EconoFact Chats: The Challenges of Macroeconomic Forecasting in the Era of COVID

Julia Coronado, MacroPolicy Perspectives

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

No one ever said that economic forecasting was easy, but now, even understanding what is currently going on presents big challenges. For example, let's consider the jobs report for November. Employers reported weaker than expected hiring, but a survey of workers showed a surge in jobs, and the unemployment rate fell to 4.2%, the lowest rate since the pandemic began. At the same time inflation is at a level not seen in three decades. The Federal Reserve seems to be shifting from a policy targeting job creation, which had been its focus since the onset of the pandemic, to one that is battling inflation.

Michael Klein:

How do we make sense of all of this? For me, I would turn to an expert. And in fact that's what I'm doing today. I'm happy to welcome back to EconoFact Chats Dr. Julia Coronado, the Founder and President of MacroPolicy Prospectives. Prior to founding MacroPolicy Perspectives in 2017 Julia served as Chief Economist for Graham Capital Management and BNP Paribas, and as a senior economist at Barclay's Capital. Before that she served as an economist at the Federal Reserve Board of Governors. Julia, welcome once again to EconoFact Chat.

Julia Coronado:

Thank you, Michael. It's very great to be here.

Michael Klein:

It's nice to have you on once again. When we last spoke in July you started off by saying that these have been humbling times for forecasters, and you said that conventional models and rules of thumb don't seem to work when the pandemic is the main determinant of economic outcomes. Even more so as you noted, the relationship between economic activity and public health metrics, like the percentage of people vaccinated, or the number of COVID cases, is far from predictable. I guess that these words ring even more true today. Would you agree?

Julia Coronado:

Absolutely, I would agree with that. We've been going through the Delta variant, the rise of the Delta variant happened since we last spoke and of course that has brought new forms of disruption. And again, it doesn't line up easily with things like hospitalization rates or vaccination rates. It's a mix of direct impacts from the disease, and then a lot of indirect impacts through consumer behavior, household behavior, and through interconnections with other countries through supply chains. So not easily predictable. All we know is that it does remain a dominant force on all kinds of economic activity.

Michael Klein:

And now it's probably becoming even more difficult with the emergence of new variants like the Omicron strain of the virus.

Julia Coronado:

Right, exactly. So the Omicron obviously we're waiting to know more about that strain itself, is it as infectious? It appears so. Is it as severe, and we don't really know. How will it affect consumer behavior, we don't really know. A lot of the impacts of the Delta variant that we saw was not just through sort of consumer hesitancy, but also again through mandated restrictions or shutdowns in operations of factories. So for example the shutdown of factories in Vietnam and Malaysia had a non-linear impact on the availability of semiconductors for car production in the last few months, and we just are starting to see that normalize and recover. So a risk from Omicron is that we would see renewed shutdowns of ports or factories, or other sort of elements of the global manufacturing supply chain that can come with disruptions and potentially price increases as a result.

Michael Klein:

So there is an interaction between the global nature of the pandemic and the global nature of supply chains and the ways in which economies are interconnected?

Julia Coronado:

Absolutely, absolutely. I mean, we've had certain epidemiologists warning about this from the very beginning. That if we don't treat it as a global pandemic, and address global distribution and administration of vaccines -- each leg of that has its own challenges -- then we aren't going to really conquer the disease. And I think what we've seen in the Delta wave, and now potentially with Omicron is only underscoring that reality.

Michael Klein:

So given the difficulty of looking ahead let's turn to a somewhat easier, but still very challenging analysis of what's currently happening. As I mentioned in the introduction, the November jobs report presented seemingly contradictory information. Can you help us make sense of that?

Julia Coronado:

Sure. So the survey showed on the one hand some disappointing job numbers in the payroll numbers, but then the household survey showed more than a million jobs being added. So the employment report features two surveys, one a survey of hundreds of thousands of establishments that tell the BLS, the Bureau of Labor Statistics, how many people are on their payrolls; that was where the disappointing numbers came from. And then the household survey is a survey of about 60,000 households, and they're asked 'are you working?' And so from that survey you got a much more robust job number. So in general there's a lot of volatility between the two, they do match up over time, so if you look over the last 12 months, or over the cumulative performance of the labor market since February, 2020, before the pandemic began, they're roughly similar. They tell very similar stories, but the timing is different.

Julia Coronado:

And so in general we think that the payroll survey is more reliable on a monthly basis, a more reliable gauge of jobs, but again, from month to month there's a lot of variation, so I'm not terribly concerned about the slowdown in the payroll survey given that the household survey was very robust. And if you average, we usually average over three to six months anyway because of statistical noise, and there you're seeing job gains that are still very robust. Certainly by historical standards they are moderating and that is likely going to be the case going into next year. The fiscal stimulus is fading, growth should moderate, and even if it remains very strong, and therefore hiring should moderate, but remain pretty strong, and that I think is the underlying message coming out of the report. The job market is very strong, the economy is very strong. We are reducing labor market slack. People are finding jobs. The unemployment rate is coming down very quickly, and wage growth is robust.

