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

October 31, 2022

The U.S. economy showed continued signs of strength in the third quarter of 2022 and resilience in the face of global headwinds and persistent pandemic-related economic headwinds. The combination of continued growth in real gross domestic income (GDI) in the first half of the year and a strong rebound in real gross domestic product (GDP) in the third quarter after modest declines in the first two quarters of 2022 collectively suggest sustained growth in the US economy, despite slow growth in private domestic final demand. Labor markets remained tight—with employers adding a robust 372,000 jobs per month on average and the unemployment rate returning to the pre-pandemic, half-century low—though there also were some signs of easing, which would reduce inflationary pressures as labor demand and supply realign. With respect to prices, headline inflation slowed in the third quarter, largely reflecting falling energy prices, but core services inflation remained brisk. As a result, monetary policy tightened significantly in the third quarter as the Federal Open Market Committee (FOMC) strengthened resolve to subdue inflationary pressures in the U.S. economy. Meanwhile, the housing market correction accelerated in the third quarter due to depressed demand from rapidly rising mortgage rates and still-high home prices.

Looking ahead to the fourth quarter, there are upside and downside risks to the outlook. Supply-chain disruptions are easing, which could relive upstream price pressures on inflation, and wage growth is beginning to slow to a pace more consistent with the FOMC’s 2-percent inflation target. However, global economic growth is threatened by Russia’s invasion of Ukraine, impending oil production cuts by OPEC+, financial instability in certain major international economies, and renewed supply-chain disruptions due to resurgent COVID-19 in Asia. The International Monetary Fund (IMF) now projects subpar global growth, which may feed back into the U.S. outlook by weakening international demand for U.S. goods and service exports. Nonetheless, the U.S. economy has exhibited remarkable resilience in the face of headwinds in
recent years, and the Administration’s economic policies will promote sustainable and equitable growth.

**GDP GROWTH**

Real GDP rose 2.6 percent at an annual rate in the advance estimate of third quarter economic activity. The quarterly gain returned the economy to positive, year-to-date growth. Expansion was propelled primarily by a strong contribution from net exports—particularly trade in goods—and private consumption to a lesser extent. Business fixed investment in equipment and intellectual property products and total government spending also made smaller, positive additions to growth. By contrast, residential investment posed the largest drag on growth, followed by slower growth in inventories. Over the most recent four quarters, real GDP was up 1.8 percent, matching the pace over the four quarters through the second quarter.

Real private domestic final purchases (PDFP)—the sum of personal consumption, business fixed investment, and residential investment—ticked up 0.1 percent in the third quarter, slowing from a 0.5 percent gain in the second quarter. This measure excludes government spending, international demand for goods and services, and the change in private inventories; it is typically considered an accurate indicator of the private sector’s capacity to generate self-sustaining growth.

Real PCE—the largest component of PDFP and roughly two-thirds of real GDP—rose by 1.4 percent in the third quarter on an annualized basis, slowing from a 2.0 percent pace in the second quarter. The third quarter reading suggested that households are slowing rotating consumption patterns towards pre-pandemic patterns, in which services dominate—though the adjustment remains slow. Although the share of services has risen from 60 percent in early 2021 to 62 percent in the third quarter, it remains below the pre-pandemic average of about 65 percent. Consumption of services rose 2.8 percent, led by demand for health care services and other services, including financial services, restaurants, and travel-related businesses. Meanwhile, consumption of goods fell by 1.2 percent, reflecting lower spending on both durable and nondurable goods.

Business fixed investment (BFI) surged by 3.7 percent at an annual rate in the third quarter, after ticking up by 0.1 percent in the second quarter. The reading marked the ninth consecutive quarterly increase in BFI. Third quarter BFI growth was led by a 10.8 percent rebound in equipment investment, following a 2.0 percent decline in the previous quarter. Investment in intellectual property products rose 6.9 percent—strong but somewhat slower than the second
quarter’s 8.9 percent pace. By contrast, investment in structures posed a drag on growth for the sixth consecutive quarter, dropping 15.3 percent in the third quarter after a 12.7 percent drop in the second quarter.

Real residential investment—the third and final component of GDP—dropped 26.4 percent at an annual rate in the third quarter, after falling 17.8 percent in the second quarter. The contraction in this sector, which started in the second quarter of 2021, is accelerating. In the third quarter, lower investment was led by less new single-family construction. Single-family structures spending fell 36.3 percent while multi-family structures investment was down 5.5 percent. Other structures investment—which includes manufactured homes, group housing, and ancillary spending like brokers’ commissions—dropped 21.5 percent in the third quarter.

