ECONOMIC REPORT

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ECONOMY PICKED UP IN EARLY 2021 THANKS TO STIMULUS, VACCINES; FED TO KEEP PEDAL TO THE METAL

SUMMARY

- Real GDP increased 6.4% at an annual rate in the first quarter of 2021, and is almost back to its pre-recession peak. Vaccines and federal stimulus are driving the economic recovery.
- Economic growth will be very strong through the rest of this year and into 2022.
- The FOMC kept monetary policy unchanged at its April 28 meeting. Monetary policy will remain highly expansionary over the next couple of years.

Real GDP increased 6.4% at an annualized rate in the first quarter of 2021, according to the advance estimate from the Bureau of Economic Analysis. This does not mean that the economy grew by 6.4% in the first quarter; instead, it grew by 1.6%, and would grow by 6.4% if it maintained this pace for an entire year.

Real GDP fell more than 10% from the fourth quarter of 2019 to the second quarter of 2020 as the pandemic came to the U.S. Since then real GDP has increased by about 10%. As of the first quarter of 2021, real GDP was 0.9% below its pre-pandemic peak in the fourth quarter of 2019 (see Chart). Over the past year real GDP has increased by 0.4%.

Consumer spending led growth in the first quarter, up 10.7% annualized, contributing 7 percentage points to growth. Spending growth for goods was especially strong, up almost 24%. Spending on services rose about 5% in the first quarter, as consumers still remained reluctant to go out.

Private fixed investment rose 10.1% in the first quarter, adding 1.8 percentage points to growth. Both housing and business investment added to growth in the quarter, although business investment in structures (primarily commercial construction and energy infrastructure) fell. Inventories subtracted 2.6 percentage points from growth as consumers bought goods and businesses found it difficult to restock them amid extremely high demand and supply-chain disruptions.

Government consumption and investment rose 6.3% in the first quarter, adding 1.1 percentage points to growth; almost all of that came at the federal level. This category includes government spending on services it provides (like healthcare and government salaries) and on investment (like infrastructure spending), but not transfer payments like stimulus payments and unemployment insurance benefits. Trade was a drag in the first quarter, subtracting 0.9 percentage points from growth. Exports fell 1%, while imports rose 6%. The drag from trade was much smaller than in the previous two quarters.

The U.S. economy grew at a strong pace in the first quarter as consumers bought goods, and to a lesser extent services, thanks to stimulus payments, vaccines, and an improving outlook. Growth will be even stronger over the next few quarters. Consumers have lots of cash available, thanks to stimulus and extremely high savings, and will be looking to spend, especially on services. Rising vaccination rates and a greater willingness to go out in public will also support consumer spending. Business investment will be strong as firms try to keep up with rising demand, although commercial construction will be weaker given lots of empty office and retail space. Supply-chain disruptions will weigh on inventory accumulation in the near term, but eventually those will be worked out and businesses will restock their shelves. And the trade deficit will decline as exports pick up with stronger global growth and import growth slows as consumer spending shifts from goods to services. Housing will also be a strong contributor to growth this year thanks to extremely low mortgage rates and strong demand for single-family homes in the wake of the pandemic.

U.S. real GDP growth will be better than 6% in 2021, as measured on a fourth quarter to fourth quarter basis; this would be the strongest year for the economy since the mid-1980s. Real GDP is set to surpass its pre-recession peak in the

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second quarter. Growth will be better than 3% in 2022, well above the economy's long-term trend.

In its April 28 statement, the Federal Open Market Committee once again promised to maintain its highly expansionary monetary policy until inflation has picked up and there is significant improvement in the labor market. The committee said that it will maintain its purchases of long-term Treasurys and mortgage-backed securities "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." And the FOMC said that it will keep its short-term policy rate, the fed funds rate, in its current near-zero range "until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."

The three paragraphs on the outlook for monetary policy were unchanged from the FOMC's previous statement on March 17, and in the two statements before that, going back to December 2020.

In the section of the April 28 statement on current conditions, the FOMC noted that "indicators of economic activity and employment have strengthened," citing vaccines and policy support, presumably both monetary and fiscal policy. The March 17 statement said that "indicators of economic activity and employment have turned up recently," a less positive assessment. In addition, the April 28 statement said that "the sectors most adversely affected by the pandemic remain weak but have shown improvement." The comparable language from the March 17 statement said that "the sectors most adversely affected by the pandemic remain weak."

The April 28 statement said that "inflation has risen, largely reflecting transitory factors," while the comparable section on March 17 said that "inflation continues to run below 2 percent." There are two transitory factors that the FOMC is referring to. The first is the comparison with the period one year earlier; prices declined in March and April 2020 at the start of the pandemic, and thus inflation is accelerating on a year-ago basis because of base effects, but those will wash out of the data over the summer. The second is pandemic-related supply-chain disruptions that are temporarily raising prices of some inputs.

