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2023 Economic Outlook: Soft or Hard Landing?

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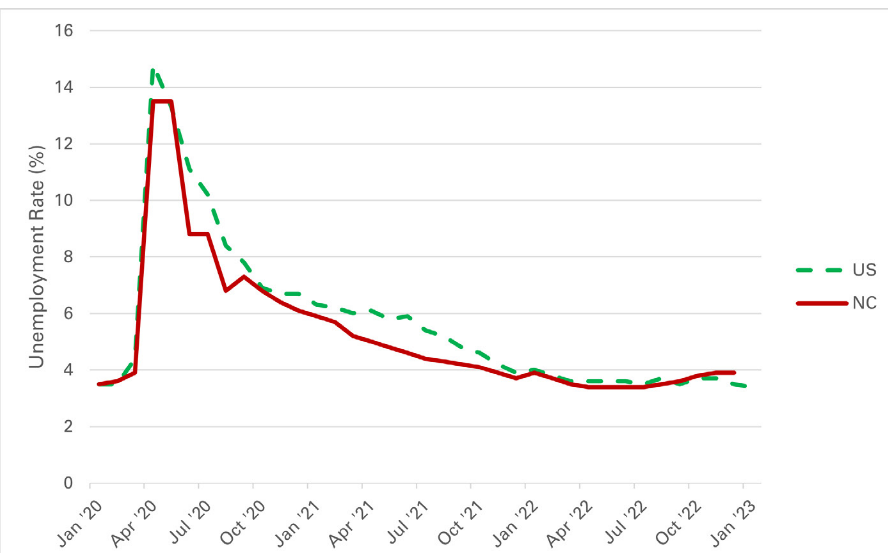
2022 in Review: A Shift in the Problem

2022 was the year that U.S. economic policymakers shifted their focus from fighting the pandemic and its short-term negative impacts on jobs, wages, and firms' financial health to addressing one of the longer-term consequences of the pandemic – inflation. This reorientation will impact both the nation and North Carolina. It will make 2023 a year of economic challenge, but also an opportunity for policy success.

In terms of aggregate growth, 2022 was a generally positive year nationally, but even more so in North Carolina. Comparing third-quarter data in 2021 and 2022 (due to the current unavailability of 2022 fourth-quarter data), the national output of goods and services (known as GDP, or gross domestic product) increased 1.9% nationally but jumped 3.2% in North Carolina.[1] Annual national job growth was 3.3% in 2022, but again a higher 4.3% in North Carolina. Also, workers in North Carolina saw their wage rates rise 5.4% in 2022 compared to 4.8% nationally. However, national and state-level wage increases did not keep pace with inflation, or the overall rise in the prices of food, housing, and other household staples. This dynamic meant that workers' wages fell in real terms.

Figure 1. Trends in U.S. and North Carolina Unemployment Rates



Data Source: U.S. Bureau of Labor Statistics.

With respect to ongoing concerns about labor shortages, the good news is that at the end of 2022, total employment in North Carolina rose by 230,000 relative to the pre-pandemic period - reflecting a 5% gain. Total U.S. employment at the end of 2022 was also more than at the start of 2020, but the increase was only 1%. As shown in Figure 1 both the national and North Carolina

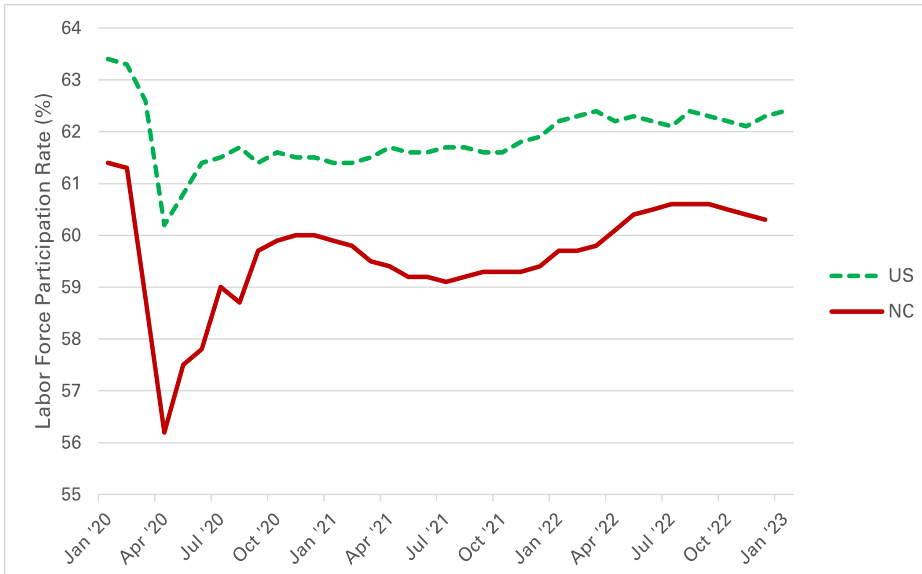
1 GDP numbers are adjusted for inflation, meaning the year-to-year comparisons have removed the impact of the increase in average prices.

