U.S. DEPARTMENT OF THE TREASURY

Economy Statement by Benjamin Harris, Assistant Secretary for Economy Policy, for the Treasury Borrowing Advisory Committee August 1, 2022

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Economic data were mixed in the second quarter of 2022. Real GDP contracted mildly for a second consecutive quarter, but employment continued to rise. Firms added an average of 375,000 jobs per month and the unemployment rate remained near a half-century low. Surging energy and food prices—due in part to Russia's invasion of Ukraine—pushed up headline inflation to new highs, though core inflation remained elevated as well. At the same time, housing data suggested the start of a market correction as high house prices and rising interest rates constrained demand for new and existing homes.

As in the first quarter, the economic environment was framed by the emergence of new coronavirus variants, tightening monetary policy, negative impacts from Russia's invasion of Ukraine, and supply-demand mismatches. Production was constrained by physical disruption of transportation and other aspects of supply chains, including COVID-related lockdowns, and continued shortages of production materials, such as semiconductors for motor vehicles. Inflation at the headline and core levels has continued to climb this year, but at the margins, there is some easing of prices in some markets: the federal government has taken a variety of steps to reduce gasoline prices and tightness in grain markets may be loosening.

GDP GROWTH

According to the advance estimate of second quarter GDP (released Thursday, July 28), real GDP declined by 0.9 percent at an annual rate, following a 1.6 percent drop in the first quarter. The pullback in economic activity in the second quarter primarily reflected a significantly slower build-up of private inventories, in addition to less residential investment and government spending. By contrast, net exports and personal consumption expenditures (PCE) both contributed positively to GDP growth. Despite two consecutive quarters of modest contraction, real GDP was still up 1.6 percent over the last four quarters.

Real private domestic final purchases (PDFP)—the sum of personal consumption, business fixed investment, and residential investment—was flat in the second quarter, after rising 3.0 percent at an annual rate in the first quarter. This measure, which excludes final public and international demand for goods and services, as well as the change in private inventories, is typically a better indicator of the private sector's capacity to generate self-sustaining growth. A flat reading for PDFP indicates a slowing in underlying growth.

Real PCE—the largest component of PDFP and roughly two-thirds of real GDP—rose by 1.0 percent in the second quarter on an annualized basis, slowing from a 1.8 percent increase in the first quarter. Consumption reflected the rotation from goods to services as households slowly returned to pre-pandemic patterns of spending. Consumption of services rose 4.1 percent due to recovering demand for food services and accommodations, recreation, transportation, and health care. Meanwhile, consumption of goods fell by 4.4 percent as spending on both durable and nondurable goods pulled back from elevated levels. Household expenditures on durable goods were 2.6 percent lower, while spending on nondurables dropped 5.5 percent. The latter partly reflected higher prices for gasoline as well as for food and beverages consumed at home. Although households are returning to pre-pandemic styles of consumption, the rotation remains incomplete. The composition of total PCE remains weighted more heavily toward goods than services: as of the second quarter of 2022, the share of goods in total PCE was 4 percentage points higher than the pre-pandemic (2015-2019) average.

Business fixed investment (BFI) declined 0.1 percent in the second quarter, after surging by 10.0 percent at an annual rate in the first quarter. This was the first decline in BFI after seven consecutive quarterly advances. Investment in structures posed a much larger drag on growth, dropping 11.7 percent in the latest quarter, after slipping 0.9 percent in the first quarter. Equipment investment decreased 2.7 percent in the second quarter, following a 14.1 percent jump in the previous quarter. Investment in intellectual property products, which was the sole positive contributor to business investment spending, rose 9.2 percent at an annual rate in the second quarter, slowing modestly from a 11.2 percent advance in the first quarter.

Real residential investment—the third and final component of PDFP—fell by 14.0 percent at an annual rate in the second quarter, following a 0.4 percent increase in the previous quarter. Lower investment was broad-based. Single-family structures spending fell 4.2 percent while multi-family structures investment was down 5.6 percent. Other structures investment—that

is, manufactured homes, group housing, and ancillary spending like brokers' commissions—dropped 22.2 percent in the second quarter.

