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Time to Heal

INTRODUCTION

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Time to Heal

BY MARK ZANDI

It is time to take stock of how the U.S. economy performed in 2021 and consider its prospects in 2022. With the Omicron wave upon us, it would be Pollyannaish to get overly enthused about the economy's prospects in the new year. Omicron is substantially more contagious than previous variants of the virus that causes COVID-19, and even if it is much less virulent, it is already doing significant economic damage. But if the economy's performance last year is a guide, we should not be too pessimistic either. Despite being hit hard by the Delta wave of the virus, the economy grew like gangbusters in 2021. It will not grow as strongly in 2022, but inflation, which took off in recent months, will come back to earth. Having said this, how good a year the economy will have depends on the pandemic's path and how well policymakers respond.

2021 in review

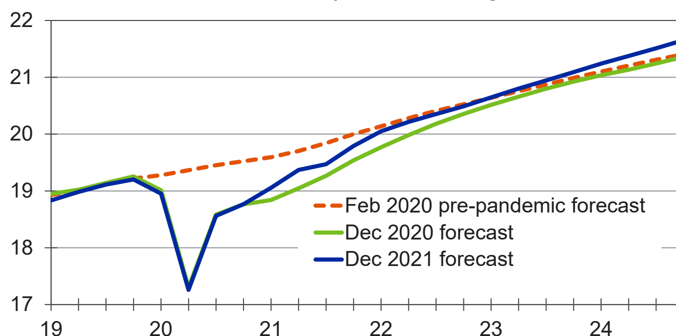
For the most part, the economy had a good 2021 and a better year than we had anticipated at the start. Real GDP is on track to post over 7% annualized growth in the fourth quarter, and for the year it should advance 5.5%. In our December 2020 baseline forecast, we expected real GDP to grow by just over 4% in 2021 (see Chart 1).

Further testament to the economy's strong performance was the average 550,000 jobs per month created last year, which pushed the unemployment rate to near 4%, within hailing distance of where it was prior to the pandemic. A year ago, we expected monthly job gains to be less than 300,000 per month and unemployment to end the year at 6.5%. The stock market posted record highs throughout 2021, and house prices have sizzled. Retail sales this holiday season were among the best ever even after accounting for higher inflation.

This economy's surprising recovery can be traced in significant part to the federal government support provided by the American Rescue Plan. This massive nearly $2 trillion relief package, signed into law last spring, provided funds that are still being used to battle the pandemic, shore up school systems and state and local governments, and help financially hard-pressed lower- and middle-income households. In December 2020, we knew that Joe Biden would soon be inaugurated as president, but we expected Republicans to hold on to the Senate and stymie any additional deficit-financed help for the economy like that provided in the ARP.

Growth would have been even stronger in 2021 if not for the Delta wave of the pandemic, which hit during the summer. Delta was especially unnerving, as it crashed upon us not long after the vaccines rolled out. At the time, there was widespread optimism the vaccines would put a quick end to the pandemic. President Biden had predicted a "summer of freedom" from COVID-19. Our freedom was short-lived. Too many of us refused to get vaccinated and take other precautions, and the virus evolved. Delta has given way to the Omicron variant, which requires that we get booster shots to avoid the worst of the virus. But too few of us have done so. Perceptions are highly dependent on expectations, and if reality falls short of expectations, people are dismayed. Delta and now Omicron make clear that the pandemic is not over, and optimism about an end to the pandemic was misplaced.

Delta is also largely behind the biggest disappointment in the economy's 2021 performance—much higher inflation. At the end of 2020, we forecast consumer price inflation of 2.5% in 2021. This would have been a substantial acceleration in inflation but consistent with the Federal Reserve's inflation tar-



get. Instead, CPI inflation is set to come in at a much hotter 4.5%. The scrambling of global supply chains in the wake of Delta goes a long way to explain the higher-than-expected inflation. Delta was especially hard on Asia, where many supply chains begin, including for the vehicle industry, which depends on semiconductors produced there. Without chips, auto production and inventories collapsed, and vehicle prices soared. A similar dynamic has played out for a wide range of goods.