unemployment rates ended 2022 under 4%, close to what they were before the COVID-19 outbreak.

But there are three caveats to these labor market improvements. First, the economy (GDP adjusted for inflation) has grown faster than employment. National GDP increased 4.8% from prior to the pandemic, and gained 7.8% in North Carolina from the pre-pandemic period - with both increases greater than the percentage increases in jobs. Some, but not all, of the excess gains in production compared to employment was due to an increase in worker productivity during the last three years.

Second, the labor force participation rate (LFPR) has not recovered to pre-pandemic levels (Figure 2). The LFPR measures the percentage of potential workers who are employed or looking for work. Potential workers are defined as everyone aged 16 and over who is not in the military or institutionalized. If the LFPR was at the same level at the end of 2022 as it was pre-pandemic, there would have been 1.3 million more workers in the nation and 51,000 more in North Carolina. Lower LFPR's are most significant among individuals aged 55 and over and aged 18-24.

Figure 2. Trends in U.S. and North Carolina Labor Force



Data Source: U.S. Bureau of Labor Statistics.

Third, job gains have been uneven across the economy, and some sectors have experienced declines. Employment in government positions has dropped by 2%, and jobs in manufacturing and leisure/hospitality have increased by only 0.5%. So severe labor shortages continue in key parts of the economy.

While last year's news on economic growth and the labor market was predominantly positive, clearly the biggest negative news in 2022 was the surge in inflation. The uptick in inflation began in early 2021 but continued through mid-2022, when the year-over-year inflation rate hit 9.1%, the highest level in four decades. But on the positive side, the second half of 2022 saw a more moderate year-over-year inflation rate, ending the year at 6.5%.

The historic jump in inflation was caused by a perfect storm of rising demand and falling supply. As the economy started to reopen at the end of 2020 and early 2021, consumers began to spend more, including the trillions of dollars pumped into the economy by both the Trump and Biden administrations' programs aimed to fight the pandemic. But producers couldn't match consumers' buying appetites by rapidly ramping up production due to labor shortages and worldwide supply-chain problems which, themselves, were another casualty of the pandemic. Hence, there was a classic situation of "too much money chasing too few goods and services," with the result being higher inflation.

The inflation rate began to abate in the second part of 2022 for several reasons. First, labor markets and supply chains have significantly improved. Second, oil prices fell and with them so did gasoline prices. Third, the Federal Reserve Bank's (or the Fed, for short) policy of raising interest rates to curtail consumer and business spending appeared to be working.

Therefore, 2022 ended with some optimism about inflation. But dampening that feeling was fear about another potential problem – recession. Will 2023 just trade one problem for another?

2023 Outlook: Fall before the Rise, or Getting Policy Just Right?

The task of curtailing the inflation rate, especially now that supply chains have been revived, falls mainly to the nation's central bank, the Fed. As an independent federal agency funded by member banks, the Fed is insulated from political pressures and therefore largely independent. The Fed's extraordinary influence on the economy comes from its unique ability to create and destroy money which has a profound effect on interest rates.

The Fed used its powers to the maximum during the pandemic. By printing more money in early 2020, it pushed its key interest rate to zero and other rates followed to historic low levels. The Fed also helped finance the trillions of COVID relief money by injecting more dollars into the economy. The Fed's goal was to promote spending and borrowing in order to keep the economy afloat during the pandemic.

It can be argued the Fed's medicine worked. An economic depression was avoided, and somewhat surprisingly, personal income rose during the COVID recession and its aftermath. The economy rebounded rapidly and actually expanded in 2021 and 2022.

