of age, the LFPR stagnated during 2021, ending the year 0.1 percentage points lower. In the first quarter of 2022, their LFPR increased by 0.4 percentage points to 38.9 percent, but this is still more than a full percentage point below the 40.1 percent average rate from 2016 to 2019. Further progress in older worker LFPR could support employment growth in 2022.

By some measures, labor markets are even tighter than what headline statistics suggest. According to the Job Openings and Labor Market Turnover Survey (JOLTS), labor demand has been at or near record highs since February 2021. Prior to the pandemic, the number of job openings peaked at 7.42 million at the end of October 2019. By the end of February 2022 (latest available date), job openings were 11.27 million. Combined with the somewhat slow recovery in LFPR, labor supply is not keeping pace with labor demand, which has enhanced workers' confidence about job mobility as well as their leverage in wage negotiations. By the end of February 2022, there were 4.35 million job quits (2.9 percent of employment), higher by nearly three-quarters of a million from the pre-pandemic high.

This favorable labor market for workers has led to strong growth in nominal wages. For production and nonsupervisory workers, nominal average hourly earnings increased 6.7 percent over the year through March 2022; twelve-month gains in this measure have remained well above 6.0 percent in each of the past six months. 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 March 2022, matching the previous quarter's twelve-month pace as the fastest 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 9.0 percent over the year ending in the fourth quarter of 2021, while the retail trade ECI was 7.4 percent higher. Wage growth appears to be outpacing productivity growth, likely contributing to inflation.

PRICES

Inflation picked up markedly in 2021 and continued to accelerate earlier this year. Over the four-quarters of 2021, the Consumer Price Index (CPI) rose 7.0 percent. The CPI for energy goods and services, which surged 29.3 percent over the year, accounted for roughly a third of year-over-year headline inflation as companies scaled back production due to uncertain demand during the pandemic. Food prices—which were subject to rising energy prices and wages, as well as supply-chain disruptions—rose 8.8 percent over the year and contributed another 12 percent to headline inflation. Meanwhile, core CPI—which excludes the volatile categories of food and energy that are often subject to temporary shocks—increased 6.5 percent as demand recovered more quickly than supply. Demand has been boosted by high saving rates during the pandemic as well as federal government pandemic support programs. In addition, supply has not been able to keep pace with demand, due in part to supply-chain disruptions as well as a delayed return of many workers to the labor market.

This brisk pace of growth continued into the first quarter of 2022. The CPI for all items accelerated in each month, surging 1.2 percent in March. Russia's invasion of Ukraine exacerbated headline inflation as it severely disrupted energy supply: the price of West Texas Intermediate advanced 13 percent from the end of February through mid-April and U.S. retail gasoline price increased 17.2 percent through the end of March. Supplies of grain from Russia and the Ukraine have also been disrupted, which is likely to exacerbate already-rapid food price inflation. While there has been some easing of oil and gasoline prices in recent weeks, food prices are likely to remain elevated for some time.

At the core level, the CPI slowed to 0.3 percent in March as high prices reduced demand for some goods. In 2021, motor vehicle prices were a significant contributor to core inflation, reflecting low inventories and supply chain disruptions; but in recent months, motor vehicles prices have eased as used vehicle prices have fallen. Even so, shortages in a variety of goods persist, owing to port backlogs and other shipping delays. For services, solid inflation has persisted as surging house prices and rising rents have together pushed up the shelter price index, households have returned to pandemic-sensitive consumption, and tight labor markets have pushed up wages.

The PCE price index assigns different weights for different components than does the CPI and uses a different methodology in its calculation. Nonetheless, the drivers of both measures have been similar. As with the CPI, the headline PCE accelerated to 0.9 percent in March, but the core PCE measure decelerated, rising 0.3 percent in March.

HOUSING MARKETS

Throughout 2021, housing market developments reflected 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 20.2 percent over the year ending in February 2022, a sharp acceleration from the 12.1 percent and 3.5 percent rates seen in February 2021 and February 2020, respectively. The FHFA house price index rose 19.5 percent over the year ending in February 2022 and showed comparable accelerations over the previous two years. Both indices have risen above 1 percent on a monthly basis since August 2020; in February, growth in both indices was above 2 percent.

