COVID AT THE TWO-YEAR MARK:

Taking Stock of the Economic Trajectory

FIU Steven J. Green School of International & Public Affairs

FIU Jorge M. Pérez Metropolitan Center

COVID at the Two-Year Mark: Taking Stock of the Economic Trajectory

Howard Frank, Ph.D.

Overview

We are approaching the second anniversary of the start of the COVID pandemic. During the past two years, numerous lockdowns, a thirty percent drop in economic activity followed by stunning recovery, coupled with 800,000 lost lives, allow for retrospective sense-making with an eye to the economic and social future. This assessment is "in vitro" and subject to wide predictive intervals. For example, Omicron is less lethal than its forebears, which casts a degree of optimism regarding the pandemic's trajectory. Similarly, we are seeing signs that year-over-year inflation readings are ticking down, suggesting supply chain shortages and labor supply issues are easing. But optimism on these fronts could be quickly reversed.

Our current unemployment is 3.9% after hitting nearly 15% in April of 2020. During the last quarter, we have been adding nearly 200,000 jobs monthly. Even labor force participation, which hit a COVID-era low of 61% in 2020, has inched closer to 63% in recent months. While that is lower than pre-COVID, it represents strong demand for the available pool of workers. With the notable bugaboos of inflation and falling real wages (more below), there are signs the economy is recovering strongly from its 2020 lows.

Positive Signs

The Consumer is Strong

According to the National Retail Federation (NRF), consumer spending during the 2021 Holiday Season was $886.7 billion, 14.7 percent higher than 2020. NRF's Chief Economist, Jack Kleinhenz, sees this spending increase as a gauge of a number of factors, not the least of which is consumer psychology. The availability of vaccines and antivirals has fostered a greater sense of resilience. Equally important, the vaccines' rollout has greatly minimized hospitalizations and fatalities among the vaccinated. This builds greater consumer confidence in the face of rising COVID counts and consumer price increases.

Another sign of consumer strength is reflected in record high FICO credit rating scores. As 2021 ended, the average score hit 716, its highest since 2005 when scores were first tracked. Interestingly, the increase was largest among consumers with 550 to 599 scores, in the "Fair" range. This reflects lower unemployment, better family balance sheets, and lender flexibility during the crisis.

Consumer spending is 70 percent of the American economy. As we start 2022, Americans are opening their wallets and purchasing in store and online, across all categories, with particular emphasis on clothing, sporting goods, furniture, and electronics. This portends a healthy economy and an increased sense of normalcy. Consistent with this pattern, the Florida Legislature reports sales tax revenue trending 15% higher than budget, with Fiscal Year 2022-23 estimates tracking $4 billion higher than last year. In sum, spending in the U.S. and Florida is returning to pre-pandemic levels.

Inflation is Moderating

The Consumer Price Index (CPI) rose 7.0 percent in 2021. That was the highest annual gain since 1982. This headline number is concerning on several fronts and called into question the Federal Reserve's contention that COVID-based inflation was "transitory." Further, rapid inflation gains have spooked financial markets, with the Dow Jones Industrial Average and Nasdaq Composite approaching bear market (20 percent) declines. Lastly, while salaries have increased year-over-year, their increase was 3.4 percentage points below the inflation jump.

The good news: There are signs of moderating inflation. In December of 2021, the index for meats, poultry and fish dropped 0.4 percent from November, after rising 0.9 percent from October to November. Fresh vegetables decreased by 0.3 percent. Energy dropped 0.4 percent and the number of U.S. oilrigs online is back to pre-pandemic levels with a record number of rigs expected in 2023.

Thirty-seven percent increases in used car prices, eleven percent increases in new car prices, and double-digit increases in food and commodities are unlikely to repeat in 2022. Many experts liken last year's COVID-related price shocks to what America experienced after World War II when the end of rationing and wage and price controls coupled with unleashed consumer demand, lead to significant inflation. But high single-digit price gains diminished by 1947. Presently, high demand is exceeding supply, leading to a price surge. However, many economists believe that supply chain issues will diminish as higher wages and improved pandemic health outcomes bring workers back into the labor force.