But the Fed didn't let up on the monetary gas during the recovery. This is because the Fed thought the recovery from the COVID recession would repeat the slow recovery from the "Subprime Recession" of 2007-09. During this time the unemployment rate in both the nation and North Carolina stayed in the high single or low double digits for three years after the recession ended, but the inflation rate remained low. Hence, after the COVID recession, the Fed thought the problem would be high unemployment rather than high inflation.

With hindsight, we can say that the Fed was wrong. And importantly, it did not recognize its misreading of the economy until almost a year after inflation started its upward climb. The Fed's slow course correction is why some economists think it will not be able to achieve its desired "soft landing."

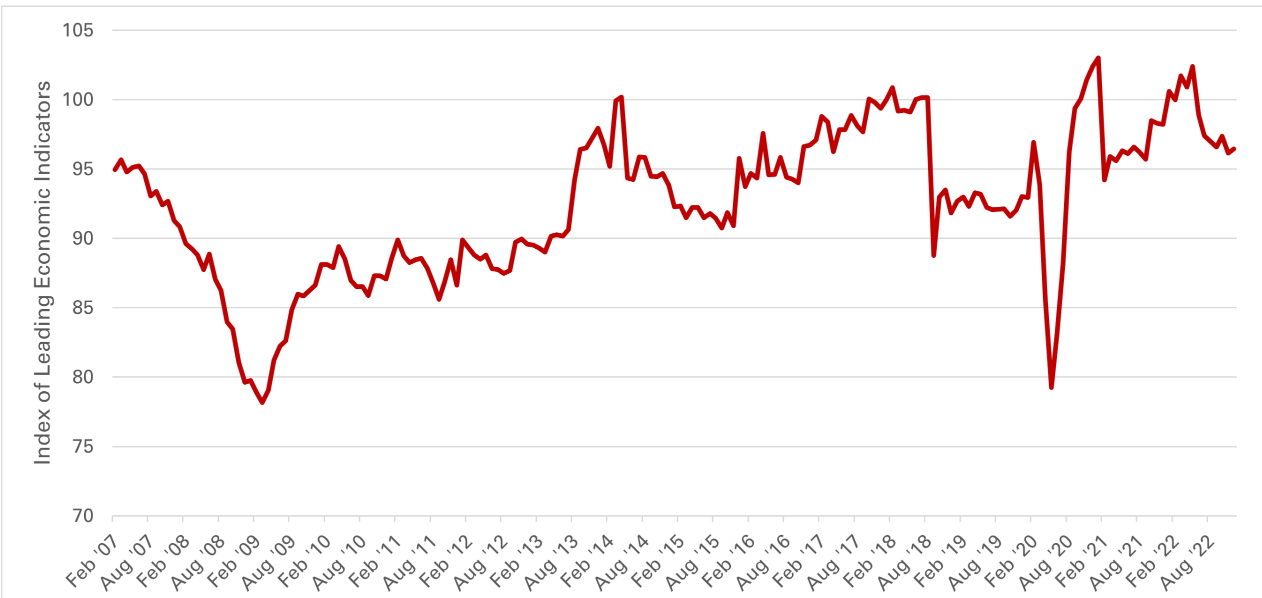
The term "soft landing" is an analogy to an airplane landing safely on the runway. Here, the airplane is a symbol for the economy, and the "soft landing" means the economy slows and inflation is reduced without a crash into a recession. The alternative, a "hard landing," means the economic plane crashes into the runway, implying the economy endures a recession in order to reduce inflation.

Soft landings are possible. Former Fed Chair Alan Greenspan achieved two soft landings in the 1990s, where the inflation rate was reduced without causing a recession. Greenspan had an uncanny ability to predict economic movements. In the case of these two soft landings, he raised interest rates before inflation became too high, hence "nipping inflation in the bud" and avoiding a recession.
Of course, the COVID recession is different, and in many ways, more challenging and unpredictable than its predecessors. Many economists worry the current Fed Chair Jay Powell started the fight

against inflation too late, and therefore it will take a recession to bring the inflation rate down to the Fed's stated goal of 2%. But there are other economists who think a soft landing is possible, especially in light of the recent progress in reducing inflation even while the job market continues to improve. Indeed, these economists believe that even if consumer and business spending contracts, economy-wide layoffs can be avoided as businesses continue to fill the large number of vacant jobs still present in the economy.[2]

The current general consensus among economists seems to be that economic activity will slow in 2023. My leading economic indicators index for North Carolina (Figure 3) clearly suggests slower economic growth in the months ahead. The Index has consistently fallen on trend since May of last year. The big question is whether the slowdown foreshadows a period of slow growth or negative growth, i.e., a recession.