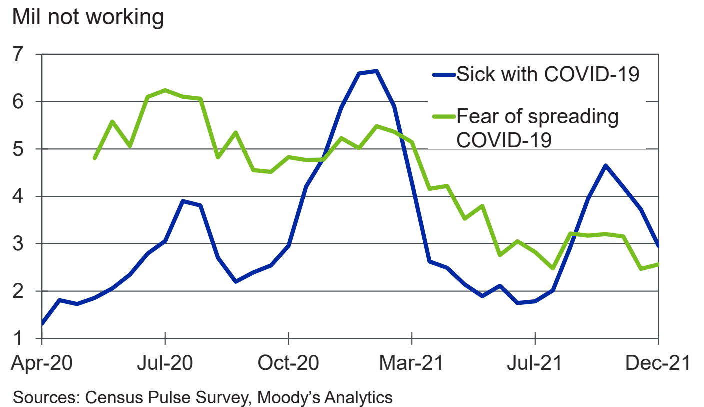
Higher-than-expected inflation was also driven by much higher oil and natural gas prices. Before last year began, we expected West Texas Intermediate oil to average about $45 per barrel in 2021; instead it came in just under $70. While oil demand picked up on cue with the better global economy, returning to near pre-pandemic demand, global oil producers, including OPEC and North American frackers, were slower to increase output than anticipated to meet the increased demand.

2022 by the numbers

This year may well be an even better year for the economy. Growth will slow; we expect real GDP to increase 4% and monthly job gains to average 330,000 in 2022. But the economy should return to full employment and inflation to near the Federal Reserve's target by year's end.

At the risk of sounding overly precise, we think full employment is consistent with an unemployment rate of 3.5%, a decline of more than 0.5 percentage point from its current rate, and a labor force participation rate of 62.5%—an increase of more than 0.5 percentage point from its latest readings. Unemployment has been falling quickly, and another half-point decline seems well within reach. However, participation has long been stuck well below where it was pre-pandemic.

Chart 2: Lots of Sick People Not Working



Sources: Census Pulse Survey, Moody's Analytics

The biggest constraint on participation is simply that there are lots of sick people. According to the Census Bureau's Pulse Survey conducted in the first half of December, about 5.5 million people said they were not working because they were sick with the virus, taking care of someone who was, or fearful they would spread it. The survey was taken before Omicron, and the number of sick people not working is sure to rise substantially in early 2022. However, we do not expect it to rise to the previous peak of more than 12 million at the top of the pandemic wave that hit this time last year, or perhaps even the 8 million in the middle of the fall Delta wave. And if the pandemic and illness recede as expected, those not working because they are sick should decline substantially by year's end, lifting participation (see Chart 2).

Participation should also receive a boost as many more parents with young children and lower-wage workers get back to work. The problem for parents has been finding affordable day care, since many facilities shuttered early in the pandemic and remain closed. This should change as the pandemic recedes. Lower-wage workers who have taken their time returning to work given the substantial government support they received during the pandemic are running out of

