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NABE Annual Meeting:
The Other Side of the Looking Glass

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I have just returned from the National Association for Business Economics (NABE) annual meeting, my first in-person conference since late February 2020. The same group hosted my last in-person meeting before the world slipped into a pandemic. This time, it was a hybrid event which required vaccines, masks and rapid COVID tests for each participant; it was simultaneously streamed for those who didn't feel comfortable traveling or meeting in person.

It provided a glimpse of what the world could look like as the pandemic morphs into an endemic. We will need to go to greater lengths to prevent contagion as we attempt to do one of the most basic of human endeavors: congregate. Vaccine boosters, new vaccines, public masking, rapid testing and new treatments to render the virus less lethal will become ubiquitous.

The pandemic was a bit like walking through the looking glass; the world on the other side became a reverse of what we once knew. Labor shortages erupted even as millions remained out of work. Inflation flared, even as factories struggled to keep their plants going. Interest rates fell as deficits and debts ballooned.

Recessions usually sneak up on you, with economists marking their forecasts down slowly, never really crossing into the red until after they have started. We knew this time was different. I remember the chill that went down my spine as Wuhan went into lockdown on January 23, 2020. There is no Las Vegas in the global economy; what happens in China does not stay there. Economists soon forecast what many had spent their careers avoiding: a global recession.

Less Growth, More Inflation

The economy is expected to stagnate at a 1.4% pace in the third quarter. Consumer spending essentially flatlined over the summer in response to acute vehicle shortages and the spread of the Delta variant. Supply constraints also held back housing, even as home values continued to soar. Business investment lost ground. Inventories were further drained. The trade deficit widened dramatically. The good news was a spurt in state and local government spending, which was lifted by transfers in the last stimulus package.

Prospects for the fourth quarter are better, with growth expected to come in at a 4.6% pace. Consumer spending is expected to come back as the pace of infections fades. Vaccinations have slowed with the number of COVID cases. We are now lagging most other developed countries in vaccine uptake, which could cause another setback as temperatures drop. Housing is expected to remain constrained by a shortfall in supply. Business investment should rebound. The trade deficit is expected to narrow with stronger exports, while state and local spending remains buoyant.

Real GDP is expected to grow at a 5.4% pace in 2021. That is the weakest estimate for growth since February before the final stimulus package in March was passed. Estimates of inflation have been revised up for 2021 and 2022. The core personal consumption expenditures (PCE) index is expected to cool to 3.1% by year-end 2022, almost a percent higher than we expected last month.

The Federal Reserve Tapers. The Fed is poised to begin a tapering of its asset purchases starting in November. They hope to finish that process by mid-2022. Then, their focus will pivot to rate hikes. We have moved the first rate hike into late 2022 from early 2023.

A badly divided Congress briefly united to pass a massive emergency aid and stimulus package. The Fed jumped in to stop a meltdown of financial markets and avert a deeper and more prolonged recession. The pace of deterioration and the reaction to those losses by policy shifts eclipsed anything we had seen in the past.

This edition of ***Economic Currents*** provides some highlights of what I learned at the conference and what those insights suggest about where we are going. The conference was an exercise in humility. We weighed the risk of climate change and the losses it will trigger. We debated whether labor shortages and inflation are transitory or troublesome. They are both. Whether deficits and debt still matter. They don't, until they do; then, it gets ugly.

Congress appears to have averted a debt crisis for now but remains a constant source of uncertainty and dysfunction. The Federal Reserve is poised to taper asset purchases and start a liftoff in rates. Recent scandals have left it unclear who will be sitting at the table to make those decisions next year. Chairman Jay Powell's term ends in January and two presidents - both had penciled in rate hikes for 2022 - resigned abruptly.

Highlights

1. Climate change is the most underappreciated risk to the global economy. Governments and markets are starting to deal with threats, but too slowly. The administration rejoined the Paris Climate Accord but the bipartisan infrastructure bill continues to languish. More will come via regulation and executive orders. Markets are rewarding firms that walk the talk on the environment, social and governance (ESG) issues; those who don't will be penalized.

Insurers are at the forefront of the changes underway, scaling back their coverage of property damages due to fires and floods. This will add to the pressure companies are already feeling to comply with more strict ESG targets from their vendors and investors.