The remaining components of GDP represent public sector demand, international demand, and buildup or drawdown of private inventories. Of these, the change in private inventories (CIPI) posed the largest drag on the economy's performance in the second quarter. Although firms added $82 billion (constant 2012 dollars) to inventories in the second quarter, the buildup was less than half the $189 billion first quarter increase. As a result, CIPI subtracted 2.0 percentage points from real GDP growth in the second quarter. Inventories tend to be a volatile component of GDP and have remained volatile through the pandemic; in the second quarter, slower private inventory investment was led by slower growth of retail inventories, particularly at general merchandise stores and a drawdown in automotive inventories.

On the international side, the trade deficit narrowed by $70.0 billion to $1,474.7 billion in the second quarter, adding 1.4 percentage points to GDP growth. Total exports of goods and services surged by 18.0 percent at an annual rate, led by industrial supplies and materials as well as services (travel). Meanwhile, total import growth slowed to 3.1 percent. The second quarter improvement in the trade deficit was the first since the middle of 2020.

For public-sector demand of goods and services, total government spending declined 1.9 percent at an annual rate in the second quarter, after decreasing 2.9 percent in the previous quarter. Federal government consumption and investment fell by 3.2 percent, accounting for about two-thirds of the decrease in public spending. The nondefense category drove the decline at the federal level, largely reflecting the sale of crude oil from the Strategic Petroleum Reserve (SPR), which was tabulated as a decrease in nondefense consumption expenditures.[1] Meanwhile, defense spending rose 2.5 percent, after five consecutive quarters of decline, and state and local government consumption declined 1.2 percent in the second quarter.

LABOR MARKETS AND WAGES

Labor markets remained very tight in the second quarter. After generating 6.7 million payroll jobs last year and 1.6 million jobs in the first quarter, the economy added another 1.1 million in the second quarter. As of June, a total of 21.5 million jobs have been recovered during the current recovery, or 98 percent of those lost during the two-month recession in early 2020. Private sector payrolls now exceed pre-pandemic levels. The unemployment rate, meanwhile, has remained at 3.6 percent since March, just one-tenth of a percent above the half-century

low of 3.5 percent seen just before the onset of 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—has also continued to decline in 2022, reaching 6.7 percent in June. This is the lowest U-6 rate in the history of the series, which dates from January 1994. As of June 2022, the long-term (27 or more weeks) unemployment rate, expressed as a percentage of the labor force, also dropped sharply last year and, this rate had declined to 0.8 percent, or only 0.1 percentage point above the pre-pandemic low.

By contrast, recovery in labor force participation stalled in the second quarter of 2022. After climbing to 62.4 percent in March, or 1.0 percentage point below the pre-pandemic rate, the total labor force participation rate (LFPR) eased to 62.2 percent in June. For prime-age (ages 25 to 54) workers, the LFPR in June was 82.3 percent, down 0.2 percentage points from March and 0.8 percentage points below the nearly twelve-year high of 83.1 percent reached in January 2020. For those older than 55 years of age, the LFPR stood at 38.4 percent in June, reversing all of the improvement seen in the first quarter. Between 2016 and 2019, the LFPR for those older than 55 averaged 40.1 percent, but over the past 2½ years, this rate has averaged 38.8 percent, possibly suggesting a downward shift in labor force participation among older adults due to such factors as Covid concerns and rising retirement rates.

Labor market conditions remain historically tight as labor supply has not matched labor demand, which has been at or near record highs since February 2021. Just before the pandemic, the number of job openings were at a near-peak at 7.4 million at the end of October 2019. By the end of May 2022 (latest available data), job openings stood at 11.3 million, roughly 50 percent above the pre-pandemic high. Given the mismatch, workers retain considerable leverage with regard to job mobility and wage demands. By the end of May 2022, the number of job quits ticked down to 4.3 million but was still roughly 20 percent above the pre-pandemic high, and the official number of unemployed persons per job opening was at a record low of 0.5 for the third consecutive month in May. For the two years immediately preceding the pandemic, the unemployed person per job opening ratio ranged between 0.8 and 1.0.

Persistent tightness in labor markets continues to support strong nominal wage growth. For production and nonsupervisory workers, nominal average hourly earnings increased 6.4 percent over the year through June 2022—though this is somewhat slower than the 6.7 percent pace registered earlier this year from January to March. 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 5.7 percent over the twelve months ending in June 2022, accelerating from the previous quarter's twelve-month pace of 5.0 percent and marking the fastest yearly rate since the fourth quarter of 1982.