The remaining components of GDP comprise public sector demand, international demand, and buildup or drawdown of private inventories. The change in private inventories (CIPI) continued to pose a drag on the economy’s performance in the third quarter. Although firms added $100.2 billion (constant 2012 dollars) to inventories in the third quarter, the buildup slowed from a $145.4 billion increase in the second quarter. As a result, CIPI subtracted 0.7 percentage points from real GDP growth in the third quarter. Inventories tend to be a volatile component of GDP and became even more so through the pandemic, given changing household consumption patterns and supply-chain disruptions.

On the international side, the narrowing of the trade deficit was the largest driver of GDP growth in the third quarter. Net exports increased by $156.5 billion to -$1,274.0 billion, adding 2.8 percentage points to third quarter GDP growth. Total exports of goods and services surged by 14.4 percent at an annual rate, led by exports of industrial supplies and materials (especially petroleum, petroleum products, and other nondurable goods) as well as exports of services (including travel and financial services). Meanwhile, total imports decreased -6.9 percent. The increase in net exports was the second consecutive quarter of improvement.

After subtracting from GDP growth in each of the previous five quarters, public-sector demand for goods and services rose by 2.4 percent at an annual rate. Federal government consumption and investment grew by 3.7 percent, driven by defense spending, while state and local government consumption increased 1.7 percent, mainly reflecting increases in compensation for state and local government workers.

**LABOR MARKETS AND WAGES**
Tight labor markets persisted in the third quarter—though there were some signs of easing at the margins. Following a record 6.7 million payroll job gain in 2021, the economy has added an additional 3.8 million through September 2022—including 1.1 million during the third quarter alone. Notably, during the third quarter, the economy surpassed pre-pandemic employment levels as of August 2022. The unemployment rate, meanwhile, has fluctuated in a very low range of 3.5 percent to 3.7 percent since the first quarter; as of September, the unemployment rate had fallen again to 3.5 percent—the half-century low 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 trended lower this year; the U-6 stood at 6.7 percent in September, the lowest U-6 rate in the history of the series (starting at January 1994). In addition, the long-term (27 or more weeks) unemployment rate declined to 0.65 percent of the labor force in September 2022, matching the almost two-decade low seen near the start of the pandemic.

On the supply side, labor force participation has held within a relatively narrow band since January, fluctuating between 62.2 percent and 62.4 percent of the labor force. By the end of the third quarter, the labor force participation rate (LFPR) stood at 62.3 percent, marking a 0.4 percentage point gain since the end of 2021 but slightly below pre-pandemic expectations given the aging of the U.S. population. For prime-age (ages 25 to 54) workers, the LFPR in September was 82.7 percent, up 0.4 percentage points above June 2022 and approaching the nearly twelve-year high of 83.1 percent reached in January 2020. The LFPRs of both women and men were up over the quarter by 0.2 percentage points and 0.4 percentage points, respectively. Even for workers aged 55 years and older, the LFPR improved during the third quarter, increasing by 0.2 percentage points to 38.8 percent in September. Participation rates for this cohort remain lower than before the pandemic; for the three years before the pandemic, the LFPR for workers aged 55 years and older averaged 40.1 percent but the LFPR fell to dropped precipitously and has only recovered 0.6 percentage points since its low in March 2021. The slow recovery may reflect lingering concerns about COVID or excess retirements—those above what one would expect given demographic trends.

Although the gap between labor supply and demand remains significant, there are some signs of easing at the margins: labor force participation has been trending higher, and labor demand is starting to soften. Even so, the demand for labor has hovered near record highs for the past eighteen months. Before the pandemic, the record for job openings was 7.6 million in November 2018. Yet openings peaked in March 2022 at 11.9 million, or roughly 57 percent above the pre-pandemic high. Although job openings have declined in the intervening months,
they remain elevated at 10.1 million as of the end of August 2022 (latest available data)—still 33 percent above the pre-pandemic peak. The excess demand for labor has provided workers consequential leverage in terms of job mobility and wage demands. For example, the quits rate remains exceptionally strong: by the end of August 2022, the number of job quits was at 4.2 million, still nearly 15 percent above the pre-pandemic high despite decreasing by 7 percent since March. Moreover, although the official number of unemployed persons per job opening ticked up in August to 0.6, it remains just 0.1 unemployed worker above the record low and is significantly below the ratio of 1.0 that prevailed during the three years before the pandemic.