The Federal Reserve will soon stress-test large bank loan portfolios against the losses triggered by extreme weather events. Some banks beat them to the punch and have begun to scale back lending to the brown energy sector.

> "The Federal Reserve is already looking into how climate change could destabilize financial markets."

2. Supply chain shocks will linger. A larger and more immediate problem is supply chains, which have no easy fix. Much of what we are experiencing today was decades in the making. The move to offshore started in the 1980s at the same time companies were adopting just-in-time inventory systems.

This hits close to home. My father was both a just-in-time inventory specialist and managed a good portion of the parts business for General Motors. He had a plant in another country go on strike, which brought production at plants here to a halt. He had outsourced every windshield that went into a popular car line to that plant. He had to hire a team to extract completed windshields in the dead of night and load them into the belly of a 747 jet. The plan worked and plants in the U.S. quickly reopened but the cost advantage of offshoring evaporated.

What we are seeing today is worse, with production being idled around the world in response to outbreaks. Everything from climate change, including a rationing of water available to manufacture computer chips in Taiwan, to the spread of COVID and disruptions to production, shipping and transportation is creating costly shortages and delays.

Firms were moved to regionalize supply chains to limit disruptions prior to the pandemic. Breaking up is hard to do; China has actually increased its dominance of global supply chains since the onset of COVID. Many countries within Asia still lack the infrastructure to support the scale that China has.

The question is how long will those disruptions last? The consensus has shifted from early to mid-2022 or later. I wouldn't be surprised to see it last even longer. Countries that escaped earlier waves succumbed to the Delta variant. Eastern Europe is now seeing a new wave of infections.

Companies have begun to double up on orders to hedge against future disruptions. This could create what is known as a bullwhip effect, or unwanted surge in inventories down the road. That would rein in price increases due to supply chain disruptions but not before concerns about inflation come to a boil.

3. Labor shortages will persist. Consumers are spending and businesses are ramping up faster than workers are willing or able to return to work. The expiration of unemployment benefits for millions did not bring workers from the sidelines in September.

Current shortages are complex and represent a mix of supply and demand pressures. Retirements and burnout, notably in health care, have soared. Hospitals are reporting between 5% and 35% losses in frontline workers, some of them in the middle of a shift. This has forced some facilities to close temporarily or limit treatment to non-COVID patients.

Immigration, which already slowed to a crawl prior to the crisis, has come to a virtual standstill. Dropouts from grade school to college surged as education moved online. The completion of programs that require accreditation was delayed. Together this has exacerbated the sense of a labor shortage and perceptions of a skills gap.

Labor force participation tends to lag overall improvements in the labor market. We could still be another nine months away from a major pickup in participation given how long people have been sidelined. Childcare, mobility and up-skilling are the most cited reasons for lack of participation.

Most jobs are now posted online. A lack of broadband and the electronics needed to apply for those jobs have proved additional hurdles for low-wage workers.

> "The reasons for labor market shortages are unique to the pandemic. Retirements and burnout…have soared."

This is at the same time that large, tech-savvy retail behemoths are driving the surge in low-wage pay. They were the winners in the pivot from in-person to online transactions and continue to gain market share. They are better positioned to offset the crimp that higher wages place on profits and are working hard to automate. This will accelerate the number of workers who are more permanently displaced by new technologies.

For the first time in my career, manufacturers are being forced to compete with retailers for workers. That reflects how far wages in the manufacturing sector have fallen in recent years. It also shows how far technology in retail has come.

Those same employers are accustomed to high turnover rates and proven tough to unionize. This marks a major break from the 1970s, when workers had an upper hand over employers. Back then, nearly 80% of wages were tied to a cost of living adjustment (COLA), which was determined by changes in the consumer price index (CPI).

Those shifts were years in the making and baked the surge in inflation triggered by the Vietnam war, bad policies of the Nixon administration and the formation of OPEC into wage gains. In 1973, the term "stagflation" was born and has been misused ever since. There is nothing that comes close to allowing a repeat of that today.

Wage gains in the leisure and hospitality sector actually slowed in August and September as cases of the Delta variant picked up. This underscores just how fragile wage gains at the very bottom of the wage strata remain.

