

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

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WASHINGTON — In mid-July, the National Bureau of Economic Research's Business Cycle Dating Committee announced that the recession that started in March 2020 ended by April 2020, making it the shortest recession on record. The economic expansion which has followed is currently in its sixteenth month.

Three rounds of government fiscal aid have supported the recovery by bolstering household and small business balance sheets. This has led to a rapid reduction in the unemployment rate, robust payroll job growth, and the reopening of business establishments (particularly service-sector businesses). Combined with major strides in vaccinating the U.S. population, economic activity has recovered significantly, particularly in the first half of this year. As of this quarter, real GDP now exceeds its pre-pandemic level from the fourth quarter of 2019. However, the recovery is far from finished: economic activity remains below the level that would have occurred without the pandemic-induced recession. The projections of private forecasters suggest that the U.S. economy will return close to or above trend in 2022, though the delta variant and potential future variants add uncertainty to the outlook.

It is worth emphasizing the degree to which the pandemic and the extraordinary fiscal response has drastically reshaped economic activity over the last 18 months. Goods demand surged during the pandemic and has continued strong into the first half of 2021, driving higher imports and sharply reducing inventories as producers struggled to keep up with demand. Services demand, while recovering in recent months, remains well below pre-pandemic trend. Sectors like transportation services and education still have significant ground to recover. On the other hand, although most recessions are characterized by a sharp decline in investment, overall investment is ahead of pre-pandemic trend, driven by a surge of activity in the housing market and robust demand for equipment and software.

The sharp reallocation of activity from services to goods brought on by the pandemic has stretched activity in some sectors in the near-term, contributing to shortages of some goods and elevated price pressures. As long as activity continues to switch back towards services, inventories will be rebuilt and imports should ease, contributing substantially to economic growth in the second half of 2021. The reversion of goods and services consumption to pre-pandemic patterns, as well as the resolution of supply-chain disruptions, should also put downward pressure on inflation and reduce rates in the second half of 2021 to more normal levels.

GDP Growth

According to the advance estimate released last week, real GDP rose 6.5 percent at an annual rate in the second quarter of 2021, picking up from the already-strong 6.3 percent pace in the first quarter.

Real private domestic final purchases (PDFP)—the sum of personal consumption, business fixed investment, and residential investment—grew 9.9 percent at an annual rate, nearly a double-digit pace despite a pull-back in residential investment in the second quarter. The advance followed an increase of 11.8 percent in the first quarter. Combined, both quarters produced 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.

For the second consecutive quarter, personal consumption grew at a double-digit pace, despite a sharp drop in stimulus payments to households, which were mostly distributed by the end of March. Growth in real personal consumption expenditures (PCE), which accounts for about two-thirds of overall GDP, accelerated to 11.8 percent at an annual rate in the second quarter, up from 11.4 percent in the first quarter. Purchases of durable goods—a category that includes motor vehicles, household equipment and furnishings, among other items—grew by 9.9 percent. Significantly, this nearly double-digit advance followed a surge of 50.0 percent in the first quarter, which was supported by two rounds of federal Economic Impact Payments. The continued growth of durables purchases in the second quarter reflected strong consumer balance sheets, pent-up demand, and an improving labor market picture. Spending on nondurable goods—such as food and beverages purchased for off-premises consumption, gasoline and other energy goods, clothing, footwear, and other goods—remained very strong in the second quarter, increasing 12.6 percent, after a 15.9 percent jump the previous quarter. Household expenditures on services—roughly two-thirds of PCE and the component most severely affected by the pandemic—rose 12.0 percent in the second quarter, a marked acceleration from the 3.9 percent pace in the first quarter. Even so, household spending on services in the second quarter was 3.3 percent below the level at the end of 2019. In contrast, total

PCE in the second quarter stood 3.1 percent above its pre-pandemic level. Overall, real PCE growth added 7.8 percentage points to GDP growth in the second quarter.