Table 1: Excess Personal Saving by Income Group

$ mil

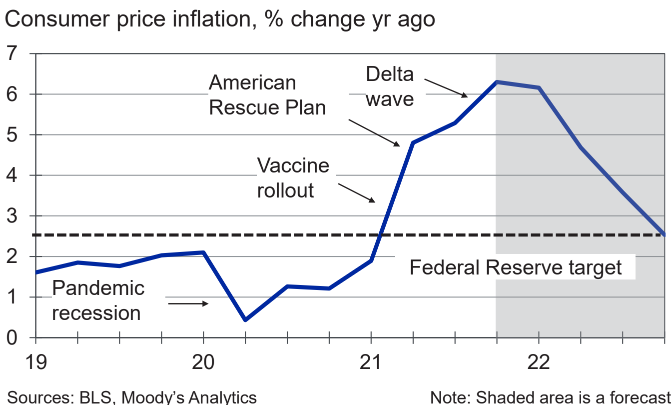
	Income group						
	0%-20%	20%-40%	40%-60%	60%-80%	80%-90%	90%-100%	Total
2020Q1	2,544	4,623	8,283	1,786	11,364	72,139	100,739
2020Q2	26,962	53,780	74,085	60,776	91,593	583,694	890,890
2020Q3	17,036	31,741	44,129	26,944	41,637	241,741	403,228
2020Q4	18,819	30,432	41,905	38,748	37,077	117,280	284,261
2021Q1	35,998	60,695	79,493	75,498	82,343	358,786	692,812
2021Q2	17,178	24,440	31,191	17,716	24,378	76,088	190,990
2021Q3	13,675	18,282	22,731	6,174	13,088	58,718	132,667
Cumulative total	132,211	223,992	301,817	227,641	301,480	1,508,446	2,695,587
Share of cumulative total, %, 2021Q3	4.9	8.3	11.2	8.4	11.2	56.0	100.0
Households, ths, 2021Q3	25,601	25,601	25,601	25,601	12,800	12,800	128,003
Cumulative excess saving per household, 2021Q3	5,164	8,749	11,789	8,892	23,553	117,845	21,059

Note: Excess saving is the difference between actual saving and saving that would have occurred if there had not been a pandemic.

Sources: Federal Reserve Board, BEA, Census Bureau, Moody's Analytics

Chart 3: Inflation Has Peaked

Consumer price inflation, % change yr ago

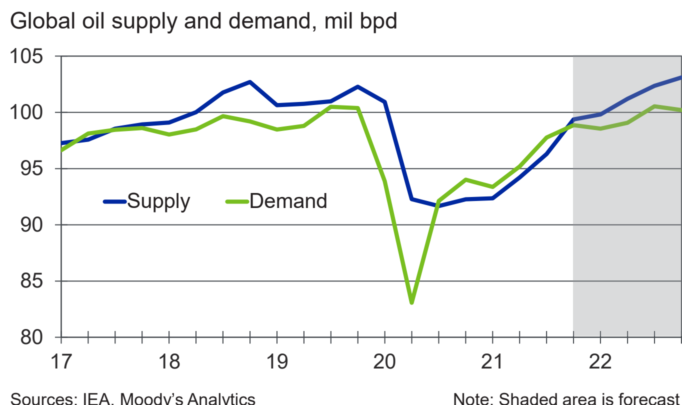


Sources: BLS, Moody's Analytics

Note: Shaded area is a forecast

Chart 4: Oil Supply Catches Oil Demand

Global oil supply and demand, mil bpd



Sources: IEA, Moody's Analytics

Note: Shaded area is forecast

time as they spend down those funds. As of September, those in the bottom 40% of the income distribution had an estimated close to $350 billion in excess personal saving. But with no additional financial support coming, even assuming those not working have pulled back on their spending to stretch their dollars, those excess savings will be gone in the next few months. The financial pressure to return to work will be strong (see Table 1).

Despite the expected increase, labor force participation will still fall well short of where it was pre-pandemic. That is due to another issue: baby boomer retirement. Many boomers pushed forward their retirements because of the pandemic and the surge in stock, housing and other asset values that swelled their nest eggs. There is no hard-and-fast rule as to when the economy is at full employment, but by late 2022 we expect little debate that the economy will have arrived there.

Inflation should also moderate significantly in the coming year. Consumer price inflation surged this past fall to a nearly 40-year high of almost 7% on a year-over-year basis. But that was likely the peak. CPI inflation is expected to slow to less than 3% by the end of 2022—not too far from the Fed's inflation target (see Chart 3).

Oil and natural gas prices are already well off their recent highs and will decline more in coming months as supplies increase. There is plenty of excess capacity globally to produce more oil and gas, and producers will not be able to resist doing so for long given the profits they are able to make. We estimate the long-run equilibrium price for oil—the cost of producing and transporting the last barrel of oil to the global market to satisfy demand—at close to $60 per barrel. Oil should be flirting with its long-run price by late in the year (see Chart 4).

