Richmond Fed

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The Economy: What We've Learned

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2022 Financial Forecast

Highlights:

- I take five key lessons from 2021. First, COVID-19 still impacts our growth, but it has largely become a supply side and inflationary challenge. Second, government support helped bridge our economy through the initial shock, but we may also be seeing other effects. Third, our supply chains were too lean to support the wide swings in demand. Fourth, power has shifted to labor as demand has exceeded supply. Finally, the word transitory did not serve its intended purpose, as inflation has lasted longer than many expected.
- These lessons help shape my outlook for 2022. While there are many unknowns ahead, I expect increases in household balance sheets to sustain demand for quite some time. It may take a year or longer to get to the other side of supply chain pressures, but they will eventually catch up. Labor will remain short. Prices will cause consumers to adjust as savings erode, and wages will bring people off the sidelines.
- But what will happen to the path for inflation? I am closely watching the prices for goods versus services. Will they continue on their historic paths or will present adjustments persist? How these two sectors net out will matter as the Fed continues to work to meet its stable price mandate.
- In terms of policy, we have started the process of normalization, but the timing and pace of any future rate moves will depend on the answer to my question on inflation.

Thanks for having me here. The last time I was with you in person was two years ago. At the time, the question was how long our historically long 10-year upturn could last. I remember saying that expansions don't die of old age — they die of a heart attack. I guess my point was right, but for sure I had the wrong disease.

It's hard to believe we've now been dealing with this pandemic for two years. From an economist's point of view, we had the deepest but also the shortest recession in memory. So now, technically, we are in the midst of a 20-month recovery. And not just any recovery. This one is historic.

Today, I thought I might look back and then look forward. We've learned a lot that will help inform where the economy goes from here. These thoughts represent, of course, my views only and not necessarily those of anyone else in the Federal Reserve System. So, what did we learn in 2021? I took five lessons.

First, even with vaccines, COVID-19 still calls the shots.

In 2020, the pandemic drove uncertainty and lockdowns, which in turn meant job loss and spending that was depressed and deflationary at first and then rotated to goods over services. In 2021, vaccines largely freed demand from COVID-19's control (except for a few sectors like business travel). Despite the delta variant, consumer spending more than fully recovered, and we saw the highest number of job openings on record.

But the COVID-19 economic threat — much like the virus — has evolved. You can see that with the omicron variant. Cases have spiked. But, as the virus starts to become perceived as more endemic than pandemic, U.S. communities are no longer closing down. Demand, especially for goods, remains healthy. But uncertainty around health, child care and in-person schooling suppresses labor force participation. Outbreaks internationally disrupt global supply chains. So COVID-19 has now largely become a supply side and inflationary challenge. We saw that with air travel over the holidays. People want to fly. We just can't find enough flight crews.

Second, it turns out that $6 trillion is a lot of money.

Historic levels of government support helped bridge workers, small businesses, and heavily impacted industries to the other side of the initial economic shock. It fueled this strong recovery. GDP is now 1.4 percent over the fourth quarter of 2019 and will likely soon even surpass the pre-COVID-19 trend line.

But these actions had consequences. Stimulus created strong demand, especially for goods, which are up 16 percent. That demand broke supply chains. Workers were slow to return to the labor force, perhaps supported by these transfer payments. And of course, we've seen a considerable increase in the national debt.

Third, we're too lean for our own good(s).

Prior to the pandemic, productivity meant lean operations, global supply chains, just-in-time inventories and flexible labor models.

COVID-19 exposed those strategies. As demand ebbed then spiked, manufacturers lost control. Input shortages, transportation challenges and labor constraints proliferated. We all understood when auto manufacturers shut down in the context of lockdowns, but who expected they would have to shut down again last year due to a lack of chips?

Fourth, power has shifted to labor.

We've been living for decades in a world of excess workers, driven by the baby boom, improved health, women in the workforce, immigration and offshoring. These kept wages and benefits, and effectively cost-driven inflation, down.

But in 2021, the tables turned. Labor is now painfully short. Workforce participation has stayed remarkably stagnant since the spring at around 1.5 percentage points below the pre-pandemic level. 3.6 million fewer people are working.[1] We see fewer retirees returning to work, more parents leaving the workforce and countless workers reassessing their lives. Quits are at record highs. As a result, employers are raising wages, improving working conditions, broadening their search efforts and becoming more flexible. 2021 saw the highest wage growth since before the Great Recession, peaking at 4.7 percent in September, according to the Atlanta Fed's Wage Growth Tracker.

Finally, transitory is a bad word.

For much of 2021, we used the word "transitory" to describe inflation. It tried to capture the idea that rising prices were connected to COVID-19 forces that should eventually dissipate, such as supply bottlenecks.

But as the chair said in his recent testimony, the word didn't serve its purpose. Webster's has two definitions for transitory: "of brief duration" and "not persistent." Most of us interpreted it as the former, even if we meant the latter. And elevated inflation has clearly lasted longer than most of us expected. On a 12-month basis, core PCE inflation is at the highest level in over 30 years.

