Title: General Economic Outlook – COVID calls the shots again

Author: Larry DeBoer

Article ID: PAER_2022-1

Tags: Covid, Economy, GDP, Economic Growth

Summary: Uncertainty over the course of the pandemic and the response by workers and businesses to inflationary pressures are expected to be the determining factors in what is likely to be slower GDP growth in 2022.

# General Economic Outlook: COVID calls the shots, again.

**Larry DeBoer**
**December 2021**

The outlook for the general economy depends on the course of the COVID pandemic. Perhaps COVID will fade by this summer—but that's what we predicted last year. Perhaps the worst of COVID is still ahead of us, with the spread of the highly-contagious Omicron variant. Perhaps we'll see another lockdown and a second short, sharp recession. Perhaps we'll simply ignore COVID, go about economic business as usual, and accept the elevated case rates.

Needless to say, the pandemic creates more than usual uncertainty about the general economic forecast. Let's suppose, as a baseline, that COVID cases peak again this winter and fall during the summer. Many consumers and employees will be fearful of COVID during the first half of the year, but fear will subside in the fall. Schools and businesses will close and reopen sporadically for the first half of the year. And let's assume that the government will encourage social distancing, mask wearing and vaccinations, but will not lockdown the economy again.

The economy recovered rapidly in 2021. Real GDP grew 4.9% in the past year, the fastest growth in at least 20 years. The unemployment rate fell from 6.7% in November 2020 to 4.2% this November. Still, the economy is not back to where we want it to be. Unemployment was 3.5% in January 2020. The Congressional Budget Office estimates that output is still 1.6% below potential, which is what output would be if all resources were fully employed.

High inflation was a surprise. The consumer price index increased 6.9% in the year through November, which was the highest 12-month rate in almost 40 years. Energy prices contributed, rising 33%, and food prices rose 6.1%. But the "core" rate, not counting food and energy, still was the highest in 30 years at 5.0%.

Consumers have shifted purchases from services to goods during the pandemic. In October 2021 goods accounted for 35% of spending, up from 31% in January 2020. This shift is reflected in the inflation rates. Prices of goods excluding food and energy increased 9.4% in the year up to November. Prices of services rose 3.4%. Manufacturing and transportation of goods has been stressed by the spending shift. Goods inflation may remain high as long as the pandemic lasts, because many people fear the face-to-face transactions of service purchases.

The shortage of labor is also a source of inflationary pressure. The Bureau of Labor Statistics measured 11 million job openings but only 7.4 million people seeking work in October. That's a shortage of employees of 3.6 million. A reason for this shortfall is the extraordinary decline in labor force participation. The percentage of the population that is employed or seeking work was 61.8% in November 2021, down from 63.4% in January 2020. There are almost 3.5 million fewer people working or looking for work—not coincidently, about the same number as the employee shortage.

The breakdown by age is revealing. More than half of the missing workers are over age 54. These are the people most vulnerable to COVID, and also the people most likely to retire. Early retirements may be a large part of the participation decline. Retired people sometimes return to work, but many are likely out of the labor force for good.

Federal spending was a source of demand for both goods and services in 2021. Spending in 2021 was 54% higher than it was in 2019, mostly due to COVID relief programs. This represents an extra $2.4 trillion. The federal budget deficit was 13.4% of GDP.

With no added COVID aid, and the apparent failure of the administration's Build Back Better bill, the federal deficit will fall substantially in 2022. In July the Congressional Budget Office projected a drop in the deficit to 4.7% of GDP. That's a subtraction of almost $2 trillion in fiscal stimulus.

The passage of the infrastructure bill in November will modify this estimate slightly. The bill envisions $1.7 trillion in added spending over ten years, but the impact in 2022 is expected to be only $155 billion. New infrastructure should eventually improve productivity, raise output growth and even reduce inflation—but not in 2022. Next year the overall fall in federal spending will be a drag on the demand for goods and services.

Interest rates remained near record lows, with the ten-year Treasury yield at 1.6% and the 3-month yield near zero. The Federal Reserve cut the federal funds rate to near-zero in March 2020 and has held it there since then. Policymakers recognized that they raised rates too much during the second half of the 20-teens expansion, and pledged to keep rates low in order to achieve inflation rates averaging 2% to 3% over several years.

Then the inflation rate increased. The Fed held to the view that the inflation would be transitory through most of 2021, but in November decided it wasn't transitory enough. As a result, the Fed will lessen monetary stimulus during 2022, and expects to raise the federal funds rate three times to near 1%.

Is inflation transitory or will it be sustained for years? That depends on inflationary expectations. If employees expect inflation, they'll require wage hikes to cover it. If businesses expect wage increases, they'll pass them along in higher prices. Business and employee expectations would be confirmed, and the spiral would continue.

Inflationary expectations can be measured by the difference between the nominal and inflation-adjusted Treasury bond yields. The nominal yield shows the return lenders need to compensate for inflation; the adjusted rate shows only the return after inflation. Ten-year Inflation expectations were 2.5% in November, up slightly from the 1.5% to 2% range during the second half of the 20-teens. Inflationary expectations are not high yet, so inflation still has a chance to be transitory.

Where do these trends leave us? Suppose consumption growth slows with the drop in federal COVID aid. The shift from goods to services consumption doesn't get started until the second half of the year. Investment continues to grow despite the Fed's interest rate increases. Rising home prices should encourage home building. The labor shortage should encourage investment in business equipment. Imports should grow more slowly as goods demand slows in the second half of the year. Exports should grow more rapidly as COVID fades. Federal spending will fall, but state and local government spending should rise. Many states are flush with revenue, and much of the federal COVID aid to local governments remains to be spent.

Output growth will be constrained by low labor force participation and supply disruptions. Participation should begin to rise in the second half of the year, and supply problems should lessen with the shift to service consumption and new investment in manufacturing and transportation.

**Expect real GDP to grow more slowly next year than this, at 3.5% to 4%. Call it 3.8%.** That's faster than usual, but slower than we'd like.

With so many more job openings than job searchers, the unemployment rate should continue to fall. **Expect an unemployment rate around 3.7% by this time next year.** Twelve-month inflation rates will register above 7% early in 2022, but lower federal fiscal stimulus, monetary tightening, lower oil prices and improving supply conditions should reduce **inflation to 4.5% by December 2022**. Federal Reserve tightening should add three-quarters of a point to the long-and short-term Treasury bond yields.  That would make the **10-year Treasury yield about 2.3% and the 3-month yield 0.8% by the end of 2022.**

What could go wrong?  COVID calls the shots for this economy.  Suppose the pandemic gets worse and stays bad.  Consumers pull back and labor force participation doesn't improve. Supply disruptions continue.  Inflation is sustained, and the Fed must raise interest rates higher. Fiscal stimulus grinds to a halt.  Output growth could be as low as 2% with inflation above 6%.

But have a good thought.  What could go right?  Suppose the omicron variant burns itself out by Spring, and we're finally done with COVID.  Labor force participation rises, consumers shift spending to services, and pressure on supply abates. Inflation proves more transitory than not. Further tightening of monetary policy is not needed.  Parts of the administration's Build Back Better bill pass, so fiscal policy is not such a drag on spending.  Real GDP growth could be 5%, with inflation under 4%.

Uncertainty is the order of the day.  But remember, though pessimism is often mistaken for realism, optimism is right about half the time.