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Omicron and the Economy:
Two Scenarios

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Omicron's spread has underscored one truism: The health of the economy is ultimately dependent upon the health of the population. The more people who are ill due to COVID, the harder it is to keep the economy operating. Fear of contagion and an aversion to in-person events is no longer the primary driver of economic losses. We now face acute worker shortages that will prompt some venues to close for a period of time.

The spread has been so fast and is affecting so many people that the number of those out sick will be a hurdle to growth in the first quarter. The slowdown could be much more pronounced and broad-based than we saw during the Delta wave over the summer.

It is hard to imagine a sector that will be unaffected by staffing shortages. Thousands of flights have already been canceled. Restaurants are closing. Fire departments don't have enough workers to respond to emergencies in hot spots. State and local government offices are closing. Many school districts have delayed reopening to ensure students get negative tests. They will face challenges staying open given staffing shortages and outbreaks.

The whole health care system is being overwhelmed. Risk of hospitalization is smaller with Omicron but the number of people infected, including children, is pushing up the number of those seeking emergency care. This is at the same time that burnout and resignations have already left many hospitals short of staff.

The CDC's pivot to shorten quarantines from ten to five days was a red flag. The sheer number of people likely to be out sick threatened to hobble the economy.

Boom/Bust

Real GDP is expected to end 2021 on a high note with growth of 6.7% in the fourth quarter; growth for all of 2021 is estimated to average 5.7%. That marks the fastest pace of growth since 1984.

The economy was firing on all cylinders before the onset of Omicron. Consumer spending picked up as travel and tourism returned and the Delta wave abated. Home buyers scrambled to lock in low rates and investors snapped up properties to rent. Supply chain bottlenecks eased, business investment accelerated and inventories finally started to rebuild.

The only negatives were government spending and trade. State and local government spending essentially flatlined, while federal spending plummeted with the end of supplements to unemployment insurance. The trade deficit widened, as imports picked up more rapidly than exports. Much of what we imported ended up in inventories.

Prospects for the first quarter are significantly weaker. Our baseline is for 1.5% growth, which is a bit slower than we saw during the Delta wave in the fourth quarter. Omicron has collided with the Delta wave to cause disruptions to demand and supply.

Consumer spending is the most vulnerable, but disruptions could extend well beyond the service sector. Businesses are expected to hesitate on executing investment plans until the dust settles. Inventories are expected to be drained and the trade deficit is expected to widen. Exports fall more rapidly than imports as lockdowns abroad are already in place. Government spending should rebound but school closures will stunt those gains.

Supply chains are at risk given the global spread of the virus. China’s zero tolerance for outbreaks is already disrupting trade. The push to idle factories to clean the air ahead of the Winter Olympics in Beijing will exacerbate those problems. This is at the same time that tensions between China and Taiwan, which has a chokehold on computer chips, are escalating.

The only silver lining is the speed with which Omicron receded in South Africa. That drop was enhanced by mitigation efforts and summer weather; we lack both. We are also struggling with a collision of Delta, Omicron and a surge in other respiratory illnesses, including the flu.

This edition of ***Economic Currents*** takes a closer look at the first quarter and how Omicron could play out. There are two scenarios. Scenario 1 shows our base case, which includes a temporary slowdown in consumer spending. Scenario 2 shows a more dramatic pullback, as closures due to staffing shortages and contagion migrate from the service sector to the broader economy. (See Chart 1.)

Neither scenario includes additional stimulus but stranger things have happened in election years. The absence of fiscal support delineates Omicron from previous waves.

Scenario 1

The Omicron surge is expected to be short-lived and abate quickly; it receded as rapidly as it spread in South Africa. Fear of contagion, coupled with a loss in hours worked, will slow but not derail consumer spending. Production is temporarily disrupted. Supply chain problems will resurface but demand will be weaker than it was through the Delta wave last summer.

