

Economy Statement by Catherine Wolfram, Acting Assistant Secretary for Economy Policy, for the Treasury Borrowing Advisory Committee November 1, 2021

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The U.S. economy grew rapidly during the first half of this year, bringing the level of real GDP above the pre-pandemic level by the second quarter. However, the pace of real GDP growth slowed in the third quarter, in large part due to supply-side disruptions that have been exacerbated by the persistence of the pandemic. Notably, the late-summer surge in domestic cases of Delta variant COVID-19 and the wind-down of federal fiscal aid were less pronounced headwinds for the economy. Household demand for pandemic-sensitive services – such as transportation, recreation, and food services and accommodations – continued to recover in the third quarter, while strong wage growth and excess savings built during the pandemic mitigated economic drag from lower federal pandemic-related transfers.

Meanwhile, U.S. labor markets saw strong payroll job growth in the third quarter and further reductions in unemployment. Firms added an average of 550,000 jobs per month, and the unemployment rate fell from 5.9 percent in June to 4.8 percent in September—the lowest rate since the first month of the pandemic in March 2020. Labor markets also made notable progress in stemming the number of the long-term (27 or more weeks) unemployed, which fell by 1.3 million from June to September.

Inflationary pressures eased somewhat during the third quarter, but inflation remained elevated due to multiple factors. A faster than anticipated global reopening has raised prices for gasoline, fuel oil, and electricity and natural gas services. Severe weather and labor shortages have lifted the prices of foods. Supply-chain disruptions continue to drive price growth for durable goods—particularly new vehicles. And house price appreciation during the pandemic is now filtering into rents and other shelter prices.

Overall, U.S. economic performance in the third quarter was modest. Growth should rebound in the fourth quarter and early 2022 as some factors that have held back growth – lower motor vehicle

production, continued inventory drawdown, and weak export growth – turn positive. Private forecasters predict that GDP may return to trend – that is, reach the level that it would likely have grown to without the pandemic-induced recession – in 2022.

GDP GROWTH

According to the advance estimate released last week, real GDP rose 2.0 percent at an annual rate in the third quarter of 2021, following very strong gains of 6.3 percent and 6.7 percent in the first and second quarters, respectively. Although economic growth slowed in the third quarter, the pace is consistent with the average 2.2 percent quarterly rate seen in the five quarters prior to the onset of the pandemic in the first quarter of 2020.

Real private domestic final purchases (PDFP) – the sum of personal consumption, business fixed investment, and residential investment – grew 1.1 percent at an annual rate in the third quarter. The slowdown follows two consecutive quarters of double-digit growth which together marked the strongest growth of PDFP for any half-year since 1950—excluding the unprecedented rebound in the second half of 2020 after the initial lockdowns.

After two consecutive quarters of very rapid growth fueled by Economic Impact Payments and other federal fiscal aid, personal consumption growth slowed to a pace more consistent with pre-pandemic rates. Growth in real personal consumption expenditures (PCE), which account for about two-thirds of overall GDP, rose by 1.6 percent at an annual rate in the third quarter, following a 12.0 percent increase in the second quarter and a 11.4 percent advance in the first quarter. Even so, strong wage growth and excess household savings likely helped cushion the downward pressure on household spending from the Delta variant and the waning of federal stimulus from the first half of the year. PCE in the third quarter stood 3.5 percent above its pre-pandemic level and was close to trend; the composition, however, remains heavily skewed towards goods over services.

Purchases of durable goods – a category that includes motor vehicles, household equipment and furnishings, among other items – contracted by 26.2 percent at an annual rate, following growth of 11.6 percent in the second quarter and a surge of 50.0 percent in the first quarter. The decline in spending on durable goods mainly reflects fewer purchases of motor vehicles and parts, which fell by 53.9 percent as output at factories and inventories at dealerships have been strained by supply-chain disruptions. Spending on nondurable goods – such as food and beverages purchased for home, gasoline and other energy goods, clothing, footwear, and other goods – continued to expand, rising 2.6 percent in the third quarter, albeit more slowly than the rapid second quarter pace of 13.9 percent. Meanwhile, household expenditures on services – roughly two-thirds of PCE and the

component most severely affected by the pandemic – grew at a rapid pace, rising 7.9 percent in the third quarter following an 11.5 percent advance the previous quarter. Consumption of services added 3.4 percentage points to GDP growth, and pandemic-sensitive services (transportation, recreation, and food and accommodations) accounted for nearly half of that contribution. Notably, household spending on services was almost fully recovered as of Q3 – just 1.5 percent below the level at the end of 2019, though still well below trend. Overall, real PCE growth added 1.1 percentage points to GDP growth in the third quarter, after contributing nearly 8 percentage points to growth in the previous quarter.