PRICES

Inflation strengthened in the second quarter of 2022. Over the twelve months through June 2022, the Consumer Price Index (CPI) rose 9.1 percent. The CPI for energy goods and services surged 41.6 percent over the year through June, accounting for a third of the headline increase and marking the largest year-over-year increase since the Russian invasion of Ukraine in late February. Food prices rose 10.4 percent over the year, contributing about 15 percent of the overall increase in June, and reflecting rising prices for energy as well as fertilizers and other agricultural input costs and ongoing supply chain disruptions. Stripping out the volatile food and energy components, core inflation was 5.9 percent over the twelve months through June, slowing marginally for the third consecutive month.

With regard to monthly developments, the CPI for all items has generally trended higher thus far in 2022. More than half of inflation experienced so far in 2022 is accounted for by food and energy. After slowing to 0.3 percent in April, reflecting a modest and temporary retreat in energy price inflation, the headline rate has since accelerated on sharply higher energy and food prices, rising 1.3 percent in June. Looking at specific commodities in the wake of the Russian invasion, the price of West Texas Intermediate (WTI) advanced nearly 33 percent from the day before the invasion through early June, and the price of natural gas increased almost 106 percent over the same period. Depending upon the variety, the price of wheat increased over that same period by as much as 47 percent. Meanwhile, the average price of U.S. regular gasoline jumped about 42 percent from the same point in February through mid-June. Since then, however, regular gasoline's price has declined 9.4 percent through mid-July and wheat prices have fallen been 20 and 25 percent, depending upon the variety. Despite the notable easing in commodity prices in recent weeks, gasoline and other energy prices remain significantly elevated relative to year-ago levels, and food price inflation may remain elevated as high energy prices filter through agriculture supply chains.

Core CPI growth has accelerated in each month of the second quarter and rose by 0.7 percent in June. Among the components of core goods CPI, new and used car prices have begun to increase again—albeit at a slower pace than seen last year. Among services, the shelter price

index—which accounts for about 40 percent of the core CPI—has been running in the range of 0.5 percent to 0.6 percent for the past five months. In June, CPI rent of primary residence jumped 0.8 percent and owners' equivalent rent surged 0.7 percent accounting for 40 percent of monthly core CPI inflation. In recent months, the owners' equivalent rent portion of shelter has dominated shelter inflation, but would-be home buyers appear to be turning to the rental market amid rising mortgage rates and high house prices. With evidence that new leases are being contracted at increasingly higher rates—monthly increases in the mid-teens in some metropolitan areas—the shelter component is expected to keep core inflation rates elevated in the near-term.

The Federal Reserves' preferred measure of inflation is the PCE price index. The PCE price index assigns different weights for different components than does the CPI and uses a different methodology in its calculation, the drivers of both measures remain similar. As with the CPI, the headline PCE accelerated to 1.0 percent in June, and the core PCE measure advanced 0.6 percent. Inflation as measured by the PCE and core PCE price indices is running at a lower rate than CPI inflation, largely due to the higher weight of health care services in PCE, which has seen more normal rates of price increases. PCE inflation typically runs at a slower pace than CPI inflation due to the methodological and weighting differences. From 2000 to 2019, headline PCE inflation was 0.3 percentage points slower than CPI inflation on a year-over-year basis, while core PCE inflation was typically 0.2 percentage points slower than core CPI inflation. Since spring 2021, however, the gaps have widened considerably. As of June 2022, PCE inflation was 6.8 percent on a year-over-year basis, or 2.3 percentage points below CP inflation. The gap between core measures has also widened—though to a lesser extent. Core PCE inflation was 5.3 percent over the year ending June, compared to 5.9 percent inflation as measured by the core CPI.

HOUSING MARKETS

In the second quarter, housing markets began to see minor easing of the supply-demand imbalances that were aggravated by the pandemic. Rising mortgage rates and still-rapid price appreciation have weighed on home purchases. Existing and new home sales have been trending lower since the beginning of the year. In June, existing home sales—which account for 90 percent of all home sales—declined 5.4 percent over the month and were down 14.2 percent on a twelve-month basis. New single-family home sales declined 8.1 percent in June and were down 17.4 percent over the year through June. Lower sales have led to higher inventories of homes available for sale: since falling to an all-time low of 850,000 homes in

January and February 2022, existing home inventories have risen to nearly 1.3 million homes as of June. Inventories are now equivalent to 3.0 months of sales, roughly double the series' low of 1.6 months from January, but still low relative to the average 3.9 months of supply in 2019. For new homes, the inventory of new single-family homes available for sale has risen well above the 7-month supply deemed consistent with a balanced market; at the end of June, there were 9.3 months' supply of new homes on the market.