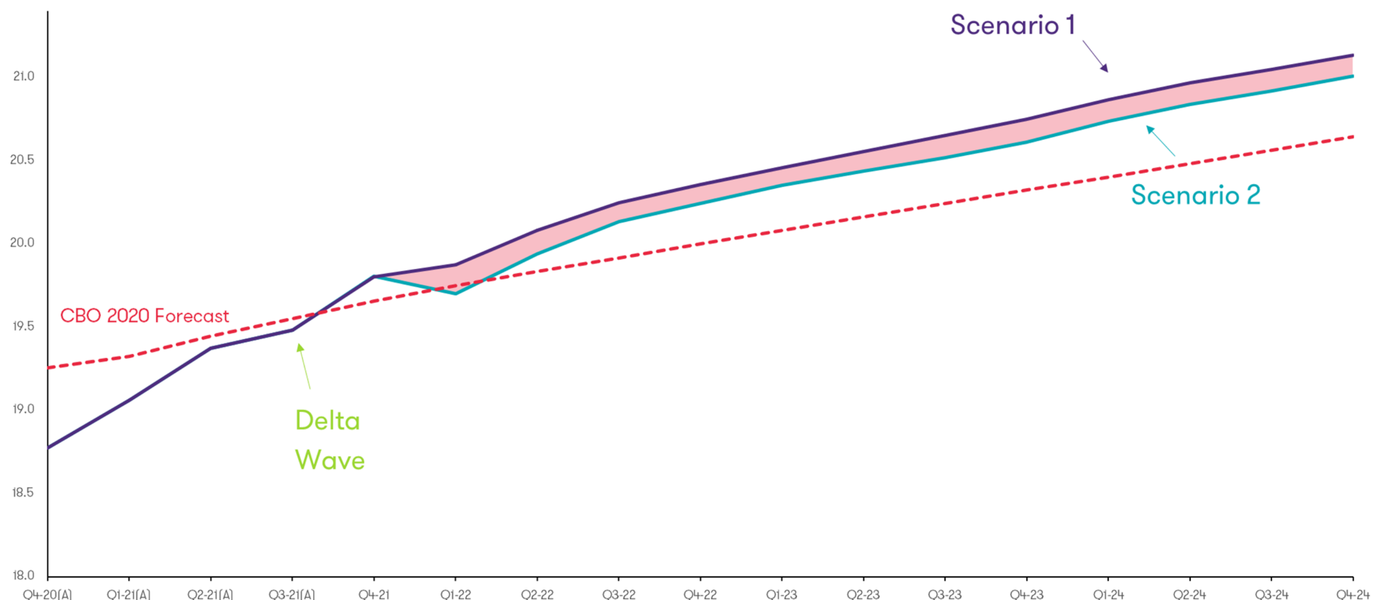
Real GDP slows to a 1.5% pace in the first quarter, the weakest since the start of the recovery in May 2020:

- Employment hits a speed bump in January as firms are forced to idle and schools move back online. Leisure and hospitality are hardest hit.
- Large online retailers are likely to retain seasonal workers to cover for those out ill; they also may leverage layoffs elsewhere to fill openings.
- Small and midsize firms lose as idled workers seek employment elsewhere.
- Participation in the labor market falls in response to fear of contagion, school closures and the need to care for ill family members. Women tend to bear the brunt of child and elder care.

Chart 1

Hard Start to 2022: Two Scenarios for the Economy

GDP, 2012 $, Trillions



Source: Bureau of Economic Analysis, Grant Thornton LLP

- The upward pressure on wages is not likely to abate, given the yawning gap between job openings and those actually looking for work. Large online retailers are creating a floor for wages, while quit rates hit a record in November.
- Inventories will be drained but not to the lows we saw in 2021.

Real GDP is expected to rebound at a 4.2% pace in the second quarter. Growth for 2022 is expected to average 3.7%, a half percentage point weaker than we were expecting a month ago, but well above the tepid 2.3% annual rate in the decade leading up to the pandemic.

Risks: The Congressional Budget Office's scoring of the most recent iteration of the administration's plan gets the economy back to the growth path we were on pre-Omicron in 2022. Emergency aid via stimulus checks would more rapidly blunt the blow of Omicron. Spending on goods would pick up more than spending on services. The hardest part to tackle is lifelines for small businesses.

New Peak for Inflation

The core personal consumption expenditures (PCE) index, which takes out the volatile food and energy components, is expected to rise 4.6% from a year ago in the first quarter. That is cooler than we expected a month ago, but still the highest quarterly rate since 1989:

- Moderating demand will reverse the upward pressure on airfares, hotel rooms and car rentals.
- Trucking costs should fall with lower prices at the gas pump but driver shortages are likely to remain acute.
- Shelter costs are expected to continue to accelerate. Investors buying properties sight unseen are pushing up prices and crowding out first-time buyers.

