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With Recoveries Like This, Who Needs Recessions?

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The U.S. economy grew at a 4% pace in the fourth quarter of 2020 after surging 33.4% during the third quarter. That marks two consecutive quarters of gains, which many use as a rough rule of thumb to declare the economy in a recovery instead of a recession. This is despite the fact that the economy was still down 3.5% for all of 2020, the weakest pace since 1946 when the end of WWII brought a halt to defense spending and millions of soldiers home from abroad. That definition of a recovery begs the question: With recoveries like this, who needs recessions?

We are still nearly 10 million jobs in the hole since the peak in February 2020; those figures do not include the self-employed. That is more than the 8.8 million jobs lost during the height of the 2008-09 recession.

Unemployment fell to 6.3% in January but that is an undercount. It does not include the unprecedented drop in participation in the labor force since February. Close to four million people have stopped looking for work entirely, mostly women of color who were forced to quit working to care for children who are now learning online instead of in school. The actual unemployment rate when those workers are added back into the mix is closer to 9%.

This is why the National Bureau of Economic Research (NBER), the official arbiter of the timing of business cycles, has not yet declared an end to the COVID recession. The process is much more nuanced and requires more certainty about the course of the economy than we are currently seeing.

Executive Summary

The economy is still recovering from the pandemic but could post the strongest gains since 1984 in 2021. Much of that strength depends upon our reaching herd immunity by early fall, which is looking less likely. Mutations and the slow ramp-up in vaccinations suggest that COVID may be something we learn to manage instead of eradicate. That means that it will take even longer for a full reopening of the economy.

More people are likely to remain unemployed for longer, even as we find ways to congregate with some level of social distancing still in place. The nonpartisan CBO estimates that it will take until 2024 before we reach the precrisis peak in employment. Hence, the need for a more coordinated response to COVID mitigation and vaccinations, support to financially distressed households, stimulus checks, transfers to the states and aid for small businesses.

Most economists support more aid, as does the public. Some fear a spike in prices triggered by easy fiscal and monetary policy. The Federal Reserve would look past a temporary spike in inflation tied to an unleashing of pent-up demand. Risks of a more systemic rise in inflation and interest rates are much lower. Others worry about rising federal debt and deficits. The lessons of the 2008-09 recession were that austerity cost us more than it bought us in terms of economic stability.

The biggest near-term threats are mutations of the virus, the slow rollout of vaccinations and limits of vaccine sales to developing countries. Vaccine nationalism and slow uptake of vaccines up the ante for mutations. We very likely will have to rely on annual vaccinations, testing, tracing, therapeutics and mitigation efforts to suppress outbreaks. COVID is currently about ten times more lethal than the flu and leaves at least 10% of survivors with long-term health effects which could curb their ability to work and increase their risk for fatality.

The economy will reopen but may retain more work-from-home and social distancing than we all would like. I don't miss crowds but I do miss the warm embrace of family and loved ones whom I can't see as often as I once did. Technology is a bridge to stay connected but pales when compared to in-person interactions.

