Exchanges at Goldman Sachs

Outlook for Global Growth: Less Synchronized, More Complicated

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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research. For this week's episode I'm delighted to welcome back Jan Hatzius, the firm's Chief Economist and Global Head of Research to discuss the economy, takeaways from Jackson Hole and his views on economic growth and inflation. Jan, welcome back to the program.

Jan Hatzius: Hi Allison. Good to be on.

Allison Nathan: So, let's start with last week's Fed conference in Jackson Hole, Wyoming, which is, of course, a closely watched annual meeting held by the Kansas City Fed. What were your key takeaways from the conference? And did anything Chair Powell say surprise you?

Jan Hatzius: Not much, no. It was pretty much in line with what we had thought coming out of the minutes of the last FOMC meeting in July. I think if you take what Chair Powell said and what we saw in the minutes, there are two key points about the timing of tapering of asset purchases. One is that they want to get started this year, which basically means that they probably have to announce by November. And number two, according to the minutes, they will provide advance notice of tapering. Which basically means that they can't really announce it in September. So that really only leaves the November meeting.

Obviously, that could change if we saw, you know, shifts in the economic outlook. Something very negative happening. It would be delayed of course. But our baseline is that we'll get a November announcement and a December start to tapering.

It's a little bit less clear how quick the tapering would occur. We haven't gotten as much indication about that. Our baseline is that they reduce purchases by $15 billion per meeting. So, if they start from $120 billion a meeting, that would basically take them down to zero by October next year. There are some people who want to go faster. But that's, I think, still an open debate. And ultimately, we think it's probably going to be something more like $15 billion.

That would then mean that by the fourth quarter of next year, you could in theory start to hike rates. They're not going to be hiking while they're tapering QE. But for that you would probably need to see significantly higher inflation and somewhat stronger growth than what we have in our forecast. So in our forecast it takes until maybe third quarter of 2023 before you then get the first rate hike. But that's much more uncertain. And it really depends on the economic outlook and what we see in the numbers.

Allison Nathan: So, let's talk about growth. You've had a strongly above consensus call for US growth for much of the year. But you've recently taken your forecast down. What's behind those revisions? And do they mark an important shift in your growth expectations?

Jan Hatzius: Yeah. I think it's always important when there's a change in direction. And there is a change in direction in terms of, you know, both where we are relative to the consensus, partly on the back of our downward revisions. And we've taken 2021 down by about a percentage point. We were at seven or a little above seven. We're now at 6 percent. That's one shift.

On net, the consensus has been revised up in 2021 so far. So, that's why we're not a little bit below the consensus. And if you look at the sequential pace of growth, we now think that the peak is probably behind us. And that's true for the quarterly GDP numbers just about. It's also true for the business surveys. I think those have probably seen the highest levels. And probably are going to decline from here. And that's always going to be an important shift for markets.

What are the drivers of the shifts that we've made? The main driver really has been virus related. The rebound in virus cases in the US has been, certainly, bigger than we had thought several months ago. The impact on activity has still been reasonably limited. But there has been some impact. And we've seen somewhat more as the delta wave has progressed. And, you know, it's probably just going to take longer, especially in the service sector, for activity to get back.

We already saw some signs that, for example, the return to office was pretty slow, even during the period when enthusiasm about vaccinations was probably at a peak. And with this renewed setback, of course, you've got to believe that it's going to take even longer. And we've built that into our forecasts a little bit more.

Then the other thing I'd say is beyond the downgrade that we've made to our numbers, we've always had a pretty subdued growth forecast in the second half of 2022, basically because of the payback for the very large amount of fiscal support that we're getting in 2021. So, we've only got 1.5 to 2 percent sequential growth in the second half of next year. That's not a change. But obviously, as we're moving closer to that, it's also becoming more relevant for markets and for policy makers.

Allison Nathan: And what about other countries outside of the US? We've also been downgrading forecasts there. So, what's driving the weaker growth elsewhere?

Jan Hatzius: In some places, I mean, mainly in Asia. We really haven't made significant changes elsewhere. But in Asia, we've taken down China most importantly on the back of the delta outbreak and, you know, much smaller numbers than in the US. In terms of, you know, virus cases this is a very small fraction. But China is still trying to achieve, basically, zero COVID. And that's meant some pretty significant restrictions on activity in the service sector. So, we now think that third quarter sequential growth is probably only going to be something like 1.5 percent annualized. That's come down significantly.

We do think that as the numbers in China have also improved, again, as far as virus cases are concerned, there will be a significant rebound. Policy makers are providing support. But nevertheless, it's going to leave an imprint in the annual numbers. So, a few tenths less in terms of growth. Not 8.5 percent, but maybe, you know, 8.2 percent, 8.25 percent, those kinds of numbers.