A surge in inflation in the spring of 2021 set the stage for a moderation in year-over-year measures for the rest of the year. That does not mean the level of prices will fall; rather, the pace at which prices rise will slow.

In response, the core PCE index is forecast to drop to a 2.5% pace in the fourth quarter. This is still well above the Federal Reserve's 2% target. The Fed's goal is to get inflation low enough that it doesn't distort spending decisions.

The Fed watches core inflation because overall measures of inflation tend to converge toward the core over time. The Fed has less control over food and energy prices (which can swing with changes in the weather) than it has on other kinds of inflation.

Risks: Additional fiscal stimulus would likely keep prices elevated for longer. Stimulus checks are more immediate but not well targeted and tend to fuel price hikes; they are quickly spent and could exacerbate shortages in the goods sector.

Fed Executes on Rate Hikes

The Federal Reserve has concluded that variants are more inflationary than disinflationary. The disruptions to supply have been greater than the disruptions to demand, thus far. That may not be the case now that the fiscal stimulus has lapsed. The slowdown in inflation that we have forecast is still too little too late to hold off rate hikes by the Fed.

That said, the Fed is expected to wait for the pace of infections to abate before it attempts a liftoff in rates. Our forecast for three rate hikes in 2022 has not changed. An additional four rate hikes are expected in 2023, as long as the Fed doesn't panic on overheating. The Fed has become more hawkish regarding inflation.

Risks: Fiscal stimulus that is short-lived but poorly targeted, such as stimulus checks, could force the Fed to raise rates more rapidly in 2022.

> "Every time it seems we have a tether to pull us out, the ground beneath us shifts again in response to a new wave of infections."

Scenario 2

The Omicron wave collides with the Delta wave on a global scale. Parts of Europe have followed the CDC and shortened quarantine times for those infected because of the threat to economic activity. Outbreaks last longer and trigger losses in manufacturing and construction as well as the service sector. Businesses and government offices are forced to close, mimicking a mandated lockdown.

Real GDP contracts by 2.2% in the first quarter, the first drop since the onset of the recovery:

- Employment drops in January and February and rebounds in March.
- Layoffs mount and unemployment rises.
- Participation in the labor market suffers a setback.
- Recruiting slows as uncertainty about when and how fully the economy will reopen escalates.
- Small business failures rise; employment becomes even more concentrated in large firms. This could amplify the power of large monopsony firms.
- Shortages mount but are partially offset by disruptions to demand.

Real GDP bounces back at a 4.9% rate in the second quarter. Growth for the year comes in at 3%, more than a full percent slower than we expected last month.

Risks: Congress gives in to election-year pressure and passes additional stimulus. That fortifies the rebound in growth during the remainder of the year.