Business fixed investment (BFI) growth slowed to 1.8 percent in the third quarter, following a 9.2 percent advance in the second quarter. Over the four preceding quarters, BFI growth averaged 13.3 percent. In the third quarter, BFI was held back by continued weakness in structures as well as a moderate retracement in equipment investment, likely attributable to lower motor vehicle production. In Q3, investment in structures fell 7.3 percent, marking the seventh quarter of decline in the past eight. In late-2018 and 2019, falling oil prices initiated the downward trend in structures spending as energy companies shut down unprofitable ventures—though uncertainty over trade policy in 2019 likely also played a role. The recovery in oil prices in the last several months has boosted investment in mining structures, but investment in commercial structures remains weak, influenced by expectations of longer-term changes in telework arrangements and increased online shopping—factors which tend to reduce the need for office and retail space. Meanwhile, equipment investment declined 3.2 percent, reflecting less investment in transportation equipment (a component which reduced growth by 0.2 percentage points), but this followed four consecutive quarters of double-digit growth. Business investment in intellectual property products drove BFI growth, rising 12.2 percent in the third quarter, the fourth consecutive quarter with a double-digit pace of growth. Overall, the contribution of total BFI to GDP growth was 0.2 percentage points in the third quarter, after adding 1.2 percentage points to growth in the second quarter.

The change in private inventories was the strongest contributor to real GDP growth in the third quarter, adding 2.1 percentage points. This was a significant shift from the 1.3 percentage point drag on second-quarter growth. Private inventory investment tends to be volatile, with a drawdown often followed by a rebuild shortly after. During this year's first and second quarters, there were increasingly sizeable drawdowns in private inventories, reflecting high demand for consumer goods as production struggled to keep pace. In the third quarter, firms continued to draw down inventories, but the pace slowed markedly leading to a large positive contribution to GDP growth. Inventories remain stretched and restocking needs are likely to extend into 2022, which would boost GDP growth in coming quarters.

Residential investment declined by 7.7 percent at an annual rate in the third quarter, subtracting 0.4 percentage points from GDP growth. Though less steep than the 11.7 percent drop in the second quarter, construction still was constrained in part by insufficient materials and labor. The back-to-back declines in residential investment followed three consecutive quarters of robust expansion. A large backlog of housing units under construction should contribute positively to residential investment growth in coming quarters.

Several related housing market indicators also softened in the third quarter. Single-family housing starts fell by a combined 7.0 percent in July and August, before a flat reading in September, and single-family permits, which signal future starts, declined by 2.3 percent from June to September. In addition, the National Association of Home Builder's confidence index has been trending lower since reaching a record high of 90 in November 2020. Although still elevated – the homebuilder confidence averaged 66 in 2019 and 70 in 2020 – the index fell from 81 in June to 76 in September. However, October's reading of 80, the first for the fourth quarter, suggests rebounding homebuilder optimism.

Demand for homes surged last year, especially in the second half of 2020, but sales declined in the first half of 2021 as supply was not able to keep pace. In September, however, existing home sales – which account for 90 percent of all home sales – jumped 7.0 percent over the month, and average sales over the quarter were 3.8 percent higher in the third quarter than in the second. Similarly, new single-family home sales reached a 14-year high in January 2021 but trended lower in the first half of 2021. However, new home sales in September advanced 14.0 percent over the month, and average sales in the third quarter were little changed from the second. The downtrend of home sales through much of 2021 have largely reflected very lean inventories. At the end of September, existing home inventories were equivalent to 2.4 months of sales, a bit below the already-low 2.7 months' supply of a year earlier, and well below the roughly 7-month supply realtors considered a balanced market. By contrast, the inventory of new single-family home sales available for sale has moved closer to a balanced market. From a supply of 3.6 months in January 2021, supply averaged 6.3 months over June, July, and August, before slipping to 5.7 months in September.

The supply-demand mismatch for housing has led to a sharp acceleration in the rates of house price growth matching the housing boom in the 2000s, significantly impacting affordability. The Case-Shiller national house price index – which only includes existing home sales – was up 19.8 percent over the year ending in August 2021, a sharp acceleration from the 5.8 percent and 3.1 percent rates seen in August 2020 and August 2019, respectively. The Federal Housing Finance Agency's purchase-only house price index, which includes new homes, surged 18.5 percent over the year ending in August 2021, over twice the 8.4 percent pace a year earlier and nearly four times the 4.8 percent rate

over the year through August 2019. Mortgage rates have trended up this year: the average 30-year rate stood at 3.14 percent at the end of October, about 50 basis points above the record low reached in January. Although rates are still relatively low, housing affordability remains a concern given the magnitude of the increase in home prices.