Causes for Concern

Economics is Surpassing COVID as the #1 Policy Issue

December 2021 surveys from the University of Chicago's National Opinion Research Center revealed that economy and inflation are overtaking COVID as the nation's biggest policy challenges. Part of this anxiety may be driven by wages failing to keep pace with inflation—they rose 4.6 percent in 2021, but as noted above, they lagged inflation. Double-digit, year-over-year increases at the gas pump and grocery store are daily reminders of inflation's toll. Another driver of negative sentiment may be empty shelves at retail stores and supermarkets as well as shortages of building materials. Housing costs grew during the pandemic as well, putting consumers in a wage-price squeeze unseen in 40 years. In essence, inflation is moderating but consumer price increases are a thorny short- and long-term hangover of COVID's economic impact.

Long-Term Decline in Labor Force Participation is Continuing

Labor force participation has continued to decline during the Pandemic. While it has bounced from its low of the second quarter of 2020, the secular trend is downward. This does not bode well for future economic growth. As my colleague, Maria Ilcheva and I noted in recent Metro Center paper, lower labor force participation in the U.S. is tied to slowing population growth and tightened immigration. These factors are viewed as major contributors to the relatively sluggish GDP growth experienced since the late 90's.

The major component of declining participation is "aging out" of 55+ workers. This is a longstanding phenomenon accelerated by the pandemic. Older workers have opted for less exposure to COVID via retirement. Significant build-up of retirement account and housing assets is another factor. Pew Foundation findings note that during the Great Recession (2007-2009), older workers deferred retirement and even reentered the labor force due to the collapse of housing and deferred retirement plan values. Pew's polling confirms that the reverse has held during the pandemic—housing and stock market gains have facilitated early retirement among the 55+ population.

Older workers are not alone in their decision to opt out of the labor force. Women in general, and in particular, women of color with children under age six, have exited the labor force at an accelerated pace. Women are more likely to have people-facing service professions hardest hit by the pandemic and its associated public health closures. Further, they face a shortage of affordable, quality daycare. These factors portend stay-at-home parenting and concomitant drops in labor participation. This decline continues a secular trend that started with the Great Recession and shows no signs of abating.

Hospitality and Tourism Are Mending but Not Back to Pre-COVID Levels

Data from the Florida Office of Economic and Demographic Research's January 2022 report portray a glossy picture with some nicks and scratches. Revenue in this sector is just four percent below its February 2020 level, suggesting widespread recovery. On the other hand, in three hospitality-centric counties, Miami-Dade, Broward, and Orange, overall employment has experienced a drop between 5.6 and 12.5 percent. These counties are also contributing proportionately less to the state's GDP than prior to the pandemic.

The revenue figure reflects the robust economic recovery as well as Florida's appeal to outsiders given its warm climate, open space, and relaxed COVID restrictions. Nonetheless, the employment and economic share drops speak to potential long-term trends in the hospitality sector. For example, will businesses rely more on virtual conferencing? Will small restaurants cut employment or close permanently because of higher food and labor costs? It may be another 12-24 months before we have definitive answers but current trends raise fundamental questions about this sector's long-term prospects.

Where Does This Take Us?

At a glance, an athletic analogy applies to the American economy. We are playing through pain—psychic, economic, and physical—and continue to work and consume. While COVID cases and hospitalizations have risen due to Omicron, cases in some regions are declining. More importantly, we are no longer viewing morning and evening TV news reports with distressed health care providers bemoaning the passing of their patients with no next-of-kin present. Vaccination and antivirals have lowered hospitalizations and deaths. This resilience makes a significant difference in attitude and behavior. Could a "Deltacron" variant that combines severe health outcomes and high transmissibility (particularly among the vaccinated and boosted) change the landscape? Yes. It is perhaps the ultimate wildcard in assessing economics in the coming year and beyond. Nonetheless, assigning probabilities to this outcome is difficult, even among epidemiologists. Sticking with a sports analogy, we are hopefully in the final furlongs of a race to endemic status with COVID as another flu variant rather than a driver of daily activities.