Following three consecutive quarters of double-digit gains, growth of business fixed investment (BFI) slowed to 8.0 percent at an annual rate in the second quarter. Strong investment in equipment and intellectual property products was partly countered by an outright decline in structures investment. For four consecutive quarters, equipment investment has grown at double-digit paces—including a 13.0 percent gain in the most recent quarter—driven by strong investment spending on transportation and industrial equipment. Investment in intellectual property products rose at a double-digit pace for the third consecutive quarter, increasing 10.7 percent at an annual rate and following a 15.6 percent increase in the first quarter. In contrast, investment in structures resumed its longer-term decline, falling 7.0 percent in the second quarter, after a short-lived rebound of 5.4 percent in the first quarter. Aside from the first quarter of 2021, business structures investment has been trending lower since the fourth quarter of 2019, due to a variety of influences. Initially, structures investment was constrained by low oil prices—which shuttered many unprofitable rigs and reduced oil and gas well drilling—. More recently, recovering oil prices have boosted mining structures investment, but investment in commercial structures has declined, reflecting uncertainty regarding telework, firms' need for office space, and the ongoing shift towards online, rather than on-site, retailing. Overall, the contribution of total BFI to growth declined to 1.1 percentage points, after an addition of 1.7 percentage points in the first quarter.

After returning to a more normal pace of accumulation in last year's final quarter, the private inventory component of real GDP registered a considerable drawdown in the first and second quarters. Movements in this component of GDP tend to be volatile, and a large drawdown in one quarter can precede a large rebuild in the following quarter. However, the consecutive large drawdowns reflect recent supply-chain disruptions—like the global semiconductor shortage that has hindered motor vehicle production—as well as persistent high demand for consumer goods. In the second quarter, the change in private inventories subtracted 1.1 percentage points from economic growth, after reducing growth by 2.6 percentage points in the first quarter.

In four of the five preceding quarters, residential investment grew at double-digit paces, but declined 9.8 percent in the second quarter, after a 13.3 percent advance in the previous quarter. The pull-back subtracted 0.5 percentage points from growth in the second quarter. Consistent with the decline in residential investment in the second quarter, housing market indicators have softened. Single-family housing starts trended lower during the first four months of this year, before growing again on a monthly basis in May and June. Single-family permits, which signal future starts, have declined in

four of the last six months, including a 6.0 percent drop in June. Relative to pre-pandemic levels, starts were 10 percent higher and permits were up 5.6 percent from February 2020, despite a recent retracement. The National Association of Home Builder's confidence index has been trending lower since reaching a record high of 90 in November 2020, but at 81 in June 2021, remains at an historically high level, relative to the average levels of 66 in 2019 and 70 in 2020.

Demand for homes surged during the pandemic, and supply has not been able to keep pace. In June, existing home sales, which account for 90 percent of all home sales, rose by 1.4 percent and were 2.8 percent above pre-pandemic levels. After reaching a 14-year high in January 2021, new single-family home sales declined in each of the past 3 months, including a 6.6 percent drop in June. Lower home sales have largely reflected very lean inventories. At the end of June, existing home inventories were equivalent to 2.6 months of sales, down by 1.3 months from 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, rising from 3.6 months' supply in January to a 6.3-month supply as of June.

The supply-demand mismatch for housing has led to brisk rates of house price appreciation 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 16.6 percent over the year ending in May 2021, a sharp acceleration from the 4.4 percent and 3.4 percent rates seen in May 2020 and 2019, respectively. The Federal Housing Finance Agency's purchase-only house price index, which includes new homes, jumped 18.0 percent over the year ending in May 2021, well above the 5.2 percent pace a year earlier. Despite relatively low mortgage rates—the average 30-year rate dropped to 2.80 percent at the end of July, just 15 basis points above the record low—housing affordability remains a concern.