Total government spending rose 0.8 percent at an annual rate in the third quarter, rebounding from the second quarter's 2.0 percent decline. Although federal spending declined 4.7 percent, this was offset by a 4.4 percent advance in state and local spending; the latter was the fastest pace since an identical increase in 2020 Q1, at the onset of the pandemic. The decline in federal spending largely reflected less consumption of private services – particularly fees to Paycheck Protection Program lenders – and nondurable goods. Meanwhile for state and local governments, increased employee compensation, particularly for workers in education, drove the increase in expenditures. Altogether, total government spending added 0.1 percentage point to real GDP growth, after subtracting 0.4 percentage points in the second quarter.

The trade deficit widened considerably in the third quarter, increasing \$67.2 billion at an annual rate to \$1.31 trillion. Total exports of goods and services declined 2.5 percent in the third quarter, reversing sharply from the second quarter's 7.6 percent gain. Although service exports increased in the third quarter, this was more than offset by a decline in exports of goods. Imports were up 6.1 percent in the third quarter, comparable to the 7.1 percent advance in the second quarter. Higher services imports drove import growth, led by travel and transport as more U.S. citizens traveled abroad. In the third quarter, the widening of the trade deficit pared 1.1 percentage points from GDP growth, significantly more drag than the 0.2 percentage point subtraction in the second quarter.

LABOR MARKETS AND WAGES

As of September 2021, the economy had generated 17.4 million payroll jobs since April 2020, recovering 77.8 percent of the 22.4 million jobs lost over March and April 2020, when initial lockdown measures were implemented to contain the spread of the COVID-19 virus. Payroll employment remains 4.97 million below the level posted in February 2020. However, the pace of job creation has remained at an elevated level thus far in 2021: job creation averaged 550,000 per month during the third quarter, very near the 567,000, monthly average during the first and second quarters of this year.

In September 2021, the headline unemployment rate stepped down by 0.4 percentage points over the month to 4.8 percent and was a full ten percentage points below the 14.8 percent, post-World War II high reached in April 2020. The steady reduction in unemployment has brought the headline rate to just 1.3 percentage points above the half-century low reached in the months before the pandemic.

Similarly, the broadest measure of labor market slack, the U-6 unemployment rate, has now returned to 8.5 percent, the lowest level since February 2020. This rate is just one-third of the 22.9 percent high reached in April 2020 and is only 1.7 percentage points above the pre-pandemic low of 6.8 percent posted in December 2019. During much of the pandemic, the long-term (27 or more weeks) unemployment rate had trended higher but has begun to decline rapidly in recent months. By the end of the third quarter the share of the labor force who were unemployed 27 weeks or more stood at 1.66 percent, down from 2.47 percent at the end of the second quarter and 2.63 percent at the end of the first quarter. Long-term unemployment is still about 1 percentage point above the 0.68 percent rate seen in February 2020, but the recent acceleration in the pace of improvement is noteworthy.

The headline and prime-age (ages 25-54) labor force participation rates (LFPRs) have improved from the lows seen in April 2020 but remain well below pre-pandemic levels. Over the past six months, total LFPR has held in the narrow range of 61.6 to 61.7 percent. In September 2021, it was 61.6 percent, or 1.4 percentage points higher than in April 2020 but still 1.8 percentage points below the six-year high seen in January 2020. Part of the decrease in the total LFPR reflects retirements, as many workers 55 and older have left the labor force. Some of these withdrawals may reflect COVID-19 concerns and may abate as cases recede. The prime-age LFPR has improved to a greater extent and has fluctuated in a wider range of 81.3 percent to 81.8 percent over the past two quarters. In September, the prime-age LFPR was 81.6 percent, 1.8 percentage points higher than the April 2020 low but still 1.4 percentage points below the 11-year high seen in January 2020.

The employment report for October will be released this Friday, November 5. Weekly unemployment insurance claims data suggest that labor markets continued to improve in October. In the weeks between the September and October labor market survey weeks – the weeks containing the 12th of the month – initial unemployment insurance claims fell by 17.1 percent and regular state continuing claims (or claims paid) dropped by 20.2 percent.

At the beginning of the pandemic, low-wage service-sector workers were those most likely to lose their jobs from business closures, which yielded outsized 12-month wage growth rates. As lower-wage workers were rehired and the composition of wage-earners in the labor force became more balanced, monthly wage growth rates began to slow. Over the past six months, growth of nominal average hourly earnings for production and nonsupervisory workers averaged 3.7 percent, comparable to the 3.5 percent average monthly growth rate seen in the six months leading up to the pandemic.