4. Inflation is mostly transitory but still troublesome. The worst of the pandemic-related surge in prices appears to be cresting. Some of those increases are self-correcting. Consumer attitudes about buying new vehicles and homes cratered in recent months as prices skyrocketed. Home buying attitudes have hit their lowest level since the early 1980s over the summer.

The problem is that shelter costs tend to lag overall inflation measures, which means we could be seeing the rent and owners' equivalent rent components of inflation pick up even as other prices are moderating. Shelter costs alone represent a third of the consumer price index (CPI) and could easily add more than a half percentage point to overall inflation next year.

Medical costs represent another upside risk. Treating COVID has been costly, but not profitable. Hospitals that were overwhelmed are now also understaffed; patients who skipped routine exams are showing up with more chronic or acute problems. Those shifts will show up as a surge in insurance rates and higher copays.

Core measures of inflation will abate from recent highs but could remain closer to 3% than 2% by year-end. Those increases should moderate fairly rapidly as we enter 2023 but that is a long time to wait with inflation well above the Fed's 2% target. That could add to a sense of urgency at the Fed to raise rates and stomp on inflation much sooner than they anticipated.

5. Working from home will stick. Working from home is not new. Firms were already experimenting how much leeway they could provide their workers prior to the pandemic. The pandemic tested that thesis to an extreme, as it forced everyone who could to literally work from home, overnight.

Research on that mass experiment suggests that a much larger portion of work will remain remote in the post-pandemic world. More than 60% of full-time workers, 20-65 years of age, were pleasantly pleased with how much they could accomplish from home. The longer the pandemic lasted, the more entrenched their views on working from home at least a few days a week became.

Workers spent about a third of the time they saved from commuting on additional hours worked; the remainder was divided between family responsibilities and leisure.

More than 85% of workers cited concerns about safety when asked about why they wanted more flexibility. This is key as the pandemic morphs into an endemic, like the seasonal flu, but worse.

Employers who go to greater lengths to ensure the safety of workers while working will be able to better recruit and retain workers; 20,000 flight attendants applied for 2,000 openings at United after the firm required vaccines of its employees.

Employers are less convinced than workers about the benefits of working from home. Small and midsize firms have been more likely to embrace flexible work schedules than large firms. All workers desired some level of flexibility in their schedules.

More than 40% of workers surveyed said they would search for a new job or quit if their employer did not allow them to work some days from home. Two days of working from home equate to about an 8% raise.

College-educated women with school-age children and people of color value work-from-home options more than women without children and white workers do more broadly. This raises issues of fairness and equity.

6. The migrations triggered by COVID have legs. The 2020-21 COVID migration was triggered by the shift to online schooling when young adults returned home from college. Layoffs prompted workers to relocate to look for work elsewhere. Then there are those who moved from the city to the suburbs and other states, seeking less expensive and larger living spaces.

The question is whether those shifts will stick or reverse as we continue to reopen. Young people have begun to return to cities to restart their education. Foreign students, a key driver of in-migration, are slowly returning. Many who bought in rural areas are finding the limits of those purchases, given the need for high-speed internet to work efficiently.

7. Housing shortages intensify. The housing market has come to embody all that is good and problematic about the pandemic recovery. Record-low rates, coupled with the shift to working from home, unleashed pent-up demand for housing among millennials. They are now aging into their prime, home-buying years.

This happened at the same time that demand from wealthy buyers for second homes soared and high-income homeowners relocated to less expensive cities and states. Those shifts, coupled with chronic supply shortages going into the pandemic, pushed up home values at an astonishing pace.

"The second largest economy is slowing, something that has ramifications for the rest of the world."

Widespread consolidation in the materials market, supply chain problems, long backlogs on appliances, a loss of immigrant workers and a shortage of skilled tradespeople are compounding housing shortages.

Older home owners are beginning to sell but inventories remain tight. Older and less energy efficient homes add to our carbon footprint and fuel the demand for remodeling; they make up the largest portion of the housing stock.

Home buying sentiment hit the lowest level since the early 1980s this summer. In response, investors are flipping homes to rent instead of buy, which further limits the number of homes for sale.

"This is the first time in my career that I have seen manufacturers compete with retailers for workers. That reflects how far wages in the manufacturing sector have fallen."