Julia Coronado:

Even though another feature of the report was that wage gains are moderating, and there's an open question about how much labor supply will come back, how many people that dropped out of the labor force because of the pandemic will come back; and the November report gave us some hope on that front, we saw a pretty decent rebound in labor force participation. A pretty decent rebound in a key metric, the prime age employment population ratio. And all of that says that definitely the labor market is moving in the right direction, and that's something that is also confirmed by consumer surveys. When they ask consumers about job market conditions, job availability, ease of finding jobs, consumers report that this is the best labor market since the '90s, so definitely there's still labor demand. Definitely there are matches being made between workers and employers at a very robust rate, so the economy is kind of firing on all cylinders it looks like right now.

Michael Klein:

Part of the robust growth is that we started from a position of such depth, right?

Julia Coronado:

Yeah.

Michael Klein:

That we saw this huge drop in employment with the onset of the pandemic, and now we're coming back. So is it the case that when you come from such a deep point eventually it's going to slow down just because you start in a very deep hole and once you climb out of that hole the gains can't look as big. Is there part of that is the explanation of what's going on as well?

Julia Coronado:

Yes. I mean, definitely that's part of the explanation. And in addition, one of the features of this recovery is that there was so much fiscal and monetary support that was front loaded, that was put into place at the beginning of the pandemic. And then there were a couple more rounds, but they were all sort of one off fiscal transfers, so they really lifted growth. So we have a particularly strong, early boom in the recovery. And that again is the macroeconomic experiment we've been running -- go big, go early, don't wait around, don't micromanage or nickel and dime your fiscal response, just get money into people's pockets. We did that, it's led to this booming recovery. We're booming out of this deep hole instead of crawling out of this deep hole. But then again, since that was all sort of transitory, dare I use the word, transfers, it will moderate and that's fine. It has to moderate. We're running very, very hot. And it will by design because the fiscal transfers are not scheduled to repeat.

Michael Klein:

The deep hole that we had, it was deeper than what we saw in the great recession in 2008. And you I guess kind of alluded to the fact that then we crawled out of the hole, we didn't jump out of it, and it took a long time. So in economics we have a relationship called Okun's Law that links economic growth to changes in the unemployment rate. And in the wake of the great recession that began with the financial meltdown in 2008 the estimate suggests that employment did not recover as quickly as Okun's Law would've predicted. What's going on with that relationship today? Is it even more fraught because it's not just the demand for jobs, but it's people's willingness to work as well in the face of health concerns, and concerns about not enough childcare and so on?

Julia Coronado:

Yeah. So when we're using a metric like the unemployment rate I think the lesson from this cycle is similar to the last cycle in that the unemployment rate itself, it's a useful metric in terms of telling you the direction of the economy, but the precision of measuring labor market slack is significantly confounded by the entry and exit of people from the labor force. So that can lead it to rise or fall a lot faster than otherwise as people make these decisions. And of course we know that the pandemic had a very significant impact in driving people out of the labor force, simply because they were facing health concerns, they were facing childcare challenges, so absolutely that disrupts Okun's Law.

Julia Coronado:

If you look instead at sort of the demand for labor, the relationship between growth and the demand for labor, we can look at something like aggregate hours worked. There you see a more consistent relationship and the wedge is driven by productivity. So productivity also is quite noisy, it can jump around from quarter to quarter, but what we saw last cycle was a pretty dismal productivity performance after that initial burst. So typically when employers are restructuring their businesses in the middle of a recession they're looking for efficiency gains and we see productivity jump, and then it tends to moderate as the recovery proceeds. Last cycle we saw the recessionary jump, but then we moderate it to a very sort of subpar, below expectations pace of productivity gains.

Julia Coronado:

I think a lot of analysts, including myself, are more optimistic this time around because another thing that we've avoided is the recessionary dip in investment. So typically we see equipment investment, intellectual property investment, decline through and after a recession, and we haven't seen that, we're kind of in an investment boom, commercial real estate aside. But if you look at equipment, and software, and intellectual property investment, it's extremely strong. Profitability is extremely strong. If anything some of the strength of the recovery is signaling to businesses that there are opportunities. The prices, the bottlenecks are telling companies that they need to invest in improving and streamlining their operations. All of that suggests we could get a better productivity performance this cycle. But again, it's still very early days, hard to say with any confidence that that will materialize, but if we look at sort of some of the leading indicators they give us reason for hope.

