Essential Economics

S&P Global Ratings

Fed-Labor Standoff (2022) and Who Will Blink First (2023)?

Beth Ann Bovino's Year-End Blog

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This report does not constitute a rating action

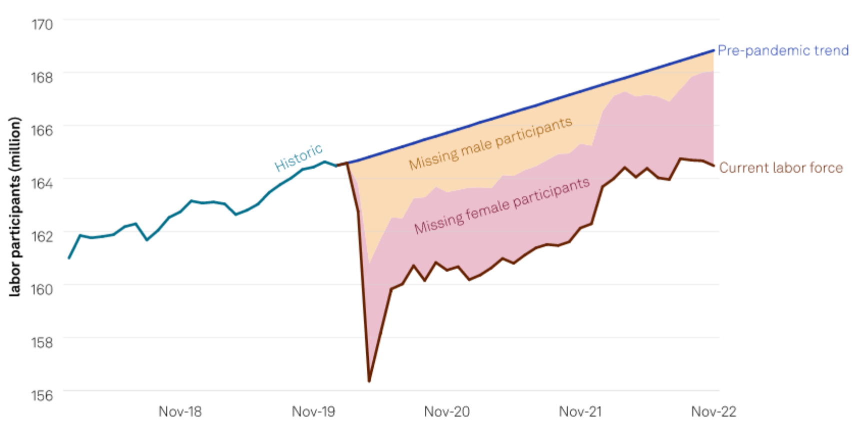
For the final edition of our Essential Economics newsletter this year, we asked each of our chief economist to share their insights on following questions:

- What was the biggest surprise for you in 2022 and what are the takeaways?
- What will you be watching most closely in 2023, and why?

A Tough Beginning To A 12-Round Bout

2022 got off to a surprising start as the Federal Reserve made an about face from its accommodative strategy after minutes from its two-day Federal Open Market Committee Meeting (FOMC) in November indicated "many participants" worried that "elevated inflation could prove more persistent". This was a marked departure from its view earlier in the year that inflation was "largely transitory" and a somewhat implicit acknowledgement of a misjudgment. The Fed came out swinging to kick off the new year with an aggressive stance of front-loading much stiffer rate hikes. However, this series of jabs and upper cuts have failed to find the target so far with only a moderate impact on prices.

Pre-Pandemic Labor Force Participation Trend vs. Current Conditions



Sources: Bureau of Labor Statistics and S&P Global Ratings Economics calculation.

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Despite easing COVID-19 restrictions and lower cases and death rates, U.S. labor markets remained surprisingly tight and resilient, adding another wildcard for the Fed and markets. I expected people to return to the workforce once vaccine options were readily available and restrictions eased. Despite being able to go out, spend, and eventually eat into their cushion of saving, far fewer workers returned to the workforce with over 4 million still out of the workforce relative to the precrisis trend--most of them women. The silver lining for the economy was they did continue to spend.

Fewer people in the workforce also means less labor productivity and more inflation, which is what the U.S. economy has been cursed with throughout the year. I expected that once young children, aged five and under, could be vaccinated for COVID-19, more parents would enter the job market. But the vaccine effect was rather modest. Labor supply remained tight throughout the year as job openings stayed high, keeping year-over-year wage gains near record levels but negative in real terms, squeezing household purchasing power. High-wage pressures, which prove sticky, are one more reason why the Fed had to remain on guard and much more vigilant than I expected this year.

Inflation Pressure Will Let Off Steam Next Year On Labor Force Re-Entry And Recession

In 2023, I'll be watching labor force data, adjusted for structural factors like age, to see when labor supply returns to precrisis levels. As the economy sags in the first half of the year, which I expect, and that quarantine savings cushion is depleted, I expect more people to come looking for work, which will help alleviate pricing pressure.

Along with how many are working, it'll be interesting to take notice of where and when. I'll be watching if there is migration back to cities, whether the longer post-pandemic commute times improve as people return to the office, or if remote working trends continue--and what these may mean for an already stubbornly resilient job market.

I expect labor force conditions will eventually rebalance, but not as fast as the Fed currently estimates. I still expect the federal funds rate to top 5% by mid-2023. But depending on whether we enter a shallow recession, as I expect, or a soft landing, the question may be whether the Fed doubles down with another about face and holds off on easing the pace and size of interest rate cuts in 2024.