*2023 Economic Outlook: Major Challenges After Year of Solid Growth*

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As the Covid-19 pandemic moved to the back burner in 2022, the world, the country and the state of Connecticut wrestled with a new host of challenges that will continue to shape the economic outlook for 2023. Chief among them: the highest rates of inflation in over forty years, aggravated by Russia’s war against Ukraine which has injected uncertainty in global commodity markets for energy and food. Meanwhile, central banks around the world are raising interest rates to tame price pressures—an effort that will inevitably chill economic growth going forward.

**The Global Economy**

Following a 6.0% rise in world output in 2021, the International Monetary Fund (IMF) projects that global growth will slow to 3.2% 2022, and moderate further, to 2.7% in 2023. The IMF outlook hinges on the assumptions that: inflation expectations will not become unmoored; the worst of the dislocations created by Russia’s invasion of Ukraine are behind us; and monetary authorities do not tighten policy to such an extent as to engender widespread recessions and upheavals in financial markets. Though an actual decline in world output does not appear to be in the cards, IMF forecasters anticipate that more than 40 percent of the world’s economies that report output data on a quarterly basis will experience a so-called “technical recession” of two or more quarters of negative GDP growth.

These topline projections, however, mask a wide gulf between the emerging and developed worlds. For the advanced economies, including the United States and Western Europe, where GDP rebounded by 5.2% in 2021 following its 4.4% plunge during the pandemic, output is expected to grow 2.4% in 2022 (slightly above its 20-year annual average of 2.1%) but by only 1.1% in 2023. High inflation will eat into purchasing power and rising interest rates will crimp consumer spending and business investment. In emerging markets, by contrast, where the toll of the pandemic was far less severe (output fell just 1.9% in 2020) and the 2021 rebound, at 6.6%, was brisker, output is expected to grow by 3.7% in 2022 and to maintain that pace in 2023. That growth rate, however, is significantly below the 20-year trend of 5.2% annually.

In 2022, the world’s economies faced the highest inflation rates in decades as the rebound in demand that began in 2021 continued and consumers rebalanced their spending patterns away from goods and toward services. At the same time, as the Covid pandemic receded, the unprecedented monetary and fiscal policy supports that nations had erected during the pandemic were withdrawn, slowing the growth in global economic output. Russia’s aggression contributed to both rising prices for food and fuel and to falling output growth. These developments created a quandary for policymakers: how to deal with rising inflation even as economic activity was already cooling?

Central banks around the world moved quickly to raise nominal interest rates to prevent inflation expectations from becoming embedded in price and wage dynamics. The U.S. Federal Reserve led the world with federal funds rate increases totaling over 4 percentage points, the Bank of England has followed with a more than 3-point increase in its benchmark rate while the European Central Bank raised rates by more than 2 points. Amid such a concerted effort, the IMF notes that the risk of “monetary, fiscal, or financial policy miscalibration has risen sharply” and that overtightening could push the “global economy into an unnecessarily harsh recession.”

Still, while the IMF does anticipate a global slowdown, it does not expect a global recession in 2023. Despite the rise in real interest rates (nominal rates less the rate of inflation), real borrowing costs remain below pre-pandemic levels. And labor markets generally remain tight, at least when measured by the ratio of job vacancies to unemployed workers.

About half of the slowdown in world output is accounted for by the three largest economies—the U.S. the Eurozone and China—plus Russia, and the IMF expects that to hold true in the outlook period as well. In Europe, the growth slowdown between 2021 and 2022 was relatively modest, with output growth dropping from 5.2% to 3.1% in the Euro area and from 7.4% to 3.6% in the UK. But output growth is expected to fall precipitously in 2023 to 0.5% in the Eurozone and to 0.3% in the UK. More than most, the economies of Europe are particularly imperiled by the effects of the war in Ukraine. Russia has reduced energy exports to Europe by more than 80%, spiking energy costs and, as the IMF sees it, raising uncertainty, hampering economic activity, particularly in manufacturing, while taxing both consumer and business confidence.

In China, by contrast, the Covid pandemic still casts a long shadow. Amid widespread lockdowns under the county’s zero-Covid policy, output growth plunged by nearly 5 percentage points, from 8.1% in 2021 to a projected 3.2% in 2022. The lockdowns have not only slashed domestic demand, but by cutting capacity utilization to below 76 percent, they have crimped exports, delayed the full opening of global supply chains, and added to inflationary pressures. The IMF projects a modest rebound in 2023, to 4.4%, but that was before China’s sudden reopening and rash of new Covid outbreaks. China’s new policy might hamper its economic performance in the short run, but it should help the country to put the pandemic in its past sooner rather than later.