There was nothing new in the April 28 FOMC statement. The committee acknowledged stronger data in March and April, but kept the same stance toward monetary policy. The committee will continue to purchase long-term securities, putting downward pressure on interest rates, until the labor market has improved significantly and inflation has picked up permanently. And the FOMC once again committed to keeping the fed funds rate extremely low until inflation is consistently at or above 2%, and the economy is at maximum employment. This time around the FOMC wants to see real progress; in previous cycles the committee would raise the policy rate based on forecasts for full employment and higher inflation. That will not be enough this go-round.

The FOMC has not committed to maintaining its asset purchases until those goals are reached. But the FOMC does want to see substantial progress in the labor market and consistently higher inflation before reducing those purchases.

PNC expects the FOMC to maintain its current level of asset purchases—$80 billion per month of long-term Treasurys and $40 billion per month of mortgage-backed securities—throughout 2021. In his post-statement press conference, Fed Chair Powell said that he and his FOMC colleagues have not yet discussed reducing asset purchases. At some point in the early fall the FOMC is likely to signal that it is ready to reduce its asset purchases, providing plenty of notice, before actually reducing those purchases in early 2022. PNC expects the first increase in the fed funds rate to come in late 2023.

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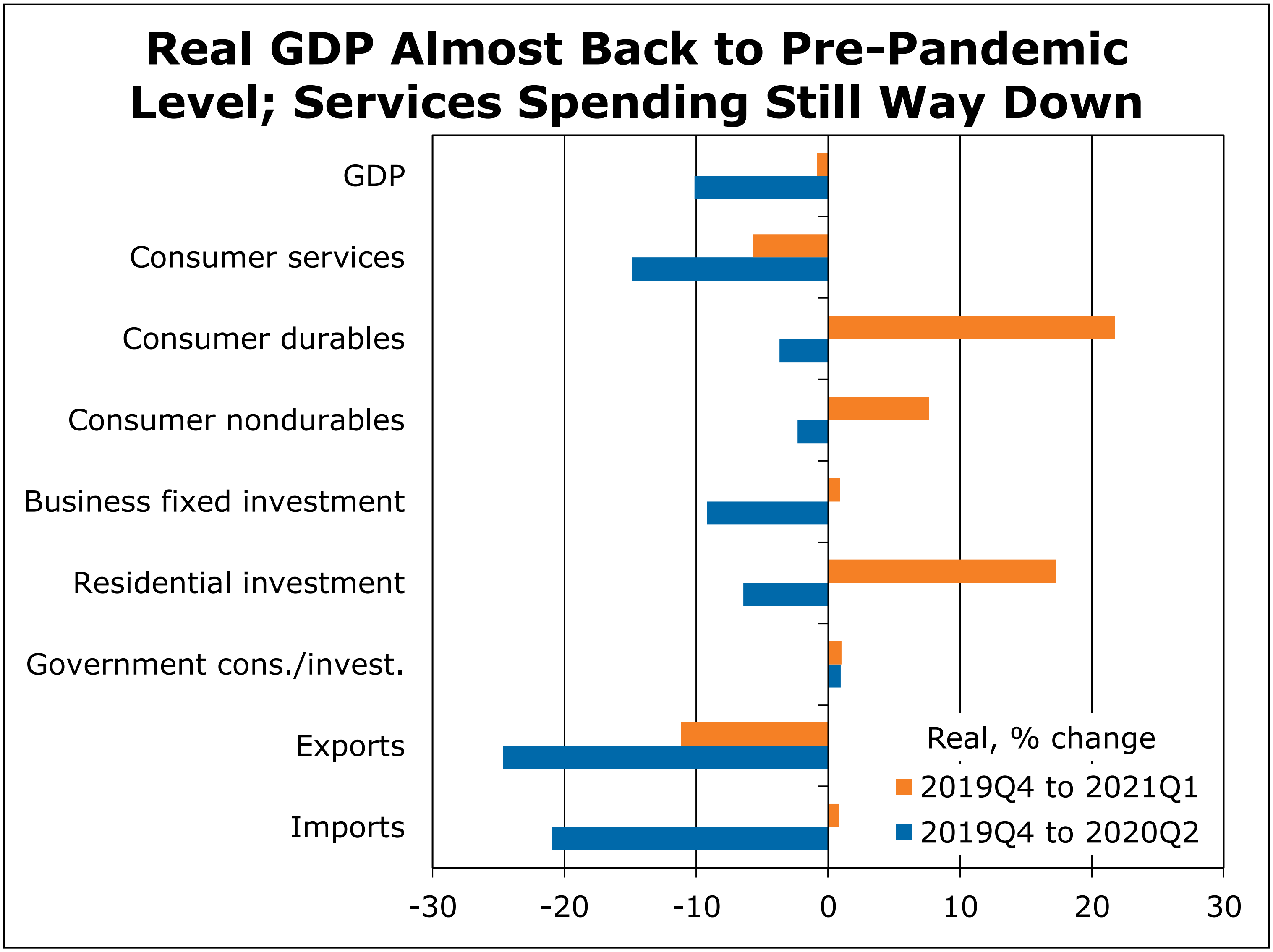

Chart source: Bureau of Economic Analysis

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