Michael Klein:

So if I think a little bit about the answer you just gave, you drew on lots of different kinds of statistics. So for a layperson or even an economist who isn't as involved in what's going on contemporaneously, that person would tend to look at say the unemployment rate and the inflation rate, but you're giving a much richer tapestry by looking at all these different statistics. And I guess that's one of the things that your clients are interested in, that you're able to look at a wide range of things and offer a more nuanced picture. If you were to suggest just one or two things besides the unemployment rate and the inflation rate that people could look at and easily find access to to help understand and what's going on, what would you suggest?

Julia Coronado:

I think profitability of businesses is a key metric of sort of the health of the economy. So if we think about the difference between the wage gains of the '90s versus the wage gains of the '70s, which became a wage price spiral, the difference is productivity, and productivity shows up in profitability. So if companies are very healthy and they are competitive and they're keeping up with the challenges that the economy presents to them, then they will solve these challenges in a way that is profitable. And if they are profitable then they will continue to invest, and that will drive economic growth.

Julia Coronado:

So I think following... I follow for example earnings reports in the earning season a lot more closely than I did pre-pandemic, because that's where I'm going to see timely information about how different companies and sectors are meeting these supply chain challenges. How much are they passing through higher cost inputs on to consumers? How are consumers responding to those? What is their labor market experience? So I would say reading the tea leaves from earnings reports and most of the mainstream financial media will cover earnings season and earnings results, and I find that to be a pretty useful way.

Julia Coronado:

If you're hearing a lot of companies saying that they're having a hard time meeting all these challenges and therefore profits are getting compressed, and they're concerned, and then that leads to volatility in financial markets, that's a very different signal than if they're saying, which as they have been recently, that despite these supply chain challenges and labor supply bottlenecks and frictions they're managing okay. They're solving these problems, they're finding ways to shift their hiring practices, or source employees in different ways. They're finding ways to solve their supply chain issues. Of course, it's a very complex picture across different industries and companies, but overall the U.S business sector has met these challenges sort of impressively well so far. And that's definitely giving us macroeconomic signals that are important as we're trying to...Some of the economic data we rely on, we measure it imperfectly, it's available with a lag, it's subject to revision, so paying attention to what's happening, what companies are saying is happening on the ground, particularly in a time of elevated uncertainty like this is quite useful.

Michael Klein:

So some of our listeners might have heard this last answer and thought well, the stock market is a measure of perspective profitability of companies, but economists know that there's this famous saying, I believe it's from Paul Samuelson, that the stock market predicted nine of the last five recessions.

Julia Coronado:

Yeah.

Michael Klein:

And we know the stock market is very volatile, so I imagine the profitability that you're looking at by digging into data on companies is distinct from just the day to day movement in stock prices. Is that correct?

Julia Coronado:

Yeah, yes, yes, that is absolutely correct. And one of the reasons that say the stock market might over predict business cycle swings is because the missing element there is how policy makers respond to that. So markets are... The job of financial investors is to stay ahead of information. So if they see some information like Omicron you might see a correction, you might see a rise in risk aversion. What will policy makers do in response to that is the question. And oftentimes that cushions the blow. So if the economy is starting to weaken and markets smell that early, and you start to see this rise in risk aversion, sometimes you'll see the Fed pivot, or the fiscal stance shift to sort of cushion that blow and address that weakness.

Julia Coronado:

It's a little bit of a complicated situation right now because the Fed has just signaled that because is everything is so strong, the labor market, inflation is running well above their target, profitability is giving them great confidence that there's momentum in this economy, and they don't need to be as accommodative, so they very strongly indicated that they're going to shift away from the support that they've been providing to the economy by ending their asset purchases early, by maybe raising interest rates earlier than expected. They're giving us that signal at a time when uncertainty around the Omicron variant is rising, that creates a very volatile financial market that may or may not translate into real economic outcomes. Ultimately the impact of Omicron is going to either be greater, or not as bad than we are currently anticipating, and then markets and policy makers will react accordingly.

Julia Coronado:

But right now, what we've seen is a lot of market volatility around that, and so again, that may or may not translate into real economic outcomes, we'll just have to wait and see, so that is correct. The stock market isn't the economy, the stock market is much more volatile than the economy, and partly that is because policy makers, that's their job, is to also be ahead of the information, especially monetary policy makers, and calibrate their policy accordingly and try to keep the economy on track.

Michael Klein:

So since you raised the issue of inflation, it's one of the most hotly debated issues these days, and it's whether the current high rates of inflation are temporary and will subside when supply issues are resolved, or instead if we should now expect that higher inflation will become a more durable part of the economic landscape. When we spoke in July you emphasize the importance of not relying too much on macroeconomic top down models of inflation, and your company while consulting these types of analysis also conducts very careful bottom up analysis. So what has the microeconomic perspective added to your understanding of inflation currently?