Total government spending declined 1.5 percent at an annual rate in the second quarter, after rising by 4.2 percent in the first quarter. The overall decline occurred as a sharp pullback in federal spending offset an increase at the state and local government level. Federal spending declined 5.0 percent at an annual rate in the second quarter, after surging 11.3 percent in the first quarter, largely reflecting fewer payments of lender fees for a new round of Paycheck Protection Program loans. State and local government expenditures, in contrast, increased 0.8 percent in the second quarter as fiscal conditions continued to improve. State and local government consumption remains well below pre-pandemic levels, but fiscal relief should ensure accelerating growth in coming quarters.

The net export deficit widened moderately in the second quarter, increasing \$39.2 billion at an annual rate to \$1.26 trillion. Exports growth picked up markedly from the first quarter while import growth moderated. Total exports of goods and services advanced 6.0 percent at an annual rate, more-than-

reversing a 2.9 percent decline in the first quarter, reflecting stronger international demand for U.S. nonautomotive capital goods and consumer goods, as well as increased travel services that has followed the relaxation of travel restrictions. Meanwhile imports advanced 7.8 percent at an annual rate in the second quarter, slowing from the previous quarter's 9.3 percent increase. The slowdown in imports was led by fewer imports of computers and peripheral equipment, automotive vehicles and parts, and nondurable consumer goods. Imports of services, however, rebounded as more Americans traveled abroad. In the second quarter, the widening of the trade deficit pared 0.4 percentage points from GDP growth, significantly less drag than the 1.6 percentage point subtraction in the first quarter.

Labor Markets and Wages

As of June 2021, the economy had generated 15.6 million payroll jobs since April 2020, recovering 70 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. Although payroll employment is still 6.8 million below the level posted in February 2020, the pace of job creation has accelerated in 2021, from an average of 518,000 per month in the first quarter to an average of 567,000 per month in the second quarter.

In June 2021, the headline unemployment rate edged up by 0.1 percentage point over the month to 5.9 percent, but was still 8.9 percentage points below the 14.8 percent, post-World War II high reached in April 2020. The significant progress made in reducing unemployment has returned the headline rate to within 2.5 percentage points of the half-century low reached in the months before the pandemic. The broadest measure of labor market slack, the U-6 unemployment rate, continues to decline steadily: at 9.8 percent in June 2021, it was less than half the 22.9 percent high reached in April 2020, as well as just 3 percentage points above the pre-pandemic low of 6.8 percent posted in December 2019. Throughout much of the pandemic, long-term unemployment has trended higher but may have begun to recede a bit recently: by the end of the second quarter the share of the labor force who were unemployed 27 weeks or more stood at 2.47 percent, down from 2.63 percent at the end of the first quarter.

The headline and prime-age (ages 25-54) labor force participation rates (LFPR) have improved from the lows seen in April 2020. In June 2021, total LFPR was 61.6 percent, or 1.4 percentage points higher than in April 2020. However, the total LFPR has been little changed over the past year, with the June reading just 0.2 percentage points higher than 12 months earlier and still 1.6 percentage points below the six-year high seen in January 2020. The prime-age LFPR, in contrast, has seen more recent improvement, rising 0.4 percentage points to 81.7 percent in June. The prime-age LFPR in June was

1.9 percentage points higher than in April 2020, but still 1.3 percentage points below the 11-year high seen in January 2020.

Recent months have seen a more extensive decline in weekly initial unemployment claims. At the beginning of 2021, weekly initial unemployment claims were still running about four times the average levels seen prior to the pandemic's onset. Over the four weeks through mid-July, however, the average weekly filing was only 1.8 times the pre-pandemic level. The employment report for July will be released this Friday, August 6.

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. The recent rehiring of many of these lower-wage workers has helped to normalize the composition of the labor force, and growth rates of nominal average hourly earnings for production and nonsupervisory workers are more consistent with pre-pandemic rates. Over the most recent six months, nominal average hourly earnings growth averaged 3.7 percent, comparable to the 3.5 percent average monthly growth rate seen in the six months leading up to the pandemic. Nominal average hourly earnings for production and non-supervisory workers rose 3.7 percent over the year through June 2021, slowing from the 5.5 percent, year-earlier advance.