So, now let me turn to what we should see in 2022.

I feel obliged to start with a caveat: Forecasting isn't easy. I'm told economic forecasters were created to make weather forecasters look good. For example, in the summer of 2021, I thought participation would rebound strongly in the fall as schools reopened and enhanced unemployment benefits ceased. I didn't foresee the longer-term workforce challenges we face. As a result, I underestimated inflation.

And 2022 is no clearer. The path and impact of current and future COVID-19 variants is unknown. Congress is still debating legislation that may or may not enhance workforce participation. Consumer sentiment is weak at a time when consumer spending is strong. The yield curve has been sending signals that are hard to interpret. The noise on inflation is elevated, yet market indicators of inflation compensation appear largely unaffected.

With that note of caution, what do I see for 2022?

Let me start by reminding you that after the last pandemic, we had the Roaring '20s. Who's to say it couldn't happen again?

Household balance sheets are flush. Household net worth was $32 trillion higher in the third quarter of 2021 than in the same period in 2019 (up 28 percent). This was driven, of course, by investment and real estate appreciation. Pandemic lifestyle changes combined with government transfers created excess savings and made households more liquid as well. In September, low-income families had 70 percent more cash on hand than pre-pandemic (albeit only $1,000), and high-income families had about 40 percent more, according to JPMorgan Chase. Recent data shows those savings are starting to be spent down.

In addition, businesses are reporting record profits and strong balance sheets. Inventories are low and will need to be replenished. States are seeing sizable surpluses. All these will sustain demand for quite some time.

Manufacturer supply chains will eventually catch up.

I'm hoping to see some progress in the first quarter. Seasonal demand reductions should give manufacturers breathing room, and some sectors will be digesting the impact of stockpiling last fall. But Omicron is of course a wild card here.

And it will take a year or longer to get fully to the other side. Constrained labor will continue to hinder supply. Capacity building takes business confidence and time. The median respondent in The CFO Survey forecasts that supply constraints should last another 10-12 months.

Labor will remain short.

The trends have been clear for a while: Fertility is down, immigration has slowed and our workforce is aging. In the last upturn, participation didn't drop as much as predicted. But the pandemic has introduced even more forces, such as unstable child and elder care and an expansion of the social safety net.

What we may find is that the aberration isn't what we see today but what we saw in the last upturn. Labor will likely struggle to meet coming demand. Companies are trading one another's workers, and this auction will continue until employers reduce their need for workers through automation or other productivity investments. Those will take time.

Price will have its say.

For the most part, we are not seeing price levels affect quantity demanded the way you might imagine. Retailers have prioritized availability over price. Employers are paying higher wages without reducing jobs. Consumers, fueled by strong savings and higher wages, haven't yet chosen to begin trading down. Labor force participation isn't moving.

But price levels will eventually have an impact. Walmart merchandisers won't abandon everyday low prices. Consumer savings will erode, driving them to price shop. Employers will pursue lower labor strategies. Higher wages will eventually bring people off the sidelines.

That then brings us to the most difficult forecasting question: the path for inflation.

Once current inflation pressures ease, will we return to the 1.9 percent core PCE inflation of the last 30 years? The 3.0 percent of the past two years? Or the 5.3 percent annualized inflation of the last nine months? Are memories short or long?

Given my view on 2022, the data I'm tracking most closely are the prices for goods versus services. For perspective, taking 24-month differences to avoid pandemic base effects, annualized CPI services inflation has been 2.8 percent, roughly in line with the prior five years. In contrast, annualized goods inflation has been 6.3 percent, significantly higher than the prior five-year drop of -0.2 percent per year.

As supply chain pressures wane, I expect goods inflation to reduce. But will the factors that have kept goods prices in line historically (like e-commerce, retailer purchasing power, and globalization) continue to have the same effect or not? Will supply chain redesign push costs and prices up instead?

And as labor shortages continue, I expect them to pressure the price of services, where wages are a more meaningful share of costs. But how much can and will be passed on to customers?

How these two sectors net out will matter as the Fed continues to work to meet its stable price mandate.

Which brings us to policy. With the labor market tight and inflation elevated, we have started the process of normalization. We started tapering asset purchases in November and then accelerated that process at our last meeting in December. At current pace, we will be done in mid-March. At that time, we will be free to begin normalizing rates, should circumstances support that. The timing and pace of any rate moves will depend on the answer to my inflation question. The closer that inflation comes back to target levels, the easier it will be to normalize rates at a measured pace. But were inflation to remain elevated and broad-based, we would need to take on normalization more aggressively, as we have successfully done in the past.

With that said, I warned you forecasting is hard. So, I am interested in what you are seeing in the market and am open to your input and questions.

[1] This is the change in seasonally adjusted total nonfarm employment from February 2020 to December 2021. Bureau of Labor Statistics via Haver Analytics.