Then we've had some pretty significant outbreaks elsewhere, in Asia as well, more serious in Southeast Asia. And, you know, with very bad health outcomes. And, of course, there are economic consequences as well. And then Australia also saw significant lockdowns. So, it's all been very much COVID-related. And, you know, the news has just been worse than we had expected and than at we had built into our numbers.

Europe continues to do pretty well despite the renewed outbreaks. We, you know, still think that the European recovery is progressing quite well. UK continues to progress pretty well despite the relatively high numbers there. Latin America, the virus numbers actually have been generally better. And that's also shown through in some of the better economic numbers. So, you know, you look around the world and there are lots of different sort of trends and lots of different, you know, virus situations and economic consequences from that. So, it's no longer quite as synchronized on the upside and on the downside as it has been for much of this pandemic.

Allison Nathan: Right. And just a little bit more on that because, you know, we had the big downturn last year. The big rebound this year. And now you talked about we're seeing the peak and deceleration. But can you just put this all in perspective in terms of where are activity levels in the US and globally, relative to where they were pre-pandemic?

Jan Hatzius: Yeah, I would say among the big economies there are three groups. One is China. Stands by itself. It's back at the pre-pandemic trend and has been for several quarters. Now, of course, they're seeing a bit of a setback at the moment. But they're basically at the pre-pandemic trend.

The US is at the pre-pandemic level. Approximately..but basically where it was in early 2020. But at the pre-pandemic level means 2 to 3 percent below the pre-pandemic trend. So, that's sort of the output gap that, at least from a GDP perspective, that you would assess. I think from an employment perspective it's somewhat more. But that's what we see in the US.

And then most other big countries are still significantly below the levels that we saw pre-pandemic. And catching up in some cases, but a long way to go. So, you take the

European countries and growth in Q2 and probably even in Q3 is going to be quite strong. But still going to leave them well short of where they were and certainly where they could have been in the absence of COVID.

Allison Nathan: So, I think I would have described your view coming into the year as very bullish because of the meaningful rebound we were expecting from the, you know, trough of the pandemic last year. How would you describe your view right now globally in terms of how you're thinking about growth?

Jan Hatzius: I would say it's still pretty bullish in Europe. I see a lot of upside potential in some of the places that are still pretty deeply in the hole. And Europe is in that category. I still think that vaccinations are going to make a big difference. We're still finding that the vaccines do a very good job against severe outcomes, despite the fact that against the delta variant from an infection perspective they're not as good as against previous variants. But as more and more of the world gets vaccinated, and activity is still quite depressed in a lot of places, yeah, I still think that we are going to see large amounts of improvement.

We're not as far away from the consensus on that as we were earlier in the year.

And in the US, you know, we're no longer above consensus. I think the recovery is going to continue. But I no longer have a bullish, cyclical view just in terms of the growth output. So, it's a bit more complicated than it has been for really most of the post, you know, March/April 2020 period. And it's a little bit harder to summarize in one word than it was.

Allison Nathan: Another strong view you've held this year is that inflationary pressures would prove temporary. Inflation prints still seem pretty strong. And you've been revising your inflation forecast up at the same time that you've been revising the growth forecast down. So, has your inflation outlook changed?

Jan Hatzius: For 2021, for sure. I mean, we're now looking for, you know, 3.75 for core PCE inflation. And this is mainly US. I mean, it's true to some degree elsewhere, but this is mainly the biggest changes have definitely been in the US. 3.75. And you know, that's far above where we were earlier in the year when, you know, generally we were looking to sort of 2.5 percent or so. So, you know, big upward revision.

I think in terms of characterizing what kind of inflation we have here, I don't think it's really been a change. Still looks very temporary, just as temporary as it did previously. We have not made changes, any meaningful changes to our 2022 inflation forecast. Still have core PCE inflation go back to 1.8 percent. That's almost identical to what we had previously.

Now, of course, if you look at average inflation, average inflation is much higher. So from the perspective of monetary policy, you know, in an average inflation targeting framework, you know, 2021, I'm not just bygones. That will have an impact on, you know, effectively the hurdle rate as inflation overshoot is going to have an impact on the hurdle rate that the Fed is going to assess in deciding when to hike.

Now, there is a little bit of a wrinkle here because in addition to the average inflation targeting framework, the

Fed also has forward guidance in place in the FOMC statement that basically says you have to be at 2 percent for hiking the funds rate. And that's a spot perspective. So, if you're below 2, I don't think they're going to be hiking, you know, unless they decided to actually change that forward guidance. And I think they're going to be pretty reluctant to do that. But I don't think you're going to have to be far above 2 percent for them to hike. You know, if we were at, say, 2.1 or 2.2 percent in late 2022 instead of 1.8, which is our forecast, it's not that huge a difference. But I think it could have important implications for the liftoff point that would move forward probably by several quarters.