Recently, however, tightness in the labor market has led to an increase in nominal wages. Nominal average hourly earnings for production and non-supervisory workers increased 5.5 percent over the

year through September 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 4.6 percent over the four quarters ending in September, a notable acceleration from the 3.5 percent reading for the four quarters ending in June. Wage gains have been most pronounced among workers in lower-income occupations and industries. In leisure and hospitality industries, the ECI for private wage growth rose 6.1 percent over the year ending in the second quarter and 7.6 percent over the year ending in the third quarter. As a result, these workers have seen real wage increases.

PRICES

Inflationary pressures increased in 2021, reflecting elevated energy prices and price increases in reopening industries, a shortage of motor vehicles, and slower deliveries. In addition, multiple federal pandemic relief programs have supported household balance sheets—and consequently demand. However, monthly inflation rates started to slow in the third quarter.

The Consumer Price Index (CPI) for all items peaked at 0.9 percent in June but since then, has trended lower on a monthly basis. The CPI was 0.4 percent in September, despite higher food and energy prices. Food price inflation was 0.9 percent in September – the strongest monthly reading since April 2020 – while energy prices rose by 1.3 percent. Core CPI inflation, which excludes food and energy, slowed to 0.2 percent in September, down significantly from 0.9 percent growth in June. The pull-back in core inflation reflects a slowing in previously outsized gains for new and used car prices as well as travel-related prices. Over the 12 months through September, headline CPI rose 5.4 percent, and core CPI inflation registered 4.0 percent over the past year, down from the 4.5 percent pace over the year through June 2021.

In March 2021, the headline Personal Consumption Expenditures (PCE) Price Index – the preferred measure for the FOMC’s inflation target – rose above 2 percent for the first time since November 2018. The 12-month headline PCE inflation rate was 4.4 percent through September 2021, and core PCE inflation was 3.6 percent. Monthly core PCE inflation rates have moderated in recent months but remain above 2 percent on an annualized basis. Many analysts expect factors driving higher inflation are temporary and that inflation will settle around the FOMC’s average target rate in 2022 and 2023.

RISKS TO THE OUTLOOK

The coronavirus remains a significant risk to the economic outlook, but other downside risks remain, including the supply chain bottlenecks which have slowed production and delivery. These

constraints have persisted for longer than expected, and in turn, could pose additional risks for price pressures. The pressing need to vaccinate a larger percentage of the population, with a view to achieving herd immunity, is being assisted by increasing issuances of vaccination mandates in the public and private sectors. As of the end of last week, 58 percent of the U.S. population had been fully vaccinated, with 19 states and the District of Columbia posting rates above the national average. The extent of vaccination varies widely, however: Vermont and Massachusetts lead the country with 80 percent of their populations vaccinated, followed closely by Connecticut and Hawaii at 79 percent. West Virginia and Idaho have the lowest vaccination rates at 49 percent, followed by Wyoming at 51 percent. Vaccination rates should increase some with approval of vaccines for children, while approval of booster shots should reduce the number of breakthrough cases. Even so, resolving the pandemic requires vaccinating a larger share of the population, particularly in rural areas, and much more needs to be done to improve global vaccination rates and reduce the spread of the virus and risk of mutation.

In addition, the global energy crisis and elevated energy prices could be another risk to the U.S. economy, but futures prices indicate that markets believe energy inflation is temporary. Spot prices for crude oil and natural gas have risen sharply in recent months and have had a direct effect in elevating inflation through prices for the gasoline, electricity, and natural gas. However, the latest futures prices for crude oil and natural gas show a stable, rather than increasing, path over the remainder of 2021 and suggest that the contribution of energy prices to overall inflation will start to unwind in the first half of 2022.

CONCLUSION

The U.S. economic recovery, now 18 months old, remains strong and healthy. The slowdown in Q3 likely represents a pause or delay in growth. Firms are likely to build back inventories as supply-chains normalize, and net exports are likely to improve as U.S. demand for goods recedes. The return to a historically normal rate of growth in the economy in the third quarter still leaves the level of real GDP 1.4 percent above that reached at the end of 2019, just before the onset of the pandemic. The third quarter of 2021 has seen substantial progress in reducing initial unemployment insurance claims and the unemployment rate, as well as further progress in vaccinating a greater percentage of the U.S. population, the reopening of schools across the country, and the re-opening of a variety of other public venues. Although the acceleration in inflation, which began in the second quarter has continued in recent months, it now reflects higher energy prices and the persistence of supply-chain bottlenecks. Most private forecasters project a significant slowing of inflation in coming quarters. Significantly, economic growth forecasts remain solid: as of early October, before the release of the

advance estimate for Q3 GDP, private forecasters projected growth in real GDP of 5.3 percent in the fourth quarter of this year. On a fourth-quarter over fourth-quarter basis, private projections put real GDP growth at the end of 2021 at 5.5 percent, and at the end of 2022, at 3.5 percent.



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