**The U.S. Economy**

For the U.S., the IMF expects real GDP growth to weaken from a projected 1.6% in 2022 to 1.0% in 2023. The IMF is not alone in its expectation that the US economy will cool further as it enters 2023 and in fact seems to be relatively optimistic in its outlook. The Federal Reserve Bank of Philadelphia’s latest Survey of Professional Forecasters (SPF) projects that the that U.S. economic output will grow by just 0.7% in 2023. The Wall Street Journal’s (WSJ) own survey of professional economists is more pessimistic still, expecting 2023 real US GDP growth to clock in just shy of 0.5%. Meanwhile, IHS-Markit (formerly Global Insight) predicts that output will inch up 0.3% and the Conference Board—better known for its survey of consumer confidence—anticipates zero growth in real U.S. GDP.

The roundup of forecasts for what lies ahead for the US economy may not be exhaustive, but it conveys the expert consensus that growth is expected to decelerate abruptly if not stall altogether.

Besides the expected slowdown in GDP growth, the other most salient economic challenge for the US economy remains the topline, all-items inflation figure which averaged more than 8 percent in 2022 and reached a high of 9 percent on a year over year basis in June, the fastest pace of price increase since 1981. Inflation has since cooled to 6.5 percent in December but remains higher than it has been at any time in the last forty years. Economists generally anticipate that the US will make significant progress toward bringing inflation closer to the Federal Reserve’s 2 percent target. Expectations for the average US inflation rate in 2023 range from 3.5 percent for the IMF, 3.1 percent for the SPF, and 2.6 percent for the WSJ.

Facing the most inflationary environment in decades, the Fed has pursued an aggressive rate-hiking policy. In a quick succession of increases, the Fed took its benchmark federal funds rate from 0.125 percent where it had been since the start of the pandemic, to a new targeted range of 4.25 to 4.5 percent. Expect the Fed’s tightening to continue in 2023 albeit at a less aggressive pace. Although technically, the federal funds rate is the rate that banks charge each other to trade reserves overnight, the practical effect of the Fed’s actions is to raise the rates that households and firms pay for all manner of borrowing.

Comparing early 2022 with year’s end, interest rates on 60-month loans for new cars jumped from 4.5 to 6.6 percent and 30-year fixed mortgage rates more than doubled from 3 to 7 percent. Existing home sales, which had shot up by more than 60 percent from the depths of the pandemic, from 4.1 million to 6.5 million units at an annual rate, have reverted to their pandemic-era nadir while prices, which had soared more than 40 percent over the same period, appear to be settling back to earth. And the stock market, having set out on a tear as the economy recovered from the pandemic, approached bear territory at the end of 2022 as investors sought the relative safety of interest-earning assets.

Despite the swoon in output and asset prices, the labor market has shown surprising resilience. Nonfarm jobs ended 2022 by growing at about 250 thousand monthly. Though slower by half compared with earlier in the year and for all of 2021, that pace of job growth still outran the average in the long expansion leading up to the pandemic. Forecasters anticipate much slower job growth in 2023, on the order of about 30 thousand per month. At less than 4 percent, the unemployment rate remains at record lows, and despite the expected slowdown in new jobs, analysts expect little more than a one-point increase in the jobless rate in 2023. That’s because employers are struggling to fill the openings they have now, with a record two job openings for every unemployed worker. For perspective, it is far more common for that ratio to be reversed, one job opening for every 2 unemployed workers, so labor remains in exceptionally short supply across industries, a fact that should cushion the blow to the labor market from any continued overall slowing in the economy.

Regionally, states in the southern and western reaches of the country have fared best in the latest recovery and have largely regained the jobs lost during the pandemic. As IHS-Markit notes, these states saw shallower job losses and fewer restrictions on activity during the height of the pandemic. What’s more, they generally enjoy lower costs and warmer climates making them a draw for new residents. IHS anticipates that these same states will lead the country in growth going forward, although the more rapid post-pandemic increase in house prices in southern metro areas will somewhat blunt their cost-of-living advantage.