Julia Coronado:

It's a great question. And again, back to the humbling times for forecasters, we've been through a series of upward revisions to our near term inflation forecast since we last talked. Much of that is traceable to the Delta variant and its disruptive impact on particularly semiconductor availability, car production, car prices. So I would say that's the majority of the upside surprise. There is an accumulation of evidence that also suggests that the underlying momentum in the economy is stronger than we had expected back in July. Delta took a little bit of a bite out of that but not... we're bouncing back pretty nicely. Certainly the October data and the November data we have in hand so far is pretty robust, and that's also adding to some broadening in inflation. So people that do rely on the top down models that have been saying, oh, the very magnitude of the fiscal stimulus was going to be inflationary, they certainly have been correct so far, and we are seeing that in the underlying strength of the recovery.

Julia Coronado:

At the same time, even though that leads to a sort of higher lifting of the inflation profile beyond 2021, mostly the profile still looks like what we talked about in July, which is this surge in inflation in 2021, followed by a moderation in 2022. That still is the shape of our forecast. We are seeing some good signs on particularly the car, the automobile front, that we could see better supply dynamics, more competitive markets, less upward pressure on prices. And also that fiscal liquidity that was provided to households is going to be fading over the year, and households might return to some degree of price sensitivity rather than that. We gave households a ton of cash just as we were kind of reopening last summer. that led to a lot of pent up demand, and enthusiasm for spending and less price sensitivity.

Julia Coronado:

One of the open questions for 2022 is where does consumer price sensitivity go from here? There's the broadening of inflation versus the broadening of wages, that hasn't been... we've seen robust wage gains, but a lot of that is very concentrated in the sectors that are most impacted by the pandemic. That is the lower wage workers who Amazon wants to hire them to distribute all the goods that we're ordering from home in the pandemic. Now the restaurant sector wants to reopen and hire those same workers, and there's a bidding war over these workers. Outside of those sectors we see wage growth that is robust, very solid, very good compared to most recessions, but not particularly something that we would worry about kind of a wage price spiral. So I still have... as a forecaster you have to kind of humbly acknowledge your errors, we were too sanguine on inflation, and then learn why. What did we learn from that? And I think we're learning two things.

Julia Coronado:

One is, just as we suspected from a bottoms up sectoral perspective the pandemic is incredibly disruptive, and it's had... the shift in demand and the disruption to operations has really combined to lead to these bottlenecks that were just a lot more intense and intensified from the Delta variant. That still looks and smells like what we were talking about in July, and should follow the same trajectory. Meanwhile, what is that underlying macro momentum? And a lot of that depends on what happens to labor supply. How many people do come back? What about productivity? How much are business able to maintain this sort of solid profitable operations, even as the labor market tightens? So those are very open questions.

Julia Coronado:

I think it's still a good baseline to assume that a lot of that inflation moderates. I think for the Fed officials who have been burned by the higher inflation, and are under a lot of pressure to address why they keep saying it's transitory and it keeps going higher, there's a communications challenge to this, that has led them to kind of pull forward some of the normalization. At the same time you need to keep feeling your way. The uncertainty is still real, it's still very high. One thing you learn in decades of forecasting is just because you were wrong in one direction doesn't mean you're going to be wrong in the same direction again. You could be surprised in different ways, and so understanding the building blocks of the surprise is key.

Julia Coronado:

And again, there's several messages. One is yes, the economy is stronger. So yes, the Fed can normalize their policy sooner. At the same time it's not all that. A lot of it is these other influences. One comparison that people have been making, again, the top down macro economists have been using the fact that inflation was so low in Europe and Japan as evidence that really this is a demand story driven by fiscal stimulus in the U.S. But now we're seeing those same price increases in Europe and Japan, which speaks to the fact that there's both of these things are happening, right, both of these things.

Julia Coronado:

One, we had a big fiscal surge. Two, we have these supply chain issues and they are passing through around the world regardless of the degree of fiscal support. So both of these elements are in place. The Fed's job is to try and disentangle and read the tea leaves between the two. That's not so simple. So keeping your options open and kind of navigating, they're kind of recalibrating and keeping their options open and trying to keep the communication clear, and it's a lot, it's a tough job right now.

Michael Klein:

Well I think your points about being humble and learning from your mistakes are very well taken and broadly applicable way beyond economic.

Julia Coronado:

Indeed.

Michael Klein:

And you said there are a lot of open questions for 2022, I hope we have a chance to chat again in 2022 and we can see how some of those things have resolved. So Julia, thank you very much for joining me once more on EconoFact Chats, I appreciate you taking the time to speak with me today.

Julia Coronado:

It is my pleasure, Michael, always a pleasure. Happy to come back next year.

Michael Klein:

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