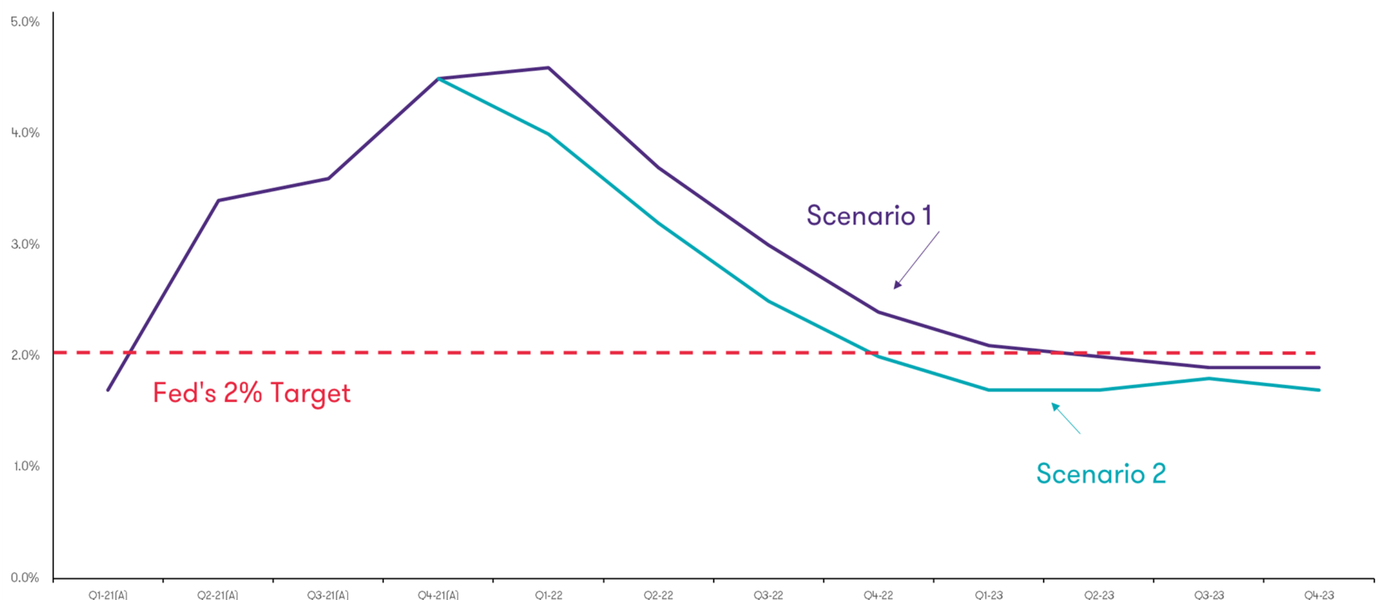
Inflation Moderates

Chart 2 compares the path of inflation under the two scenarios. The core PCE index peaks sooner and cools faster in scenario 2:

- The contraction acts as a hard stop on the economy, derailing some of the upward pressure on inflation in both goods and services.
- Inventories built during the fourth quarter of 2021 provide a buffer to shortages due to idled production.
- The exception is shelter costs, which continue to accelerate.

Core PCE inflation ends the year close to the Fed's 2% target. Inflation could cool further in 2023.

Chart 2



"The demand for workers is still so far above the number of workers looking for work that the upward pressure on wages could persist, even with a setback in employment."

Risks: Fiscal stimulus could put a floor under how much inflation cools over the course of 2022. The rebound in demand could amplify surge pricing and exacerbate price hikes due to shortages in the goods sector.

The wild card is the labor market. The demand for workers is still so far above the number of workers looking for work that the upward pressure on wages could persist, even with a setback in employment. This will compress profit margins and trigger price hikes as firms pass those costs onto consumers. The risk of a more sustained and entrenched inflation is still a possibility, even with a hard stop to the economy in the first quarter.

The one thing that distinguishes this pandemic from its predecessors has been its impact on inflation. Pandemics tend to trigger wage gains because of the blow they deal to labor supply, but not inflation. This time is truly different. Technology and the shift to working from home, combined with massive infusions of fiscal stimulus, supported demand through repeated waves of infection. The result was a surge in both wages and prices.

Fed Delays Rate Hikes

The Fed will put rate hike discussions on ice if the economy contracts in the first quarter. Watch for Fed Chairman Jay Powell to underscore the uncertainty surrounding the outlook at his press conference following the January meeting. He will be walking a tightrope. He will want to signal patience on rate hikes in the near term, while reassuring the Fed will deal with any residual inflation when the Omicron wave recedes. The Fed is expected to raise rates twice instead of three times in 2022 and only two more times in 2023.

Risks: The Fed is put in the hard position of raising rates sooner and faster in the wake of a contraction in growth. This underscores the need by Congress to target carefully any aid it doles out, which is nearly impossible given the gaping holes in our safety nets.

Bottom Line

Forecasting during the pandemic has been akin to standing in quicksand. Every time it seems we have a tether to pull us out, the ground beneath us shifts again in response to a new wave of infections. It is exhausting.

Hope is in the science that delivered us vaccines, treatments and ways to curb infections. The thought that one of my next jabs might thwart all variants is especially encouraging. The prospect that the pandemic morphs into an endemic, or something that is less of a threat and more manageable, is still high in 2022. One can dare to dream.