By contrast, states in the Northeast and Great Lakes regions have lagged in their recoveries and have yet to return to their pre-pandemic levels of labor market activity. After shouldering an outsized burden of job losses during the pandemic, these states have been rewarded with only a tepid rebound. Their higher costs and colder climates discourage in-migration, and their older populations are less inclined to participate in the labor force. So, the shortage of labor that hobbles these states today is expected to continue into the outlook period and beyond.

**The Connecticut Economy**

Connecticut’s economy showed steady improvement in 2022 as the state added nearly 40,000 jobs, cut unemployment to 4%, and expanded real output by 1.8%, according to the most recent quarterly data. State GDP has returned to its pre-pandemic levels and jobs nearly so, though both remain shy of their 2008 high-water marks. The state’s labor market is remarkably tight. Usually, unemployed workers outnumber available jobs; today there are three openings for every two jobless residents. While forecasters are divided about the possibility of the U.S. economy entering a recession in 2023, if there is a national recession or even a significant slowdown in national job growth, Connecticut could surrender some of the gains it has made in its ongoing recovery from the Covid-19 pandemic. A national recession or slowdown is possible due to climbing interest rates to tame inflation, lingering Covid kinks in global supply chains, and Putin’s brutal war on Ukraine which has roiled commodity markets.

IHS Market, one of the more pessimistic forecasters surveyed above, projects that Connecticut’s 2023 job count will exceed its 2022 number by fewer than 11,000—a far cry from the 40,000-plus job gain notched between 2021 and 2022. But those annual averages obscure the underlying month-to-month and quarter-to-quarter changes that IHS anticipates will be negative as the state moves through the year. By 2023-Q4, IHS forecasts that nonfarm employment will be 16,000-jobs lower than in 2022-Q4. Such estimates are in line with a recent survey of state forecasters by the *Hartford Business Journal*. The economists polled expect that Connecticut could gain as many as 25,000 jobs or lose as many as 16,000 in 2023.

The education and health services sector will fare far better than average, according to IHS, even outperforming its recent gains. Demand for these social services is shaped by larger demographic forces, plus the sector is still making up for ground lost during the pandemic. The state added 4,300 jobs in this sector in 2022, mostly in education, and is expected to add another 9,500 in 2023 (nearly 90 percent of the overall job increase for the state). In 2023, most of the gains will accrue to the health services side of the sector.

Faring much worse than average, will be the administrative, support, waste management and remedial services side of the business services “supersector.” Jobs in this sector provide routine support for the day-to-day activities of other businesses (e.g. office administration, clerical services, cleaning, etc.). So, it stands to reason if the overall economy is wobbling, jobs in supportive services will take a spill. The sector grew by nearly 2,000 jobs in 2022, but IHS expects 5,000 fewer jobs in 2023. Incidentally, other jobs in the business services sector, particularly those in professional, scientific, and technical services which involve considerable expertise and training and command among the highest wages in the economy, are expected to continue to grow in 2023, although at a reduced pace.

The state’s flagship financial activities and manufacturing industries could face some rough sledding in 2023 according to IHS. While Connecticut remains a financial services leader, jobs in this sector will continue a long slide that traces back to the 2008 financial crisis. And the jobs lost will carry with them an outsized share of purchasing power as the sector is tops in the economy for average wages. The sector will also account for the biggest drag on state output growth, which is expected to be flat in 2023. In the also high-value-added manufacturing sector, jobs rebounded briskly in 2022 from their 2020 Covid-related losses but are expected to stall in 2023. The generally rising tide of defense contracts for aerospace equipment and shipbuilding in recent years is buoying the transportation equipment sector and will help to offset anticipated losses in machinery and other durables this year. The IHS forecast may be too pessimistic both in general and in particular with regard to Connecticut manufacturing. Many national forecasters are predicting faster U.S. growth (really less of a slowdown) than IHS is predicting. In addition, the structure of the manufacturing industry in Connecticut makes it less vulnerable to the national slowdown that IHS is forecasting.

**Conclusion**

Despite the War in Ukraine, the ongoing effects of the Covid pandemic, higher inflation, and the decisions by central banks to raise interest rates, the global economy grew in 2022 and is expected to grow in 2023 although at a slower pace. The U.S. and Connecticut are to share in that growth (and the slowdown). While many expect a recession, it could be short and shallow enough to leave 2023 annual average GDP and employment in positive territory. The U.S. and Connecticut had solid job growth in 2022 and ended the year with low unemployment and a large number of job openings. And if the nation can avoid a recession or significant slowdown this year, Connecticut is poised for continued —although slower—job growth in 2023. n