New- and used-vehicle prices will also fall back to earth this year as the global chip shortage abates and manufacturers ramp up vehicle production and rebuild depleted inventories. The Moody's Analytics Used Vehicle Price Index has nearly doubled during the pandemic, with some used-car owners able to sell their cars at prices higher than they paid not long ago. This topsy-turvy situation is not sustainable. Goods prices more broadly may even be falling by the end of 2022 as supply chains right themselves and capacity in many industries expands in response to current high prices and the big profits to be had.

Inflation would moderate even more if not for accelerating rent growth, powered by a severe shortage of housing—vacancy rates for homes for sale and rent are their lowest since the early 1980s and still falling. Home construction is increasing, but supply-chain problems are limiting supplies of lumber and other building materials and crimping even bigger increases in new-home construction. Even after these constraints abate and homebuilding picks up more substantially, the shortage of homes is so acute it will not be resolved soon.

Tethered to the pandemic

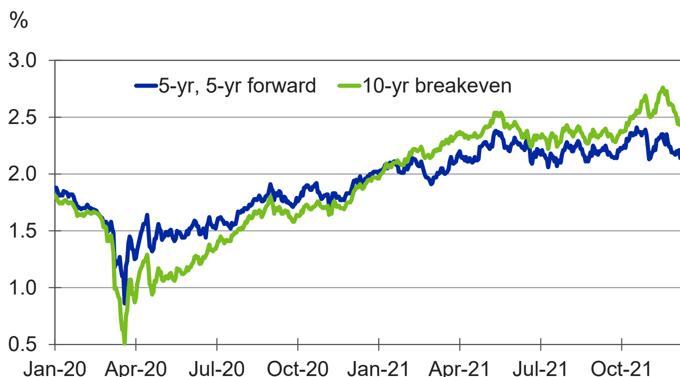
The path of the pandemic remains central to the economy's prospects in the coming year. The Omicron wave of the pandemic is already doing economic damage: Credit card spending has turned soft in recent weeks, particularly for travel; restaurant bookings are off; the National Hockey League has suspended play; much of Broadway has gone dark again; and the airlines are struggling with flight cancellations as pilots and other personnel get sick.

Growth in early 2022 will be adversely impacted, and we have revised down our forecast for real GDP growth in the first quarter from about 5% annualized to closer to 2%. This is roughly consistent with the Delta wave's hit to GDP growth in the third quarter of last year. Also, like Delta, Omicron will not have much of an impact on hiring, since businesses will largely look past the wave, knowing it will be temporary, and focus on their persistent problem of labor shortages. Indeed, we are revising up our GDP growth outlook for the second quarter, since activity will pick up quickly once the wave passes, and we assume that will happen faster than with Delta. Omicron will thus not have a material impact on calendar 2022 growth.

Unlike Delta, which significantly fanned inflation, Omicron's impact on inflation should be modest. Businesses have made meaningful progress easing the bottlenecks in their global supply chains that became evident during Delta. The impact on labor force participation will also be less pronounced—more workers will get sick with Omicron than Delta, but they should get back on the job more quickly. That is because they will be less sick, and the Centers for Disease Control and Prevention recently cut the recommended isolation period after getting sick to five days from 10.

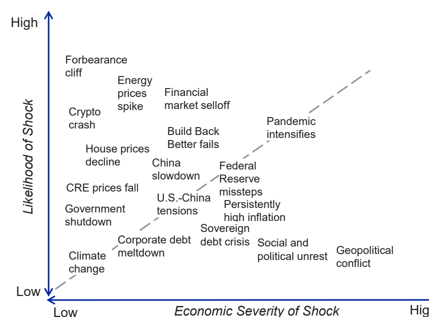
After the Omicron wave passes, there almost surely will be more. But we expect each new wave to be less disruptive to the health-

Chart 5: Inflation Expectations Hold Firm



Sources: BEA, Moody's Analytics

Chart 6: What Could Derail the Recovery?



Source: Moody's Analytics

care system and economy than the wave before it. This would be consistent with the path of the pandemic so far. An increasingly vaccinated population, booster shots, and new antiviral medications and therapies should help ensure that while many more people will get sick, there will be fewer hospitalizations and deaths. Businesses are also increasingly adept at managing through the waves. They will be less likely to significantly disrupt their operations when the next wave hits.

