Current Economic Conditions

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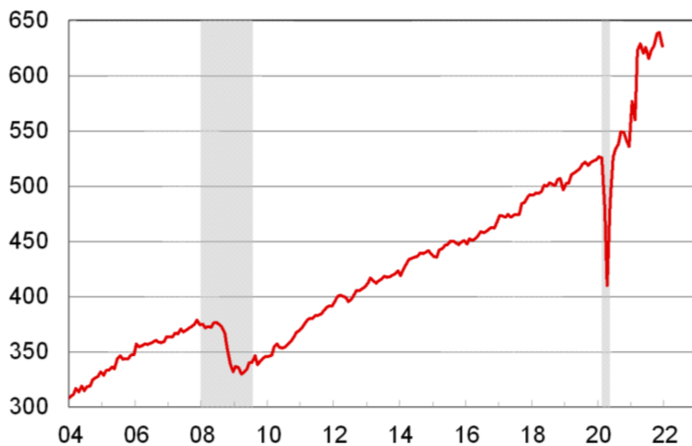
STUMBLING INTO 2022

The U.S. economy finished 2021 on a weak note, as payroll employment rose less than expected, retail sales fell sharply, motor vehicle sales slipped, and industrial production declined in December. Only housing starts rose. Payroll employment rose by just 199,000 in December, the smallest increase in a year and much less than expected. Light vehicles sold at a 12.4 million seasonally adjusted annual rate. Except for September, it was the worst month since May 2020. Industrial production in U.S. manufacturing fell 0.3%. But the biggest data disappointment of the month was a 1.9% decline in retail sales.



The disappointing data aren't reason to panic. While payroll employment, from a survey of employers, rose by just 199,000, civilian employment, from a survey of households, rose by 651,000, after a 1.09 million increase in November, and the unemployment rate, calculated from the household survey, fell to 3.9%, a post-recession low. That might indicate that there are fewer people working two jobs, since shifting from two part-time jobs to one full-time job – usually a good thing – reduces the number of jobs but not the number of employed persons. And despite the big December decline, retail sales were up 16.9% from a year earlier. Apparently, shoppers shifted purchases from December to October, when retail sales were up 1.8%, because of fears that the items they wanted would be out of stock by December. The pandemic has also played havoc with the seasonal adjustment factors that government statistical agencies use to remove the impact of normal seasonal fluctuations from most economic data. That renders month-to-month changes less reliable but doesn't affect year-over-year changes.

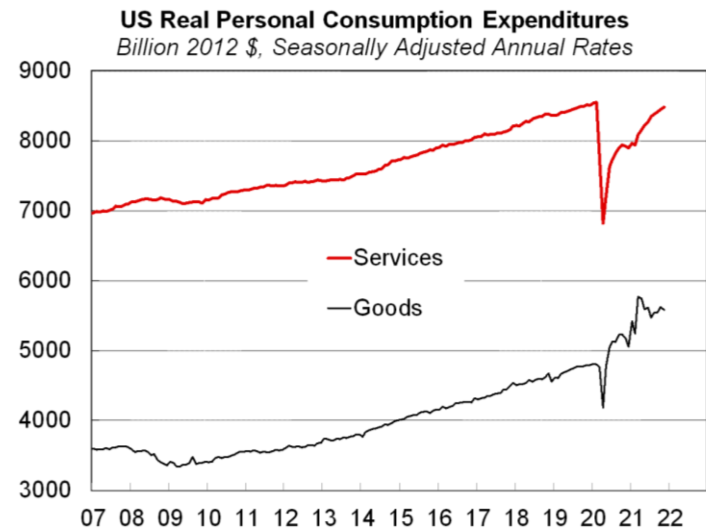
Despite these caveats, the weak December data do signal a slowdown in economic growth that will lower quarterly growth in Gross Domestic Product in both the fourth quarter of 2021 and the first quarter of 2022. A big increase in new claims for unemployment insurance benefits in the week ending January 8 indicates that the slowdown has continued into the new year. The slowdown in December and January is undoubtedly the result of the spike in COVID-19 cases due to the Omicron variant. This is hurting air travel, restaurants, movie theaters, etc., precisely the businesses that have been hurt the most throughout the pandemic. Fortunately, the impact is likely to be temporary. The number of new COVID cases in the United States peaked last week. As cases decline and people realize that the Omicron variant is much less dangerous than the Delta variant, economic activity will snap back. Consequently, I've lowered my forecast for economic growth in the first quarter but raised my forecast for the second quarter.