Economic forecast — January 2022

	2021	2022	2023	2021:3(A)	2021:4(E)	2022:1	2022:2	2022:3	2022:4	2023:1	2023:2	2023:3
National Outlook												
Chain-Weight GDP[1]	5.7	3.7	2.3	2.3	6.7	1.5	4.2	3.4	2.2	2.0	1.9	1.9
Personal Consumption	8.0	3.2	2.2	2.0	4.9	1.3	3.2	2.3	2.0	2.0	2.3	2.2
Business Fixed Investment	7.4	5.1	4.0	1.7	3.1	7.0	5.8	5.6	4.1	3.7	3.5	3.4
Residential Investment	9.1	-3.6	-3.8	-7.7	0.1	-1.5	-4.4	-3.5	-3.9	-4.6	-3.8	-3.0
Inventory Investment (bil $ '12)	-55	111	118	-67	103	62	110	135	136	137	124	112
Net Exports (bil $ '12)	-1272	-1306	-1297	-1308	-1324	-1312	-1308	-1301	-1303	-1300	-1299	-1294
Exports	4.0	5.3	7.8	-5.3	13.3	-0.3	7.8	9.7	8.8	8.4	6.9	6.3
Imports	13.5	4.4	4.8	4.7	10.1	-1.5	4.5	5.3	5.9	5.2	4.4	3.6
Government Expenditures	0.5	0.9	1.6	0.9	-2.1	2.1	1.9	2.8	2.0	1.3	1.2	1.0
Federal	0.6	-1.6	-0.1	-5.1	-4.5	1.9	-0.8	0.2	-1.2	0.1	0.3	0.1
State and Local	0.5	2.5	2.6	4.9	-0.6	2.2	3.6	4.5	4.0	2.0	1.6	1.5
Final Sales	5.4	2.8	2.3	0.1	3.3	2.3	3.2	2.9	2.2	2.0	2.2	2.1
Inflation												
GDP Deflator	4.2	3.8	2.0	5.9	6.9	2.5	2.5	1.9	1.9	2.2	1.8	2.1
CPI	4.7	3.9	2.1	6.6	8.0	0.4	3.3	2.0	2.1	2.1	1.7	2.0
Core CPI	3.6	3.9	2.2	5.3	5.1	3.4	2.7	2.4	2.2	2.1	2.2	2.2
Special Indicators												
Corporate Profits[2]	14.1	0.2	-0.7	19.7	14.1	6.9	-1.0	-3.7	0.2	1.3	-1.3	-1.9
Disposable Personal Income	2.1	-3.6	2.6	-4.3	-6.6	-2.1	2.3	3.3	1.5	3.0	2.7	2.5
Housing Starts (mil.)	1.59	1.47	1.34	1.56	1.60	1.53	1.49	1.44	1.41	1.37	1.35	1.33
Civilian Unemployment Rate	5.4	3.7	3.5	5.1	4.3	4.1	3.8	3.6	3.4	3.4	3.5	3.5
Total Nonfarm Payrolls (thous.)[3]	5151	957	400	1694	1761	872	1230	961	766	825	498	238
Vehicle Sales												
Automobile Sales (mil.)	3.4	3.8	4.0	3.1	2.7	3.1	3.7	4.1	4.1	4.2	4.0	3.9
Domestic	2.2	2.4	2.5	2.0	1.8	2.0	2.4	2.6	2.6	2.6	2.5	2.5
Imports	1.1	1.4	1.5	1.1	0.9	1.1	1.3	1.5	1.5	1.6	1.5	1.4
Lt. Trucks (mil.)	11.7	11.7	12.6	10.3	10.5	10.7	11.7	12.1	12.3	12.5	12.7	12.6
Domestic	9.1	9.1	9.7	7.8	8.2	8.4	9.2	9.4	9.5	9.6	9.7	9.7
Imports	2.7	2.6	2.9	2.5	2.3	2.3	2.5	2.7	2.8	2.9	3.0	2.9
Combined Auto/Lt.Truck	15.1	15.5	16.6	13.3	13.2	13.8	15.4	16.2	16.4	16.7	16.7	16.5
Heavy Truck Sales	0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4
Total Vehicles (mil.)	15.6	16.0	17.0	13.8	13.7	14.3	15.9	16.7	16.9	17.1	17.1	16.9
Interest Rate/Yields												
Federal Funds	0.1	0.4	1.3	0.1	0.1	0.1	0.2	0.4	0.8	0.9	1.2	1.4
10-Year Treasury Note	1.4	1.7	2.3	1.3	1.5	1.5	1.6	1.7	1.9	2.1	2.2	2.4
Corporate Bond BAA	3.5	3.6	4.3	3.3	3.4	3.4	3.6	3.7	3.9	4.0	4.2	4.4
Exchange Rates												
Dollar/Euro	1.18	1.15	1.19	1.18	1.14	1.13	1.14	1.15	1.17	1.18	1.19	1.20
Yen/Dollar	109.8	113.0	110.4	110.1	113.6	113.6	113.2	112.7	112.2	111.5	110.7	110.0

1. in 2021, GDP was $19.4 trillion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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