DC Sturm und Drang

Whether lawmakers in Washington DC are able to get it together and pass some version of President Biden's $1.75 trillion Build Back Better legislation also matters to the economic outlook. The legislation, which includes spending increases and tax credits for social programs from healthcare and housing to child and elder care to climate change and would be paid for by tax increases on large corporations and the wealthy, is currently hung up in the political process.

Given that passage of BBB requires that all 50 Senate Democrats sign on, getting the legislation across the finish line was never going to be easy. But the politics of passing the legislation recently became more problematic when Joe Manchin, the Democratic senator from West Virginia, said he could not support the bill's current version.

It would not be a game changer for the economy if BBB failed to become law, but it will diminish the economy's growth prospects and ding the fortunes of lower- and middle-income households. Our outlook for real GDP growth in 2022 would be reduced by 0.75 percentage point, since BBB is front-loaded—with budget deficits in the near term and surpluses in the longer run that roughly net out over the 10-year budget horizon. Longer run, the economy's potential growth will be reduced by several basis points per annum as BBB lifts labor force participation by lowering the cost of work, particularly for lower-income minority women.

However, Manchin has reportedly proposed a package costing a similar amount but with policies that do not sunset within the budget horizon. The senator argues that future lawmakers will not have the political fortitude to allow policies to actually expire, or to pay for them if they do not, and thus their cost will be substantially more than budgeted. To accommodate the senator's concern and pass BBB, we assume the Biden administration and congressional Democrats will scale back the policies included in BBB and eliminate sunsets. With these changes, BBB will add approximately 0.5 percentage point to real GDP growth in 2022.

Flexible Federal Reserve

Also key to the economic outlook is the Fed's ability to adjust monetary policy adeptly in response to quickly shifting conditions. If things hold together as we expect, the Fed will wind down its quantitative easing by this spring and lift the federal funds rate off the zero lower bound by summer. We expect two quarter-percentage-point increases in the funds rate by the end of 2022, and then quarter-point increases each quarter, more or less, until reaching the long-run equilibrium funds rate (consistent with an economy at full employment and growing at its potential with inflation at the Fed's target) of 2.5% by mid-decade.

This significantly overstates how graceful the normalization in monetary policy will be. Uncertainty over the pandemic and fiscal policy and the implications for growth and inflation will complicate things enormously. And these are the known unknowns. The Fed will almost surely need to grapple with a few unknown unknowns in the coming year. We assume policymakers are nimble and will pull this off.

So far so good, as demonstrated by the Fed's recent decision to accelerate the normalization process in response to the surge in inflation. Just a few months ago, Fed officials were signaling that QE would not end until summer 2022 and that the first rate hike would not occur until the economy was clearly at full employment. QE is now set to end in March, and officials suggest the first rate hike could come soon thereafter. By adopting this more aggressive policy stance, the Fed has been able to keep investors' inflation expectations in check, safeguarding that the surge in inflation will prove temporary (see Chart 5).

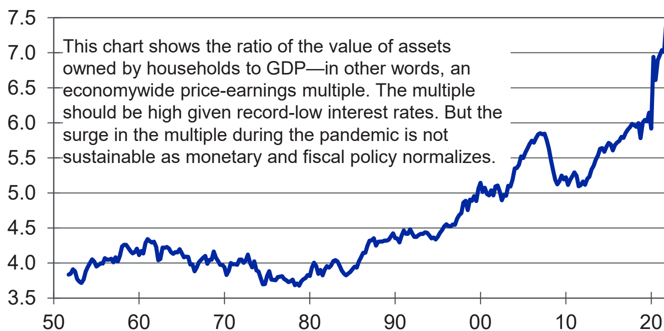
Fed officials' adroitness in setting policy will almost surely be tested again soon, depending on the economic fallout from the Omicron wave and what happens with BBB.