8. Deficits and debt matter but not in the ways we once thought. There is fairly widespread agreement that the surge in deficits and debt triggered by the crisis was necessary to navigate COVID-tainted waters. We needed lifeboats in the water; fiscal stimulus provided them. The surprise was how low interest rates remained as debt mounted both at home and abroad.

That suggests that fiscal space is greater than anyone hoped, as long as debt is issued for the right reasons. Economists are fairly unified in their views that leveraging low rates for infrastructure investments, including those needed to deal with climate change, is justified. The payoff is worth the risk, given ultra-low rates.

Spending for social programs is necessary, given the gross inequities that the pandemic exposed and exacerbated. Social spending includes mass transfers, including Social Security, Medicare and Medicaid. These transfers are more inflationary than one-time infrastructure investments. Regular transfers require "pay-fors" in the form of higher taxes or cuts elsewhere in the budget.

The current forecast assumes that the bipartisan $1.2 trillion in infrastructure spending will be passed. Large infrastructure projects take time to ramp up, which means that those funds won't really move the needle on growth until 2023 at the earliest. The $3.5 trillion in social spending proposed by the administration is expected to be scaled back; we are expecting closer to $2 trillion.

Those shifts represent a major slowdown from the aid provided to offset the pandemic. That means we will need to see the private sector step in to catch the baton as we move into 2022.

9. China becomes a major drag on global growth. The second largest economy is slowing, something that has ramifications for the rest of the world. Everything from COVID-zero policies, which enable the government to close entire cities and ports as variants spread, to recent efforts to curb carbon emissions and ration electricity is wreaking havoc on economic growth and further disrupting global supply chains.

The China Beige Book reports that borrowing by property firms from shadow banks hit a record high in recent months. The government's campaign to de-escalate risk is targeting firms in property, health care and education. China could ease credit conditions for a bit, but that would not cure problems that were years in the making.

The government can tell banks to lend and firms to borrow, but it cannot force consumers to consume nor to have more children. China has now fallen behind Japan in fertility rates. This has a significant impact on the future of the labor force and the impact the consumer will have on their economy.

10. The Fed could overreact. The Federal Open Market Committee (FOMC) would like to avoid raising rates into a supply shock. The Fed is clearly more worried about inflation than it was a few months ago; participants at the last FOMC meeting were evenly split between those who expected to raise rates in 2022 or 2023.

It has been decades since the Fed has had to chase inflation. Prices are poised to cool but could remain well above the Fed's 2% target in 2022. That could prompt the Fed to act more aggressively.

Soft landings are difficult during the best of times, which is not where we are today. The risk is that the Fed accidentally tips the economy into another recession before we have fully healed from the last. Another recession in the U.S. would have consequences around the world. Rinse wash, repeat.

Bottom Line

When we entered the pandemic, we stepped from one side of the looking glass to the other. In so doing, many old rules of thumb seemed to be upended. Forecasting in such an environment has been particularly humbling.

The whole is greater than the sum of its parts only when the parts are healthy and interactive. Technology has created a bridge for interaction but is still no substitute for some endeavors. We will have to find a balance between safe interaction and allowing some flexibility in our lives as we move forward. The NABE conference may represent too large a leap for some but reminded us that, with a little effort, we could be enjoying many more social and business interactions.

