Current Economic Conditions

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ARE WE RUNNING OUT OF ROOM TO GROW?

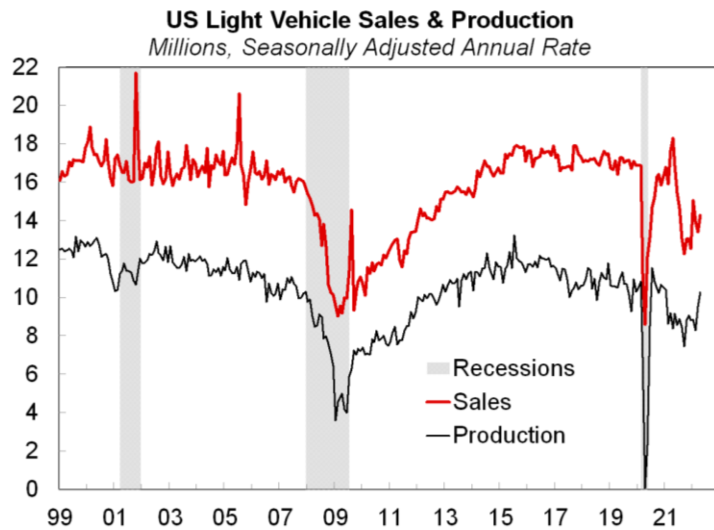
U.S. Real Gross Domestic Product fell at a reported 1.4% annual rate in the first quarter, the first decline since the second quarter of 2020, when GDP fell at a 31.2% rate due to COVID-related shutdowns. GDP declined even though demand remained strong. Real final sales to domestic purchasers rose at a 2.6% annual rate. But a big increase in the net export deficit subtracted 3.2 percentage points from growth. Demand was apparently satisfied by imports, not by domestic production. A smaller rate of inventory accumulation than in the prior quarter subtracted another 0.8 percentage points from growth.

Net exports fell because exports fell and imports rose. It's easy to explain the decline in exports; growth is weak (or negative) in much of the world, and a strong dollar is reducing the competitiveness of U.S. goods and services. There are two possible explanations for the surge in imports. One is that we were making up for what we didn't import during the 2020 lockdown and that we finally unloaded the goods that have been sitting on ships that couldn't get into ports. If that's the case, the first-quarter surge in imports will prove temporary, and imports will fall back in coming quarters, boosting GDP growth (other things equal). The second possibility is that U.S. producers simply can't meet demand because they're either out of capacity or don't have enough workers. If that's the case, the U.S. economy can't grow as fast as I've been forecasting. The first explanation just says that we **didn't** satisfy domestic demand with domestic production in the first quarter. The second explanation implies that we **can't** satisfy domestic demand with domestic production. That is more problematic.

I have been forecasting strong growth this year. I expected a strong rebound in motor vehicle sales and production as the global semiconductor shortage eased. I expected home construction to strengthen as pent-up demand was satisfied. I expected air travel to rebound strongly as fears of COVID diminished and people engaged in "revenge travel." And I expected oil and gas drilling, included in GDP as part of investment in nonresidential structures, to boom in response to high oil prices. But supply constraints threaten to put a damper on my strong-growth forecast. Light vehicle production, which plummeted in February 2021, showed no recovery through February 2022. Air travel snapped back in March, but further growth is being limited by a shortage of pilots and slow deliveries of planes from Boeing. Drilling activity is rising, but it remains near 20-year lows, in part because of shortages of workers and frac sand. And home construction, which had been supply-constrained, is now being hit on the demand side by rising mortgage rates and house prices that are unaffordable for a growing number of households.

But despite falling stock prices, consumer sentiment near its 2008-2009 lows, and a big decline in the National Federation of Independent Business's Small Business Optimism Index, there are reasons not

to throw in the towel and give up on solid growth in 2022. Light vehicle assemblies, which were at an 8.3 million seasonally adjusted annual rate in February, jumped to a 10.3 million rate in April, the highest since January 2021 and not far below the 10.6 million vehicles assembled in 2019. No one has announced the end of the semiconductor shortage, but vehicle production has surged in the last two months. Barring a reversal, vehicle sales are likely to follow, bolstering consumer spending. More broadly, industrial production in U.S. manufacturing rose 0.8% in April, pushing it to its highest level since 2008. Capacity utilization, which is industrial production as a percent of the Federal Reserve's estimate of capacity, rose to its highest level since April 2007 and is nearing its highest level since 2000.



The high rate of capacity utilization suggests that manufacturers might be running out of room to grow, but in several industries, industrial production is still below where it was in August 2018, which was the post-2008 peak until March. These industries include motor vehicles and parts and several industries that supply the auto industry: primary metals, fabricated metal products, and plastic and rubber products. They also include petroleum refining, constrained by temporary and permanent shutdowns, and chemicals.

If most manufacturing industries are not yet being capacity-constrained, and if the recent surge in motor vehicle production means the semiconductor shortage is easing, the biggest constraint on economic growth must be coming from the tight labor market. Job openings continue to exceed the number of unemployed persons by a wide margin. While some hold out hope that receding COVID fears and the depletion of past government relief checks will cause people to reenter the labor force, most of the decline in the labor force participation rate has been due to the retirement of baby boomers. Most of these people, especially the older ones, are unlikely to return to the labor force. Without an increase in labor force participation, the only way to increase the size of the labor force in less than the two decades it takes to raise a child to adulthood is through immigration.

If employers can't hire more workers, they can only expand production by increasing productivity (output per hour worked). While better education and training can improve labor productivity in the long run, most productivity growth comes through investment in equipment and software. Business investment in equipment rose at a 15.3% annual rate in the first quarter, the best since 2020. Investment in intellectual property products, which includes software, has been the most consistent contributor to growth since the 2020 recession; it rose at an 8.1% annual rate. Continued strong investment holds the key to whether American businesses can expand production and meet demand in a tight labor market.

When supply can't meet demand, prices rise. The Consumer Price Index rose "just" 0.3% in April, but my favorite measure of underlying inflation, the Producer Price Index for finished goods excluding food and energy, rose 1.0%, the biggest monthly increase since 1981. Inflation has not begun to decelerate.

U.S. economic growth this year won't be quite as strong as I've been forecasting, but a recent surge in industrial production, including a big increase in motor vehicle assemblies in March and April, suggests solid growth in the middle two quarters of 2022. I also expect first-quarter GDP to be revised up. The decline in GDP seems inconsistent with big increases in employment and industrial production. I suspect that either real imports were overstated (by understating price increases) or inventory accumulation was understated. That said, growth will decelerate into 2023 as businesses run into capacity constraints and monetary tightening starts to affect housing construction and consumer spending.

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