Downside threats

Our sanguine economic outlook for 2022 is subject to both upside and downside risks, and it remains prudent to focus on what could go wrong. That is the purpose of our risk matrix, which summarizes the downside risks in terms of the probability that they will manifest (vertical axis) and the present value of the economic loss if they do (horizontal axis) (see Chart 6).

Chart 7: Asset Prices Are Overdone

Economywide price-to-earnings multiple



Sources: BEA, Federal Reserve, Moody's Analytics

While there are many risks to consider in addition to what has already been highlighted, a high and mounting threat is overvalued asset prices. Stock, bond, real estate, commodity and crypto markets are frothy, bordering on speculative. In other words, investors are buying assets with the sole intention of selling them for a quick buck. To be sure, asset prices and valuations should be high given the near record-low interest rates and quickly recovering economy. But markets appear to have gotten ahead of themselves and are thus vulnerable to significant corrections as global central banks pull back on their monetary policy support and long-term rates rise in coming months. Though any selloff in asset markets is unlikely to be serious enough to undermine the recovery, consistent with our baseline outlook, this will become increasingly difficult to say if asset prices continue to rapidly appreciate (see Chart 7).

China's economic problems and ongoing tensions with the U.S. also pose meaningful risks to the outlook. China has been an economic juggernaut and principal driver of global economic growth for much of the past quarter-century. Although simple arithmetic meant it could not maintain the double-digit GDP growth rates that characterized much of this period, there is a reasonable concern that the country will not be able to sustain its current approximately 5% growth that we assume in our baseline. China's declining working-age population, high debt loads, serious environmental challenges, stodgy state-owned enterprises, and shift toward a more authoritarian political system do not augur well.

Moreover, China's economic relationship with the U.S. and much of the rest of the developed world, which has been instrumental to its outsize growth via trade and investment, is in jeopardy of unraveling. The Biden administration continues to confront China on a range of policies, including trade practices, intellectual property rights, cybersecurity, access to Chinese markets, and Hong Kong and Taiwan. Given how important the U.S.-Chinese relationship is to global growth, the economic recovery would quickly weaken if that relationship came undone more significantly.

A more remote, but potentially extraordinarily damaging, threat to the economic recovery is social and political unrest. The pandemic has put a heavy pall over the collective psyche, helping to foment discontent, record crime in many urban areas, and broader social unrest. It likely has also exacerbated the deep political divisions in the country, as everything from vaccinations and masking to social distancing and work rules have been politicized. The riots that wracked many cities in summer 2020 and the January 6, 2021 uprising at the Capitol are testament to the potential for more social unrest and political discord. The 2022 midterm congressional elections could be a flashpoint.

Similarly, long-brewing tensions overseas could boil over into highly disruptive conflicts. Top of mind are a possible Russian invasion of Ukraine or a Chinese takeover over Taiwan, North Korea's and Iran's nuclear programs, and never-ending drama in the Middle East. The odds that any of these geopolitical kerfuffles devolve into outright crises are low, but then again…

Happy ending

Despite it all, our economy's ability to overcome the pandemic has been admirable. If everything sticks roughly to our baseline script, it will have taken less than three years for the economy to fully recover from that first blow of the pandemic. It took a decade for the economy to recover from the global financial crisis. This is testament to the dedication of our healthcare providers and other frontline workers; the ingenuity of our pharmaceutical industry and medical technology; the massive collective response of federal, state and local governments; and the resilience of the American economy and people.

About the Author

Mark Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005.

Dr. Zandi's broad research interests encompass macroeconomics, financial markets and public policy. His recent research has focused on mortgage finance reform and the determinants of mortgage foreclosure and personal bankruptcy. He has analyzed the economic impact of various tax and government spending policies and assessed the appropriate monetary policy response to bubbles in asset markets.

A trusted adviser to policymakers and an influential source of economic analysis for businesses, journalists and the public, Dr. Zandi frequently testifies before Congress on topics including the economic outlook, the nation's daunting fiscal challenges, the merits of fiscal stimulus, financial regulatory reform, and foreclosure mitigation.

Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, Meet the Press, CNN, and various other national networks and news programs.

Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360º Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by The New York Times as the "clearest guide" to the financial crisis.

Dr. Zandi earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

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