The Employment Cost Index (ECI) better adjusts for compositional changes of the labor force than does average hourly earnings. Aside from some volatility associated with the pandemic in 2020, year-over-year growth in the Employment Cost index (not seasonally adjusted) held around 3 percent between the first quarter of 2018 and the first quarter of this year. This measure accelerated to 3.5 percent over the four quarters ending in June 2021, the most rapid pace since the first quarter of 2007. The acceleration largely reflected strong wage growth in pandemic-sensitive industries: wages and salaries for accommodation and food service workers were up 6.9 percent of the year ending in June 2021, while retail service wages rose by 4.7 percent.

Prices

Inflationary pressures have been building for some months now, reflecting recovering energy prices, constrained production from supply-chain disruptions, and elevated demand pressures from healthy household balance sheets—which were supported by multiple federal pandemic relief programs.

The Consumer Price Index (CPI) for all items accelerated to 0.9 percent in June, reflecting in part higher food and energy prices. Food price inflation doubled to a pace of 0.8 percent in June 2021,—while energy prices rose by 1.5 percent, elevated by a 2.5 percent jump in gasoline prices. Core CPI inflation, which excludes food and energy, was 0.9 percent in June. The ongoing supply-chain

disruptions in the automotive industry, which have prevented production from matching demand and has stretched motor vehicle inventories, are responsible for roughly half of the gain in core CPI inflation. Increased travel and tourism is reflected in rising airline fares and hotel prices. Over the 12 months through June, headline CPI rose 5.4 percent, marking the fastest 12-month rate since an identical reading in August 2008. However, year-over-year comparisons are less useful given the disinflation that occurred at the beginning of the pandemic. The headline gain largely reflected a 24.5 percent surge in energy prices over the year through June, which due to artificially low energy prices a year ago. Core CPI inflation registered 4.5 percent over the past year, the most rapid pace since November 1991, though this also partly reflects base effects.

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. Since then, it has accelerated further, and well beyond year-ago levels. The 12-month headline PCE inflation rate was 4.0 percent through June 2021, and core PCE inflation was 3.5 percent. Similar to CPI inflation, year-over-year PCE inflation is being elevated in part by comparisons to artificially low oil prices. These gains also reflect pressures from pent-up consumer demand, supply-chain disruptions, and reopening of pandemic-affected sectors. Most analysts expect these factors are likely temporary and that inflation will return to the FOMC's average target of 2 percent in 2022.

Risks to the Outlook

The coronavirus is the single-largest risk to the economic outlook. The United States has not yet reached herd immunity, and COVID-19 cases are rising in many areas. The delta variant of the coronavirus is more contagious than other variants of the virus; it is claiming a rising number of lives among those not yet vaccinated. Vaccines are the single-best weapon to resolving the pandemic, as they are proving extremely effective at preventing hospitalizations and deaths—even in cases of breakthrough infections. As of the end of last week, 49.6 percent of the U.S. population had been fully vaccinated, with 22 states and the District of Columbia posting rates above that average. The extent of vaccination varies widely across states, however, with Vermont leading the country at nearly 80 percent and Alabama and Mississippi showing the lowest rates at less than 35 percent. There is an ongoing need to vaccinate a larger percentage of the population.

Conclusion

The present economic recovery, which officially began in May 2020, featured very strong real GDP growth in the second quarter of 2021, as well as an accelerated pace of payroll job creation. Four consecutive quarters of growth have returned the level of real GDP to a level that is 0.8 percent above the level of activity achieved at the end of the 2019, just prior to the onset of the global pandemic in

the following quarter. The economy's reopening, which continues to gather momentum, has been accompanied by a rise in inflation, although this development is likely transitory, with private forecasters anticipating a decline in inflation rates in the next 12 months. Moreover, economic growth forecasts remain solid: as of early July, before the release of the advance estimate for Q2 GDP, private forecasters projected growth in real GDP of 7.3 percent in the third quarter of this year and of 7.0 percent on a Q4/Q4 basis at the end of 2021.



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