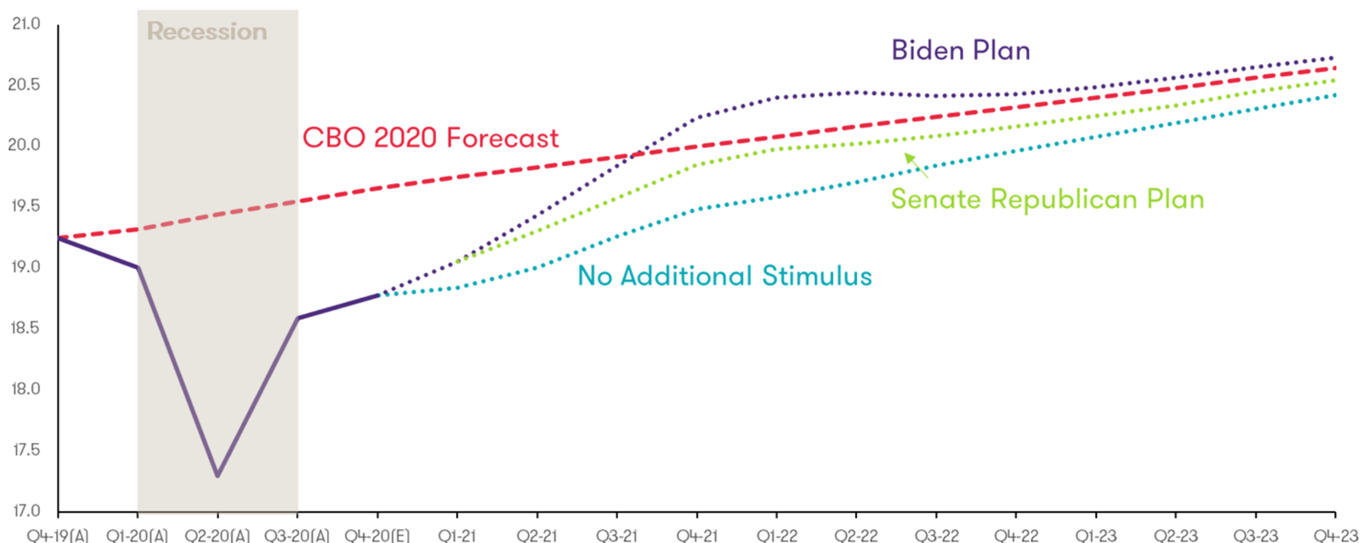
The economy that emerges may not be quick to reemploy all who were displaced by COVID. The pandemic has acted as an accelerant to automation, which is swelling the ranks of workers permanently displaced by the virus; many will need training to fill new jobs. This is at the same time that kids are losing ground in their education; many have dropped out. More will need programs to help catch up on the year(s) lost to the pandemic. Educational losses tend to be nonlinear and compound without the help of catch-up programs, including individualized instruction.

These shifts, combined with the desire to do more than fill the holes created by COVID and instead pave the way for a faster and more complete recovery, have shaped the debate on fiscal stimulus. The plurality of economists - regardless of political stripe - now believe that ultra-low interest rates have provided us with the means to do more to help the economy heal and achieve a higher trajectory of growth. That means more aid, stimulus, investments in infrastructure and an effort to reduce the hurdles that leave large pockets of the most marginalized and unfairly penalized workers unemployed.

"We want an economy where everybody can take part... that's how the U.S. economy can be bigger, stronger, growing faster," Federal Reserve Chairman Jay Powell said in reply to a question on the need to reduce the inequality that the pandemic has exposed and exacerbated.

This edition of ***Economic Currents*** takes a closer look at the current proposals for additional fiscal stimulus, the trade-offs they represent for growth and inflation and why we will never look back and wonder why we did too much to dress and heal the wounds created by COVID. We could look back with regret and ask why we didn't do more. Austerity held us back in the past; we can't afford another such mistake given the stakes.

Chart 1



Source: Edelberg and Sheiner, 2021a; Bureau of Economic Analysis

Two Proposals

The Case for More Aid

Chart 1 compares the impact that the new administration's package could have relative to the smaller package proposed by a group of 10 Republicans in Congress. The analysis was done by the Hamilton Project at the Brookings Institution. Wendy Edelberg, who heads the Hamilton Project, was the chief economist for the nonpartisan Congressional Budget Office (CBO) and is well versed in fiscal policy, how well different kinds of spending and tax cuts work and how they impact our federal debt and deficits.

Wendy and her colleagues updated the analysis with CBO's most recent forecast for the U.S. economy, which shows the U.S. growing at a 4.6% pace in 2021, its fastest pace since 1999. But employment lags overall GDP and is not expected to reach its pre-pandemic high until 2024. That is abysmal and why additional aid is needed.

One thing stands out about the two plans. The more aggressive administration plan puts growth above the trajectory we were on prior to the crisis. That allows for a catch-up and pushes the economy above its potential by year-end and through 2023. There are two reasons for the discrepancy between the Biden plan and the proposal by Senate Republicans, which go beyond the dollar value of the plans.

Table 1 shows that more of the funding will end up in the hands of the most financially distressed households, which has the largest bang for the dollar in terms of payoff for overall GDP growth. The Hamilton Project research suggests that those outlays will actually pay for themselves over the course of the next three years, given the high propensity to consume among the hardest hit households.

Next up is aid to the states, which is crucial if we hope to sustain employment gains. States are large employers. In the wake of the 2008-09 recession, state and local cuts are the primary reason the rebound in jobs was not more rapid in the wake of that recession. We can't afford to make that mistake again.