Even though growth was weak in December, inflation did not slow. While the headline (total) Consumer Price Index rose "only" 0.5%, a little less than expected, the "core" CPI, which excludes food and energy prices and is thought to be a better measure of the underlying inflation rate, rose a slightly-

more-than-expected 0.6%. It was the third month in a row with an increase in the 0.5-0.6% range. The headline Producer Price Index rose less than expected, but my favorite price index, the Producer Price Index for finished goods ex food and energy, rose 0.6%, the same as in November. Over the last nine months of 2021, this price index rose at a 7.4% annual rate, with every monthly increase in the 0.4-0.7% range. Persistent high inflation has caused the Federal Reserve to signal a major change in policy, speeding up the reduction in its bond purchases (the "taper"), moving up the start date for rate hikes, probably to March, and talking about reducing its holdings of Treasury bonds and mortgage-backed securities (the "balance sheet") as early as the second half of 2022. I'm currently forecasting four quarter-point rate hikes in 2022, four more in 2023, and three in 2024.

I expect growth to slow in the second half of this year but to remain above trend. I expect inflation to decline in the second half of this year but to remain well above the Fed's 2% target. However, these expected decelerations will not be the result of the change in Fed policy. Because monetary policy works with a long lag, tightening monetary policy this year will do little to slow growth (and nothing to slow inflation) in 2022, but will slow growth in 2023 and could ultimately bring about the end of the economic expansion, if that is required to get inflation back down to the Fed's 2% target. The lag also helps explain the Fed's tendency to start rate hikes too late and to continue them too long, i.e., until something breaks.

With its change in policy, the Fed seems to have joined me in the high-growth/high-inflation camp. While the soggy start to 2022 might cause some to question that view, I still think growth will be strong after the Omicron wave subsides. Spending on services, which accounts for about 45% of GDP, is likely to recover as people resume travel and head back to restaurants and entertainment venues. Motor vehicle production and sales are also likely to recover as the semiconductor shortage eases. Residential construction could accelerate if the diminution in COVID risks leads to an increase in immigration. (Given the make-up of the construction labor force before the pandemic, it is hard to believe that contractors will be able to hire enough workers to significantly expand construction without an increase in immigration.) With motor vehicle production rebounding and home construction remaining stable at worst, with household balance sheets in great shape because of the unusually high saving rate from April 2020 through August 2021, and with depleted inventories being replenished, demand for goods is likely to keep rising, even as demand for services recovers. The combination will keep growth strong and inflation high.



What are the risks to my high-growth forecast for 2022? Tighter monetary policy might pose a risk to financial markets but doesn't work quickly enough to pose a significant risk to growth this year. As I noted last month, I don't believe there will be a fiscal cliff, despite the failure to pass President Biden's Build Back Better bill. (Former Obama economist Jason Furman agreed in a recent op-ed.) High oil prices could hurt growth. A bigger risk to growth would be a COVID variant that's as contagious as Omicron but more lethal. (Because Omicron is so much less deadly than Delta, I consider it a positive development, regardless of the case count.) To the extent Omicron poses a lasting risk to growth, it could be through its impact on China. China's approach to COVID has been to shut down cities when COVID is detected; they have shut down some of the largest ports in the world for two COVID cases! Further shutdowns would worsen the global supply-chain problem and cause both slower growth and higher inflation throughout the world. On the inflation side, the biggest risk is that Congress will pass yet another relief bill in response to Omicron. The American Rescue Plan and the Fed's failure to tighten policy in response to it account for much of the rise in inflation over the last nine months of 2021. Congress should not repeat that mistake.

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