So far, the decrease in demand has had only a small effect on house price appreciation, though house prices are measured with a lag. The Case-Shiller national house price index—which measures sales prices of existing homes—was up 19.7 percent over the year ending in May 2022, faster than the 16.9 percent advance over the year through May 2021, and a nearly five-fold increase over the 4.4 percent, twelve-month rate seen through May 2020. The FHFA house price index rose 18.3 percent over the year ending in May 2022, in line with the 18.2 percent pace over the year through May 2021 but more than three times the 5.2 percent rise registered over the year through May 2020. Although each index in May 2022 registered its slowest monthly pace in roughly six months, both indices have risen above 1 percent monthly since August 2020.

Meanwhile, new construction weakened in the second quarter. After falling by 1.7 percent from December to March, single-family housing starts dropped 17.5 percent from March to June. Single-family permits were down 16.6 percent in the second quarter, despite a gain of 4.0 percent the previous quarter. However, the multi-family sector, albeit volatile, rebounded in the second quarter, with multi-family starts up 9.9 percent, after a 5.6 percent decline in the previous quarter. Moreover, the total number of homes under construction as of June 2022 (single-family and multi-family) was at a series high (data series begins in 1970), while the number of new housing units that have been authorized, but not yet started (i.e., the backlog of new construction) stood at 285,000 in June 2022, just below the all-time high of 290,000 units reached in March (data begin in 1999).

RISKS TO THE OUTLOOK

Since the previous Economy Statement to the Treasury Borrowing Advisory Committee, the pandemic has become a less acute risk to the economic outlook—though it still poses headwinds to the economy. Although new strains of the Omicron variant are more able to infect vaccinated people, vaccines are proving effective against serious complications and hospitalization rates are well below those seen during previous variant waves.

Inflation: Inflation remains the dominant downside risk to the economy, as it has led to lower real spending, declining real wages, and historically pessimistic consumer sentiment. Headline inflation is being elevated by the global effects of Russia's invasion of Ukraine.

Core inflation also remains high and has yet to show clear signs of easing. Inflation for owner-occupied housing, resulting from the sharp jumps in house prices in recent years, has put a high floor for core inflation, and rising demand for rental properties is putting upward pressure on rents. Core inflation is broad-based across both goods and services. Prices for core goods remain stubbornly high, and lean inventories of durable goods—particularly inventories of motor vehicles—mean minor supply-chain disruptions can lead to sharp prices increases. However, policies to reduce inflation may result in further asset market volatility, lower consumption and investment growth, and slower job growth.

Energy Commodity Prices: Following Russia's invasion of Ukraine, energy commodity prices spiked, contributing to the sharp rise of inflation and reduced demand for non-energy goods and services. Although prices of oil, natural gas, and gasoline remain high, prices started to decline at the end of the second quarter. Since mid-June, for example, consumers have seen a 14.3 percent decline in the price of regular retail gasoline, which will push down monthly inflation in July.

However, additional energy commodity price volatility poses a risk to U.S. economic growth. High energy prices feed into large aspects of agriculture and manufacturing supply-chains, further weakening the ability of supply to meet demand. Sharp price jumps also quickly reduce households' purchasing power, potentially causing a pull back in other areas of consumption. In addition, commodity price shocks are likely to have an outsized shock on other advanced economies, which can weaken international demand for U.S. goods and service exports, further slowing economic grown.

Russia's unlawful invasion is the primary cause of high global prices. Accordingly, the U.S. Treasury has been working recently with finance ministers in the G-7 to implement price caps on Russian oil, representing a significant step in advancing the Administration's twin goals of sharply reducing Russian revenue and avoiding further disruptions to global energy supplies.

CONCLUSION

Real GDP declined 0.9 percent at an annual rate in the second quarter of 2022, after dropping 1.6 percent in the first quarter. PDFP growth, which had accelerated strongly in the first quarter despite a 1.6 percent decline in real GDP, slowed in the latest quarter to a flat

reading. However, the second quarter's setback was a function of slower inventory investment; absent inventories, Real Final Sales of Domestic Product grew 1.1 percent, reflecting strong growth in exports and a further increase in consumer spending.

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[1] The federal government's sale of SPR crude oil has a net zero effect on GDP. The negative impact on public consumption was offset by a positive impact to private crude oil inventories.