Supply in the housing market is being constrained by rising mortgage rates and ongoing supply chain issues, such that the outlook for future housing supply is mixed. Single-family housing starts were down by 1.7 percent in March 2022, and single-family permits, which signal *future starts*, declined by 4.6 percent in the same month. Home builder sentiment has also deteriorated so far this year: after rising during the last four months of 2021, the

National Association of Home Builder's confidence index has declined during the first four months of 2022, dropping to 77 in April 2022, 13 points below the record high of 90 reached in November 2020. On the other hand, single-family starts were stable over the first quarter, and single-family permits were up 2.0 percent, suggesting a small increase in forthcoming supply in this segment of the market. In addition, the total number of homes under construction at the end of 2021 (single-family and multi-family) was at its highest level since 1972, while the number of new housing units that have been authorized, but not yet started (i.e., the backlog of new construction) continued its upward trend, hitting a fresh all-time high of 280,000 units (data begin in 1999).

Sales of homes continued to trend lower during the first quarter of 2022. In March, existing home sales—which account for 90 percent of all home sales—declined 2.7 percent over the month and were down 4.5 percent over the year. After jumping by double-digit rates last November and December, new single-family home sales have declined in each month of the first quarter, falling by 8.6 percent in March. Existing and new home sales were lower by about 430,000 on net over the first quarter, after declining by about 600,000 over the year ending December 2021. After reaching an all-time low last December, existing home inventories rose to a still-low 950,000 homes on the market, the equivalent of 2.0 months of sales in March. The inventory of new single-family homes available for sale moved even closer to a balanced market, rising to 407,000 homes in March—equivalent to a 6.4-month supply. Realtors consider a 7-month supply to be consistent with a balanced market.

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, commodity and energy prices, and shelter costs, while a stronger than expected return to the labor force may help wage pressures on inflation.

Pandemic: Since the first quarter Economy Statement to the Treasury Borrowing Advisory Committee, the Omicron variant firmly established itself in the United States, but symptoms and deaths were less severe than from previous variants, likely due to the number of vaccinations as well as previous levels of infections. Although Omicron affected economic growth in January and February, households quickly returned to travel and social recreational activities in March, and firms started to call workers back into the office. In addition, the mask mandate has been also lifted since the previous TBAC statement, and the director of the

National Institute of Allergy and Infectious Diseases (NIAID) and the Chief Medical Advisor to the President has suggested that the United States is transitioning to a “control phase” of the pandemic.

Still, persistence of the pandemic endangers the recovery of supply-chains, particularly in countries that have less immunity via infection or vaccination. Continued lockdowns in China have resulted in production losses and shipping delays, which could keep goods prices elevated; and price pressures could persist if additional coronavirus variants prove more resilient against current vaccines and treatments.

Moreover, the pandemic has negatively affected labor supply and population growth. To the extent that these losses are permanent, potential economic growth has been shifted lower.

Commodity Prices and Their Volatility: In February, Russia’s invasion of Ukraine disrupted markets, causing energy, food, and other commodity prices to rise. In the first weeks of Russia’s invasion of Ukraine, U.S. gasoline prices jumped by 78 cents (22 percent) while futures prices for St. Louis wheat increased by $2.11 (23 percent). Although energy prices have stabilized to some extent, especially for gasoline, the persistence of these disruptions could imply higher energy and commodity prices in the future, especially as U.S. production may be slow to ramp up. Prior to Russia’s attack on Ukraine, the Energy Information Agency had already predicted that U.S. domestic oil output would trail pre-pandemic production by about 500,000 per day. In addition, the planted area for all varieties of wheat grown in the U.S. hit a record low during the 2020/2021 marketing year and is projected to increase only incrementally during 2021/2022 and 2022/2023.

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, suggesting an imbalance in pricing between types of shelter.

Labor Force Participation: In the first quarter, labor force participation increased more quickly than it had in the second half of 2021—rising by 0.5 percentage points and 0.6 percentage points among prime-age workers. A tight labor market and strong wage growth is likely contributing to the return to the workforce as well as greater worker comfort with in-person interactions as the severity of the pandemic wanes. To the extent that labor supply continues improving at the pace seen in recent months, wage pressures on inflation may ease.

CONCLUSION

Although real GDP growth declined by 1.4 percent at an annual rate in the first quarter of 2022, there was a significant increase in the growth of PDFP to 3.7 percent, attesting to the strength of private demand.

As of May 2022, the United States is still in expansion, even though growth in January and February was affected by the Omicron variant and other factors. Before the release of the first quarter GDP reading, private forecasts expected U.S. economic activity would return to its trend path late this year and GDP would grow 2.3 percent on a fourth-quarter over fourth-quarter basis. Although this estimate may be revised down—and downside risks remain to the outlook—the U.S. economy is expected to continue its expansion this year. Waning fiscal and monetary stimulus along with recovering labor supply should help balance labor markets and relieve some inflationary pressures.

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