Allison Nathan: So, let's talk about job growth. There's been this narrative that federal unemployment insurance benefits have kept people out of the workforce. It's basically allowed people to make as much money staying at home receiving benefits as going to work. So, as these benefits end, you know, what do you expect for the labor market?

Jan Hatzius: Well, we've seen a good pick up in job growth in the last several months after some initial disappointment in the spring. The June employment report was very firm. I think what we're going to find is that the extended unemployment benefits and the $300 per week top-up, you know, did have quite a large impact on curtailing labor supply. We looked at the experience of, you know, losing these benefits in a number of states. Not just by comparing the Republican states that cut the benefits and the Democratic states that didn't, but actually looking at the micro level at individuals that are otherwise identical that lost benefits versus individuals that didn't lose benefits. And we found a pretty meaningful statistically significant effect. So, to us, that suggests that as these benefits end at the federal level, over the, you know, September, October, November period, we should see a substantial amount of additional job growth. And we've said 1.5 million in total on the back of that expiration that should show up in the payroll numbers.

I think the unemployment rate is going to come down a lot. Participation rate over time, I still think, is going to rise from here. But I think that's going to be a slow process. And we've actually scaled back to some degree our expectations for how quickly the participation rate normalizes. And, you know, I think even a year out or two years out, participation is probably still going to be somewhat below where it would have been in the absence of the pandemic.

Allison Nathan: So, what does this all mean for wages, the fact that we have seen companies struggling to find workers? Some of that might be abating as you said. But ultimately, do we think that wages are going to continue to grow here as companies need to raise them to attract workers?

Jan Hatzius: Yeah, I think they're going to continue to grow. What they're not going to do, I think, is grow at these extremely rapid rates at the bottom end of the pay distribution. If you take a production and non-supervisory workers in leisure and hospitality who, on average, make $15 an hour, we've been seeing wage growth rates at an annualized pace of 25 to 30 percent in the last three to six months. You know? Obviously far above anything we've seen in many decades, or actually ever, in this data. And that's not too surprising. Because if you make $15 an hour with the $300 top up, you know, people are basically as well off or better off from a take-home pay perspective not working than working. So, I mean this is sort of what you should expect. That then get enormous competition for these workers. And big increases in pay.

I think as those benefits end, we'll get much lower wage growth rates. I don't think we'd get outright wage declines. Wages tend to be quite sticky to the downside. So, I don't think you're going to be cutting their wages. But I also don't think you're going to have this kind of wage growth elsewhere, you know, higher up in this income distribution towards the, you know, $25 and $30 dollar per hour rates. I mean, there wage growth rates have been reasonably firm but not out of line with what we've had in the past. I mean on a composition-adjusted basis, we've seen about 3.5 percent wage growth more in the middle range of the income distribution. You know, I think we'll probably continue to see numbers in that sort of range. And, you know, steady wage growth. And if we can see substantial job growth, then that probably is going to accelerate somewhat from there.

Now, is that a pace that is sustainable? Probably sustainable. I mean, we've seen pretty good productivity growth. But in general, the productivity news has been pretty good. So, I think we should be able to sustain somewhat higher wage growth rates than we had in the last cycle, maybe on a sustained basis in coming years.

Allison Nathan: So, let's end on the big picture again. We've talked a lot about the virus, obviously a key determinant of the outlook. But you know, what do you see as the biggest risks to the US and global economic expectations we've discussed?

Jan Hatzius: I mean I wish I could say something other than the virus. But the truth is COVID variants and additional negative news on, you know, variants that are more infectious and escape vaccination, that's still the biggest risk. I mean, you look at delta, you know, in some ways it's been a negative surprise. But at the same time, the vaccines still work, you know, pretty well from a hospitalization perspective. And of course, we could see a variant that is even more dangerous because the vaccines might not work as well from a severe disease perspective. I mean I'm not predicting that. You know, I don't know. I don't think the medical experts really know. But that is the downside that I think we have to have our eye on.

You know, there are a number of, you know, obviously risks that may be a little bit closer to the usual ups and downs of the cycle that are also relevant. I mean, the fact that fiscal policy is coming off of this extremely simulative level. And that we're also certain to see a significant negative fiscal impulse. I mean, that poses some risks as well. And I do think it's going to have an impact.

But the bigger one is still going to be COVID. And some countries are going to be better placed to deal with that than others. Again, I do think that vaccination is still progressing pretty well. We're going to have, we think, 50 percent of the global population fully vaccinated by the end of the year. That's roughly our timeline. That obviously makes a very big difference. But we're also seeing higher infection numbers than we had hoped, you know, three months or six months back. So, that race is more acute in some ways than perhaps we had thought not that long ago.

Allison Nathan: So, let's hope, Jan, that we don't see a very negative turn in the variants. Thank you so much for joining us. It's always great to hear your insights on the global economy.

Jan Hatzius: Thank you so much, Allison. I'll talk to you soon.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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