Figure 3. Trends in the NC Leading Indicator Index



Data Source: Author's calculations

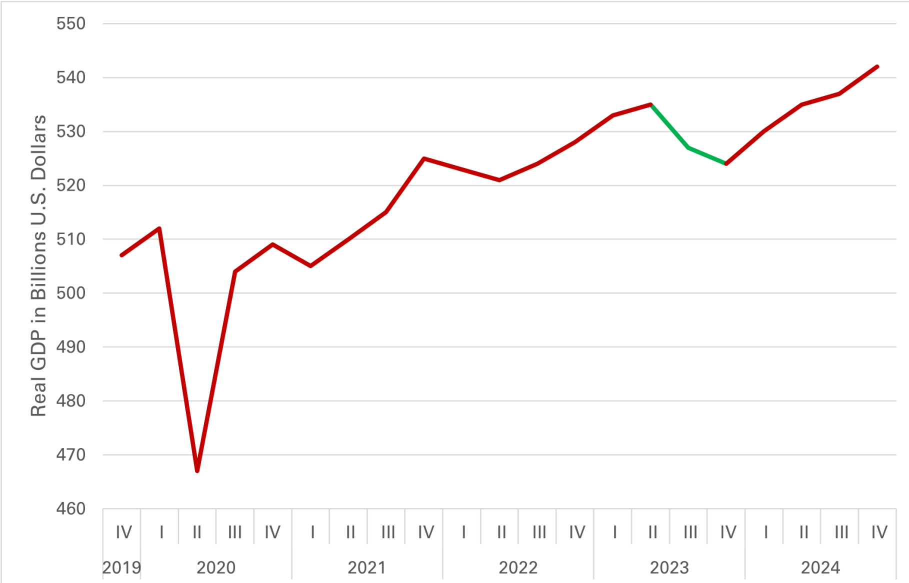
If a recession does occur, the good news is that it will likely be mild. Figure 4 shows my forecast for the 2023 North Carolina economy. Based on my leading economic indicators index, I predict that a recession will happen in the last two quarters of 2023, but it will be relatively mild and followed by a sharp rebound in early 2024 (Figure 4). Unemployment will rise, albeit modestly. I see a 2023 recession causing the unemployment rate to increase from the current 3.5% to 5% or 5.5%. This would be almost one-third the jobless rate in the COVID recession and about one-half the jobless rate in the Subprime Recession. Indeed, it wasn't that long ago that a 5% unemployment rate was the Fed's long-run target and considered "full employment." Nonetheless, we shouldn't forget that even a very modest rise in unemployment to 5% or 5.5% would add 50,000 to 55,000 individuals to the North Carolina unemployment rolls.

NC Economic Growth through Expansion into the Energy Transition

While the 2023 economy may be challenging, the long-run future remains positive, especially for

2 There can always be layoffs in specific industries, as is happening now with the tech sector.

Figure 4. Forecasted Path of North Carolina's Real GDP



Data Source: Author's calculations

North Carolina. Several groups have identified North Carolina as one of the top – sometimes the top – state for business development and economic opportunities. 2022 was another banner year for new business announcements in the state.

Of particular note was a cluster of new announcements signaling North Carolina's growing influence in the nation's energy transition from fossil fuels to renewable energy sources. VinFast, a Vietnamese manufacturer, will build a $2 billion auto assembly plant in Chatham County. Also in Chatham County, Wolfspeed will construct a $5 billion factory making computer chips. Finally, Toyota is committed to constructing a $2.5 billion operation south of Greensboro to make electric batteries. Together, these three companies will employ over 10,000 workers. With their locations between the Triangle and Triad, the companies will be able to draw labor from both metropolitan areas as well as from rural counties north and south of I-40.

At the same time, North Carolina is looking for ways to mine lithium – a key component in electric batteries – in an environmentally friendly way from its significant deposits of the mineral. Together with the new energy-related manufacturing firms, North Carolina is on the verge of developing a major supply chain for new energy.

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