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The U.S. Economic Outlook for 2021–2023
Executive Summary: August 2021

Viral Curveball

This forecast assumes there will be a significant wave of COVID-19 infections this fall driven by the faster-spreading Delta variant. That said, current vaccines remain highly effective against severe disease. As a result of the very high vaccine uptake among people aged 65 and over, we expect that even the more pessimistic projections of the need for healthcare services will justify only moderate restrictions, limiting the economic fallout from this wave of the pandemic.

Confidence Shocker

In August, the University of Michigan's Index of Consumer Sentiment crashed hard, dropping beyond the pandemic low observed in April 2020. The sudden realization by many that the pandemic is not over is the likely culprit. It remains to be seen how this unusual drop, which may have been driven by disappointment and frustration at least as much as by economic expectations, translates to economic activity.

Delta Change to the Outlook

Before the Delta strain became dominant, the economy was recovering briskly. Real GDP expanded at a 6.5 percent annualized pace in the second quarter, exceeding its pre-pandemic peak. About 5.2 percentage points of growth came from a rebound in consumption of services, with consumption of goods contributing another 2.7 percentage points. The labor market was recovering rapidly. The unemployment rate declined to 5.4 percent in July, and an average of 832,000 payroll jobs were added per month in May–July, about 676,000 of which were in the private sector.

This fall, we expect the pandemic to force many schools to go into hybrid/online mode at least for a few weeks, to delay employers' return-to-office plans, and to slightly dampen consumer activity. However, we do not expect a return of widespread government restrictions on behavior. We project a moderate deceleration of output and job growth in the second half of 2021 relative to the pace in the second quarter.

Shortages Inflating

The global silicon chip shortage continues to squeeze vehicle manufacturers. In February–July, the pace of domestic light vehicle assemblies averaged 8.9 million units, far below the 2020Q4 average of 10.5 million. Vehicle demand remained strong, evidenced by a massive inventory drain and sharp price increases. By July, days' worth of dealer supply of new vehicles dipped to the low 20s both for cars as well as trucks (versus a pre-pandemic normal in the 60–80 day range). Many buyers turned to the used market, blowing up prices there. Between March and July, the CPI for new vehicles rose by 5.9 percent, while the used vehicle CPI jumped by a whopping 30.7 percent.

The jump in vehicle prices partly explains the run-up in all-item CPI over the prior year, which registered 5.3 percent in July. With the chip shortage continuing, vehicle prices are unlikely to revert quickly. Additionally, pricing pressures seem to be building in the rental housing market. As a result, consumer inflation is likely to remain elevated in the near term.

In the broader economy, many raw materials remain challenging to procure on time, partly because of transportation bottlenecks, exacerbated by a truck driver shortage. Many manufacturing and service industries report labor shortages, rising wages, and rising prices. Until supply chains stabilize, the pressure on producer and consumer prices is likely to continue.

While not a direct input into the CPI anymore, home prices continue to rocket higher. The Case-Shiller National Home Price Index reading for June showed an 18.6 percent increase over prior year, far exceeding the fastest appreciation during the housing bubble of the mid-2000s or the inflationary period of the late 70s–early 80s. While there are some signs of the housing market moving closer to balance, these trends are likely to be a major concern for the Fed as it at-tempts to balance a fast recovery with financial and price stability.

Unfazed Fed

The Fed is still expanding its balance sheet by 120 billion dollars of Treasury securities and mortgage-backed assets per month. It intends to maintain that pace until "substantial further progress" has been made on its price stability and full employment goals. Longer-term inflation expectations remain reasonably anchored, allowing the Fed to stay the course. Recently, Chair Powell signaled that the pace of purchases could decline later this year.

We believe that the slowdown of job growth we project for this fall will push the start of the taper into early 2022, which will prove sufficient to keep inflation expectations anchored. Still, recent brisk inflation has reduced the Fed's room for maneuver. We think the Fed will begin raising interest rates at the end of 2022.

The Biden Agenda Meets the Moderates

In August, the Senate passed a large infrastructure bill in a bipartisan vote. The bill's fate in the House is tied to the rest of the broader Biden agenda. The House recently passed the agenda blueprint worth 3.5 trillion dollars. However, moderate democratic senators will likely scale the blueprint down. We expect a reconciliation bill with about 2.2 trillion dollars in further spending over ten years, with modest impact on our outlook.