Although potentially easing, this tightness in labor markets continues to manifest in higher than typical nominal wage growth. For production and nonsupervisory workers, nominal average hourly earnings increased 5.8 percent over the year through September 2022. Although still brisk, this pace was nonetheless the first time since October 2021 that nominal wage growth was below 6 percent. 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 5.2 percent over the twelve months ending in September 2022, decelerating from the previous quarter’s twelve-month pace of 5.7 percent.

**PRICES**

Inflation remained elevated in the third quarter—though monthly increases at the headline level were noticeably slower compared with the second. In July and August, monthly headline consumer price index (CPI) inflation was 0.0 percent and 0.1 percent, respectively, as falling energy prices offset still-strong price growth for food and core goods and services. In September, CPI inflation picked up to 0.4 percent—though still at least half the monthly rates seen in the first and second quarters. The CPI for energy goods and services declined in each month of the third quarter, dropping a cumulative 11.3 percent since June. By contrast, food price inflation remained elevated, declining only modestly from 1.1 percent in July to 0.8 percent in September.

Meanwhile, core CPI inflation (which strips out the volatile energy and food components) started the third quarter at a somewhat slow pace—increasing just 0.3 percent in July—but subsequently rose by 0.6 percent in both August and September. Price growth for services was the largest driving force behind core CPI inflation in the third quarter. Core services rose 6.9 percent at an annual rate in the third quarter, slowing modestly from 8.0 percent growth in the second quarter. Core services inflation has a high floor due to persistent and strong growth...
shelter prices, such as rents and owners’ equivalent rents. In the third quarter, the CPI for rents rose 9.2 percent at an annual rate, picking up from 7.1 percent in the second quarter. Similarly, the price growth for owners’ equivalent rent accelerated from 6.3 percent to 8.5 percent in the third quarter. Inflation for other core services, however, weakened in the third quarter. Excluding shelter, core services inflation dropped from a 10.0 percent annualized growth rate in the second quarter to a 4.8 percent growth rate in the third quarter. Core goods prices, meanwhile, were another key contributor to core inflation in the third quarter, stepping up from a 3.1 percent annualized growth rate in the second quarter to 5.3 percent in the third. This acceleration followed spiking prices from May to August, but monthly core goods inflation was flat by September.

On a twelve-month basis, inflation readings have been mixed. Over the year ending September 2022, CPI inflation was 8.2 percent—almost a full percentage point slower than the pace recorded over the year through June. Energy price inflation was 19.8 percent over the twelve months ending in September, well-below the 41.6 percent twelve-month growth seen in June—the peak of which followed the Russian invasion of Ukraine. Food inflation, by contrast, saw a further increase in the third quarter, running at 11.2 percent over the twelve months through September, up from 10.4 percent. Meanwhile, core inflation picked up to 6.6 percent over the year ending September, from 5.9 percent in June. Like with monthly inflation, price growth of core services—driven by strong shelter inflation—was the primary driver of faster core inflation.

The Federal Reserve’s preferred measure of inflation is the PCE price index, with a target rate of two percent. The PCE price index typically has slower growth than the CPI as it assigns different weights for different components than does the CPI and uses a different methodology in its calculation, but the drivers of both measures remain similar. Over the year ending September, the headline PCE price index rose 6.2 percent while the core PCE price index was up 5.1 percent.

**HOUSING MARKETS**

The correction observed in housing markets in the second quarter became more pronounced in the third quarter, as rising mortgage rates and high house prices depressed demand. Since the start of this year, existing and new home sales have trended lower. In September, existing home sales—which account for 90 percent of all home sales—declined 1.5 percent over the month and were down 23.8 percent on a twelve-month basis. Similarly, new single-family home sales dropped 10.9 percent in September, declining for the seventh month of the past nine. New home sales were 17.6 percent lower year-to-date. Given falling sales, inventories of homes...
available for sale have risen from all-time lows. The months’ supply of existing homes for sale stood at 3.2 months in September, or 0.3 percentage points above June’s supply and fully double the supply available at the beginning of the year—but still below the average 3.9 months of supply in 2019. Inventories have also surged for the new homes market. Months’ supply stood at 9.2 months in September—though down 0.2 months from June, inventories were still up from 5.7 months of sales in January.

Measured with a lag, house prices remain elevated after accelerating sharply over the past two years. Twelve-month rates have remained in the double-digits for nearly two years. Nonetheless, those rates have slowed in recent months; on a monthly basis, house price indices have declined outright as demand has declined. The Case-Shiller national house price index—which measures sales prices of existing homes—was up 13.0 percent over the year ending in August 2022, slowing markedly from the 20.0 percent advance of the year through August 2021 but still more than double the 5.8 percent advance over the year through August 2020. Similarly, the FHFA house price index was up 11.9 percent over the year ending in August, down from 19.3 percent pace dur the previous year through August.