Economic forecast — October 2021

	2021	2022	2023	2021:2(A)	2021:3	2021:4	2022:1	2022:2	2022:3	2022:4	2023:1	2023:2
National Outlook												
Chain-Weight GDP[1]	5.4	3.8	2.2	6.7	1.4	4.6	4.4	3.6	3.4	2.1	2.0	1.6
Personal Consumption	7.8	2.9	2.1	12.0	0.4	3.9	2.3	2.2	2.3	1.9	2.1	2.0
Business Fixed Investment	7.4	5.4	3.4	9.2	0.6	5.5	6.8	5.9	5.3	3.6	3.0	2.4
Residential Investment	8.4	-6.0	-4.2	-11.7	-8.8	-8.1	-3.3	-4.7	-4.2	-6.0	-4.9	-3.6
Inventory Investment (bil $ '12)	-95	97	139	-168	-77	-45	23	83	131	149	152	143
Net Exports (bil $ '12)	-1246	-1240	-1245	-1236	-1281	-1250	-1240	-1237	-1241	-1243	-1246	-1244
Exports	4.3	7.0	7.1	7.6	-0.3	7.1	9.1	8.1	7.8	7.6	7.4	6.7
Imports	12.9	4.4	4.9	7.1	4.9	1.1	4.6	5.0	5.5	5.3	5.2	4.3
Government Expenditures	1.0	1.9	1.2	-2.0	2.8	2.0	2.8	1.3	2.2	1.0	1.3	0.4
Federal	1.4	-0.1	-0.2	-5.3	0.0	-1.5	2.5	-0.5	0.5	-1.4	0.0	-0.1
State and Local	0.7	3.1	2.1	0.2	4.6	4.3	3.0	2.4	3.3	2.5	2.1	0.7
Final Sales	5.4	2.8	2.0	8.1	-0.4	3.9	3.1	2.4	2.5	1.7	1.9	1.7
Inflation												
GDP Deflator	4.0	3.6	2.5	6.0	5.9	3.9	2.5	3.5	2.2	2.8	2.5	3.7
CPI	4.3	3.4	2.4	8.5	6.4	2.8	2.2	3.1	1.9	2.9	2.3	3.6
Core CPI	3.4	3.8	2.9	8.2	5.2	2.9	3.2	4.2	2.8	3.2	2.6	3.9
Special Indicators												
Corporate Profits[2]	0.9	5.8	0.6	45.1	6.7	10.2	8.5	0.4	9.5	5.8	2.0	0.2
Disposable Personal Income	1.8	-3.7	2.5	-30.2	-4.1	-7.3	-2.1	2.9	3.7	1.7	2.4	1.9
Housing Starts (mil.)	1.57	1.40	1.27	1.59	1.58	1.53	1.48	1.43	1.37	1.32	1.29	1.28
Civilian Unemployment Rate	5.6	4.4	3.5	5.9	5.1	4.8	4.6	4.3	4.0	3.6	3.4	3.5
Total Nonfarm Payrolls (thous.)[3]	5360	668	204	1837	2036	659	673	730	713	556	363	211
Vehicle Sales												
Automobile Sales (mil.)	3.5	3.9	4.0	3.9	3.1	3.3	3.5	3.8	4.1	4.1	4.2	4.0
Domestic	2.3	2.5	2.5	2.6	2.0	2.1	2.2	2.4	2.6	2.6	2.6	2.5
Imports	1.2	1.4	1.5	1.3	1.1	1.2	1.3	1.4	1.5	1.5	1.6	1.5
Lt. Trucks (mil.)	11.6	12.3	12.9	13.0	10.3	10.2	11.2	12.3	12.6	13.2	13.2	13.0
Domestic	8.9	9.4	10.0	9.9	7.8	7.7	8.5	9.3	9.6	10.1	10.2	10.0
Imports	2.7	3.0	2.9	3.1	2.5	2.5	2.7	3.0	3.0	3.1	3.0	3.0
Combined Auto/Lt.Truck	15.2	16.2	16.9	16.9	13.3	13.5	14.7	16.1	16.7	17.3	17.4	17.0
Heavy Truck Sales	0.5	0.5	0.4	0.5	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.4
Total Vehicles (mil.)	15.6	16.7	17.4	17.4	13.8	13.9	15.1	16.6	17.2	17.8	17.9	17.4
Interest Rate/Yields												
Federal Funds	0.1	0.1	0.5	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.4
10-Year Treasury Note	1.4	1.9	2.3	1.6	1.3	1.5	1.7	1.8	2.1	2.1	2.3	2.3
Corporate Bond BAA	3.5	3.9	4.5	3.6	3.3	3.5	3.6	3.8	4.2	4.2	4.4	4.5
Exchange Rates												
Dollar/Euro	1.20	1.22	1.23	1.20	1.19	1.20	1.20	1.21	1.22	1.22	1.23	1.23
Yen/Dollar	108.9	109.3	104.9	109.5	110.0	109.9	109.8	109.6	109.5	108.5	106.7	105.1

1. in 2020, GDP was $18.4 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.