Optimism notwithstanding, the pandemic will leave economic scar tissue, as does every economic downturn. The recessions of the Seventies and Eighties resulted in permanent job dislocation in basic industries such as car manufacturing and steel. Housing prices halved during the Great Recession took five years or more to recover in most metropolitan areas and as noted earlier, labor force participation has dropped faster since that time.

Predicting the next economic scars is difficult but two "macro" issues may drive the manageable future. First is the end of *unusually* accommodative Federal Reserve policy. The next is private sector reaction to higher wages, particularly in people-facing service industries. Short-term, these factors may dampen post-pandemic activity. Longer-term, they may alter the landscape of sectoral winners and losers while changing employment trends therein.

The End of Massive Stimulus from the Federal Reserve:

In coming months, the Federal Reserve is likely to raise interest rates and reduce its quantitative easing to fend off incipient inflation. This has caused a significant drop in the stock market since the beginning of 2022—nearly 11% in the Dow and 15% in the NASDAQ. These policy changes are widely telegraphed. However, they have spooked investors and policymakers alike.

We are witnessing fear and loathing over the end of historically low interest rates (Federal funds rate of 0 to 0.25%). Similarly, the CPI averaged 1.6% in the decade after the Great Recession, well below the Federal Reserve's 2.0 inflation target. This landscape will change. We are likely to see three or more interest rate hikes in 2022, and a similar number of 0.25 percent hikes in 2023. Inflation is likely to exceed two percent for two or more years.

That said, interest rates and inflation will remain close to 50 year lows. The U.S. is not facing the oil shocks of the Seventies. Productivity gains and international competition are checks on higher inflation. Those holding credit card balances will face higher payments but savers will accrue marginally higher interest, particularly at longer maturities. Nonetheless, the stock market's gyrations in recent weeks speak to distinct winners and losers in a new environment. Certain sectors (banks, aggregates, and commodities) will improve profit margins and are positioned to pass higher costs on to consumers. Technology firms and other services (particularly those based on "stay-at-home" work- and lifestyles) will be challenged. Larger, older firms with strong balance sheets will have a competitive edge on their younger, smaller counterparts.

In sum, the economy's strong recovery will likely continue despite anticipated rate hikes. Nonetheless, companies leading the recovery may be from traditional sectors outside of technology and broadly defined "disruption." Overall gains in employment and earnings may mask significant shifts in winners and losers in a new economic normal.

Will Higher Wages and Tighter Labor Markets Foster Consolidation and Automation?

In May of 2021, Bank of America announced it would raise its minimum hourly wage to $25 dollars by 2025. J.P. Morgan and Citibank raised their minimums to $18 prior to the pandemic. Bank of America's Chair, Brian Moynihan, stated this increase was a statement about the payoffs related to employee retention and the value of established career paths within the organization.

These increases come against the backdrop of significant branch closings. CNBC reports that in 2021, U.S. banks closed a record 2,927 branches, with Wells Fargo at the top, with net loss of 267 retail locations. Industry consolidation and online banking adoption have driven these closures.

This pattern of higher wages coupled with downsizing of footprint may be prototypical. Restaurant, drug store, and retail chains are already cutting branches or hours. Macy's, for example, has recently announced that stores will remain central to "omnichannel" distribution but released a list of closures for 2022. While affected workers will be offered severance or relocation, the bottom line is an apparent tradeoff between higher wages and headcount.

The post-pandemic new normal may see higher wages in service industries with long-languishing wages. However, the private sector will adapt to the higher wages and lower labor availability by running leaner in people and space.

Conclusion

The start of 2022 brings a generally positive vibe to the economy. Pandemic fatigue and improved COVID health outcomes undergird a strong economic recovery. Nonetheless, increasing interest rates and uncertainty over the pandemic trajectory may cause road bumps. Inflation is likely to run higher than pre-pandemic levels, particularly in the near term as we resolve supply chain roadblocks. Longer term, labor shortages and higher wages may be offset by continued realignment of face-to-face operations. This is a time when market averages and overall financial indices will mask significant sectoral gains and losses. This emerging ecosystem will require heightened attention on a number of fronts, with inflation-adjusted earnings atop the list. The stimulative fiscal and monetary policy that has characterized the American political economy since the Great Recession is ending. A new era with hope and uncertainty is beginning.