Meanwhile, the debt ceiling is back. While the Democrats could attach it to the reconciliation bill, they have yet to signal their readiness to do so. Although defaulting is highly unlikely, the debt ceiling fight could add more drama to an already action-packed September.

The deficit barely narrows this year, from 13.6 percent of GDP in fiscal 2020 to 13.2 percent in fiscal 2021. The deficit declines more dramatically in 2022 and 2023, to 6.1 and 4.7 percent, respectively.

The 2021–23 Outlook: Catching the Prior Trend

We expect the annualized growth pace to soften to 5.5 percent in 2021Q3, and to slip further to 3.9 percent in 2021Q4 as the pandemic wave moves north. Quarterly growth will rebound to 4.4 percent to start the year 2022, driven by service consumption.

On an annual basis, we anticipate that output will expand by 5.8 percent in 2021 before growing by 4.1 percent in 2022 and 2.6 percent in 2023. Real GDP is projected to catch up with the pre-pandemic growth trajectory by the end of 2023.

Quarterly annualized core CPI inflation moderates over the forecast, falling from 8.1 percent in 2021Q2 to 3.3 percent in 2021Q4 and 2.3 percent in 2022H2–2023. As a result, annual core CPI inflation averages 3.4–3.5 percent in 2021–22 before decelerating in 2023. A rebound in energy prices pushes headline CPI inflation above core for 2021. In 2022–23, headline and core CPI inflation rates converge.

We expect the chip shortage plaguing the automakers to improve by 2021Q4, allowing the sales pace to rebound to 17 million units. Inventories for light trucks may take years to rebuild. In the meantime, prices for new vehicles will likely continue to increase.

Housing starts jump from 1.4 million in 2020 to 1.6 million in 2021, propped up by high housing prices. The bulk of the increase is due to single-family housing construction. In 2022–23, growth moderates, with starts improving by only about 50,000 units combined.

The recovery of payroll employment lags real GDP, with total payroll employment not exceeding its pre-pandemic level until 2022Q4. The unemployment rate continues to fall throughout the forecast, averaging 5.6 percent in 2021, 4.6 percent in 2022, and 4.2 percent in 2023.

	Actual	RSQE Forecast		
	2020	2021	2022	2023
GDP (billions of current $)	20893.7	22990.9	24800.9	26054.4
Real GDP (billions of 2012 $)	18384.7	19459.9	20263.6	20784.7
% change: year-over-year	-3.4	5.8	4.1	2.6
% change: 4th-qtr-to-4th-qtr	-2.3	5.5	3.4	2.4
Nonfarm payroll employment (millions)	142.3	146.1	151.3	154.0
Civilian unemployment rate (%)	8.1	5.6	4.6	4.2
Capacity utilization, total industry (%)	71.6	76.1	78.9	78.9
Inflation (private nonfarm GDP deflator, % change)	1.2	3.9	3.6	2.4
Inflation (CPI-U, % change)	1.2	4.3	3.4	2.3
Inflation (core CPI, % change)	1.7	3.5	3.4	2.3
Light vehicle sales (millions)	14.5	16.6	17.3	17.6
Private housing starts (thousands)	1396.6	1579.8	1623.1	1630.7
3-month Treasury bill rate (%)	0.4	0.1	0.1	0.5
10-year Treasury note rate (%)	0.9	1.4	1.7	2.2
Conventional mortgage rate (%)	3.1	2.9	3.4	3.9
Real disposable income (billions of chained 2012 $)	15676.2	15976.0	15448.9	15855.5
% change	6.2	1.9	-3.3	2.6
Corporate profits after tax (billions of current $)	1908.4	2339.7	2489.1	2635.5
Value of U.S. $ (FRB broad index), % appreciation	1.9	-4.0	0.7	0.0
Current account balance (NIPA basis, billions of current $)	-587.1	-829.5	-809.5	-807.0
Federal surplus (FY, NIPA basis, billions of current $)	-2840.1	-2954.1	-1478.6	-1214.0