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Preliminary Pandemic Lessons: What 2021 Taught Us

December 16, 2021

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As we close out 2021, it is time to reflect on what we learned from a macro perspective: what worked, what didn't work and what it means from 2022. Here is a short list of issues that moved our learning needle this year.

What Worked

1. **Aggressive demand-centered fiscal policy:** A key lament following the global financial crisis of 2008-2009 was that the fiscal policy response was too weak, leaving monetary policy as the "only game in town." This made the recovery shallower and more prolonged than necessary. After the outbreak of the COVID-19 crisis, governments responded forcefully with generous and fast-acting transfer schemes that successfully preserved demand. Advanced economies had more fiscal space than emerging economies - and used it. The result has been more robust growth, less lost output and, of course, more debt to pay down after the recovery. It was money well spent.

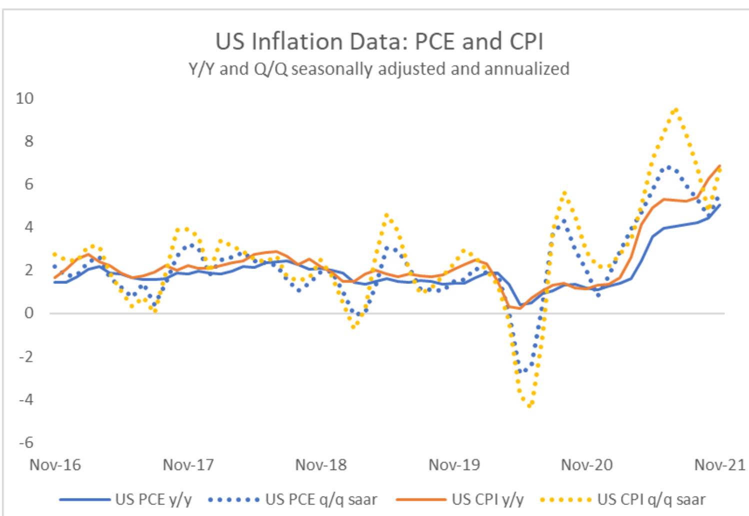
2. **Vaccinations:** The development of effective vaccines less than one year from the start of the pandemic is testament to powerful forces of necessity and investment in driving innovation. Widespread vaccinations helped to re-open economies and restore growth in 2021, while vaccine hesitancy has held back recoveries in Asia Pacific. Vaccines also support the end goal of effectively managing and containing the virus, shifting the focus from eradication (probably not feasible) to management of the virus. The end of the pandemic (not the end of the COVID-19 virus) will likely be declared in 2022, although cross-country vaccine inequality will persist.

3. **Maintaining labor market connectivity:** The pandemic presented a real time use case comparing two distinct approaches to the labor market. The European and the UK approach kept workers attached to firms through furlough schemes, reduced hours, and transfers. The US approach was to "let the market clear" meaning a separation of workers from firms and using transfers to offset employment loss. Total working hours fell by similar amounts Europe and the US, but US unemployment spiked to 14%. Critically, when the recovery arrived, Europe was able to ramp up more quickly and efficiently. In contrast, in the US the process of matching workers with firms proved problematic as the Beverage curve shifted out sharply. The resulting relative rising unit labor costs in the US fed a growing inflation gap.

What Didn't Work

1. **Global supply chains:** A perhaps surprising lesson from the COVID-19 pandemic shock was that the much touted, extremely efficient global supply chains built over the past decades as globalization surged failed the COVID-19 stress test. Lean inventories, just-in-time production and precision logistics worked well and went largely unnoticed in the long period of relatively stable growth preceding the pandemic. But the sudden stop, quick restart, and shift to durables from services over the past year has strained the system and caused supply bottlenecks. These have had knock on effects in supply and prices across the globe. The post-pandemic period is sure to see a re-examination of supply chains including their length, buffers (inventories) and redundancies.

2. **Extrapolating the post-GFC low inflation environment.** The economics profession blew this one. The forecast for 2021 US inflation one year ago was for a moderate and temporary bump over the Fed's 2% average target. In the event, the combination of supply chain disruptions, a weak oil supply response to higher prices, and wage pressures from ill-matched labor markets pushed inflation well above target for longer than most expected. The Fed is now recalibrating its language aggressively; we are set for multiple rates hikes next year and are likely to see a faster normalization path in the years ahead. Inflation was not quite dead yet after all.



Our economics and credit research teams will take these lessons to heart as we undertake our surveillance and forecast our macro-credit baseline and risk scenarios in the year ahead.

Happy New Year!

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