Meanwhile, new construction starts and permits for future starts weakened further in the third quarter. Single-family housing starts dropped 11.9 percent over the three months ending in September, after retreating by 14.9 percent in the second quarter. Single-family permits also were down over the quarter, decreasing 10.3 percent from June to September after dropping 16.6 percent in the second quarter. Construction also declined the volatile multi-family sector. After rebounding by 7.0 percent in the second quarter, multi-family starts declined 2.7 percent in the third quarter. In addition, multi-family permits decreased 4.4 percent from June to September, after rising 1.4 percent from March to June.

Although starts and permits fell in the third quarter, activity in the housing sector remains elevated as builders work through construction backlogs. The number of total homes under construction—both single-family and multi-family—rose to a series high of 1.71 million in September (data series begins in 1970). Although the number of single-family homes under construction slipped by 15,000 to 800,000 from June to September, the number of multi-family homes under construction rose by 50,000 to 910,000 over the same period. Despite the large number of projects under way, builders are pessimistic about the conditions of single-housing markets. The National Association of Home Builders’ housing market index dropped to 38 in October on a preliminary basis, less than half the level of 84 at the end of last year, suggesting
that home builder sentiment has deteriorated sharply in the wake of higher mortgage rates and rising materials costs.

**RISKS TO THE OUTLOOK**

COVID-19: The third quarter saw COVID-19 begin to transition from pandemic to endemic, with fewer cases and hospitalizations. As of late October, over 80 percent of the U.S. population have received at least one dose of the COVID-19 vaccines, and the administration of bivalent vaccines should reduce the prevalence and severity of Omicron subvariant cases. Even so, cases may rise again in autumn and winter, meaning COVID-19 could still be a potential headwind in the near term.

Inflation: As stated previously, inflation has continued at historically atypical rates thus far in 2022. Although not the sole source, Russia’s illegal invasion of Ukraine has added upward pressure to inflation since February, raising the prices of energy and food prices. Food prices are sensitive to movements in energy prices due to passthrough to agriculture supply chains. Excluding food and energy prices, core inflation is likely to stay above the Federal Reserve’s 2-percent target through at least 2023, reflecting in part elevated shelter inflation. However, with signs that rents on new leasing agreements are decreasing and home prices are beginning to fall, inflationary pressures from shelter prices may ease in coming months.

Energy Commodity Prices: Headline inflation was elevated in the first half of this year by energy prices. Although there was some relief from gas prices over the summer, energy prices have started to rise again. Russia’s unlawful invasion of Ukraine is the primary cause of high global energy prices, but OPEC+’s announcement to cut production by 2 million barrels per day starting in November has also elevated prices, which will ultimately help Russia fund its illegal war. Accordingly, the United States has been cooperating with the G-7 to implement price caps on Russian oil exports, representing a significant step in advancing the Administration’s twin goals of sharply reducing Russian revenue and avoiding further disruptions to global energy supplies.

Geopolitical Risks: Russia’s war against Ukraine has increased uncertainty to the medium-run outlook. Due to the war, Europe has shifted its supply of energy goods from Russia, which may elevate energy and food prices in coming months. High cost-of-living, tightening financial conditions, and the energy crisis in Europe caused by Russia’s invasion of Ukraine have all contributed to an erosion of the global economic outlook. According to the IMF’s latest World Economic Outlook, global growth is expected to slow to 3.2 percent in 2022 and just 2.7 percent.
in 2023. At the same time, central banks around the world are tightening monetary policy to fight high global rates of inflation. In addition, there has been financial instability in certain major world economies, and there is potential further risk from China’s continuing Zero-COVID policy. These rising risks to the global growth outlook may feed back into the U.S. outlook by weakening international demand for U.S. goods and service exports.

CONCLUSION

There are still challenges as the economy faces high inflation and significant global headwinds. But even in the face of these challenges, the economy remains resilient, bolstered by President Biden’s economic plan. Over the past two years, the Biden Administration has made significant investments to strengthen the foundations of our post-pandemic economy. The Bipartisan Infrastructure Law is modernizing our nation’s physical and digital infrastructure. The CHIPS Act is growing semiconductor manufacturing here at home. And the Inflation Reduction Act is living up to its name while also being our nation’s largest-ever investment in clean energy. These investments in infrastructure will boost economic potential as well as help our economy be more resilient to future unexpected shocks—like pandemics or climate disasters.