Direct aid to households has smaller fiscal multipliers. The more targeted aid to lower-earning households in the Senate Republican plan has higher multiples because more of the money will be spent instead of saved. This is why the administration is looking at scaling back the income threshold for people who get stimulus checks.

Dead last on the list is aid to businesses, which did not prove to be particularly effective in saving jobs and livelihoods. That said, those multipliers ignore the blow to dynamism and rise in firm consolidation triggered by the pandemic. Those shifts could undermine the job-generating capacity of the economy.

Table 1

Multipliers High to Low

Biden Plan	$1.9 Trillion	Senate Republican Plan	$618 Billion
Aid to Financially Distressed Households	$400 billion	**Aid to Financially Distressed Households**	$144 billion
$400 per week supplements to UI benefits		$300 supplements to UI benefits thru 6/30	
Continuation of expanding pandemic UI			
Supplements to cover food and shelter costs			
Health insurance subsidies			
Aid to State and Local Governments	$350 billion	**Aid to State and Local Governments**	NA
COVID Containment and Vaccinations	$400 billion	**COVID Containment and Vaccinations**	$204 billion
Funds for Vaccinations, Testing, Tracing, Reopening		Funds for Vacinations, Testing, Tracing, Reopen	
Schools, Broadband, Public Transit, VA and Mental Health		Schools & Child Care	
Direct Aid to Families	$600 billion	**Direct Aid to Families**	$220 billion
$1400 Stimulus Checks, Child Care, Tax Credit Expansion		$1000 Stimulus Checks, Lower Threshold on Income	
Aid to Businesses	$150 billion	**Aid to Businesses**	$50 billion
Child Care Providers, Grants and Loans to Small		Loans and Grants to Small Businesses	
Businesses, Paid Sick Leave			

Separately, the authors of the study are careful to point out the outsize role that COVID mitigation efforts and vaccinations will play in managing the virus. They assume with the CBO that herd immunity will be achieved by October with more federal funding and coordination. That timeline looks aspirational and less attainable, given the recent mutations, divisiveness over masks and the logistical nightmare of administering not one but two vaccine doses.

Our contacts in Washington believe we will end up with something close to the size of the White House plan, by the process of reconciliation, which requires a simple majority in the Senate instead of a bipartisan deal. The total is expected to be scaled back, as moderate Democrats push back on its size.

We expect another $1.5 trillion in aid. That is before the State of the Union address when the president is expected to push for infrastructure on top of an aid package. That will take significantly longer to work its way into the economy, if it can be passed.

A More Realistic Outlook

Chart 2 shows our outlook with 1.5 trillion in additional aid. We also assume a slower lifting of social distancing measures that gets us above our previous trajectory in 2022 and 2023.

The discrepancy is largely due to the late start of vaccinations and the risks of additional mutations. Social distancing, working from home, an inability to reengage the millions who have slipped into long-term unemployment and the need to recoup educational attainment lost to the pandemic represent a few of the hurdles we will need to overcome.

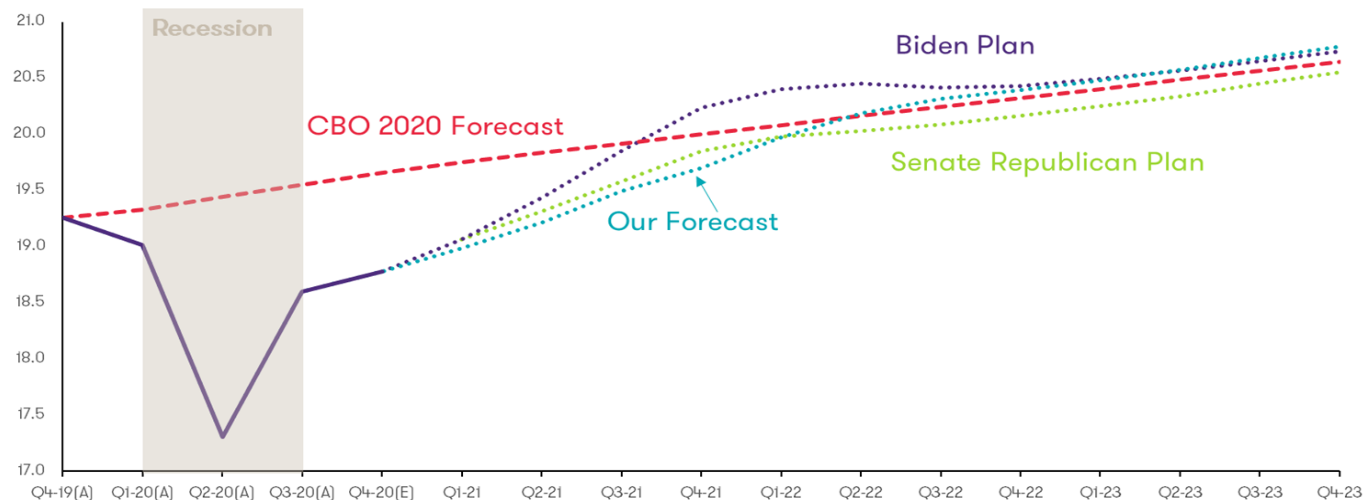
The primary driver of gains is the surge in saving and pent-up demand we unleash once social distancing is eased. The magnitude of those gains depends heavily upon several factors:

- how concentrated saving remains among the highest-income households;
- the aging of the population; and,
- the extent to which people feel safe enough to resume the kind of congregating they did prior to the pandemic.

High-income households may drain some of their savings to take a more luxurious vacation. That alone can't trigger a return to normal, whatever that may be.

Older workers were starting to save more for retirement. There is no reason to believe they will drain all of their saving post-crisis.

Chart 2



Source: Edelberg and Sheiner, 2021a; Bureau of Economic Analysis, Grant Thornton LLP

Younger workers, who have a higher propensity to spend, will have to wait until they feel safe to congregate. It will take some time before they can attend conferences, concerts and sporting events.

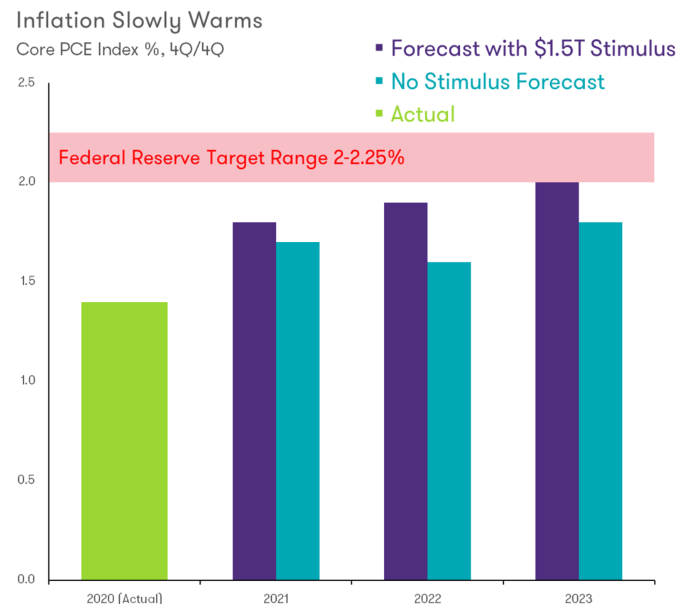
Risks. A failure to stimulate enough to get us back to the previous growth trend could leave even more people behind. Many have suffered a blow to their education and earning potential, which could become generational. Students are already losing up to a full year of math to school closures and the shift to online learning. This is why I prefer more funding for education and training in the aid package. Rising inequality will, in turn, diminish our potential to grow.

This is in addition to the research that reveals that the stress of debt and hunger can undermine educational attainment and productivity growth. That is why the CARES Act was so important. It enabled people to pay for food and shelter, and retire their debts, which supported a stronger initial rebound in growth.

Inflation Warms

Chart 3 compares inflation before and after actionable stimulus. Core PCE inflation heats up faster than it did without additional stimulus but remains within the Fed's now higher comfort zone through 2023:

Chart 3



Source: Bureau of Economic Analysis, Grant Thornton LLP

> "We want an economy where everybody can take part… that's how the U.S. economy can be bigger, stronger."
>
> \- Federal Reserve Chair Powell

- Global growth is expected to remain uneven as developing countries find themselves left out of the vaccine bonanza. This will take a toll on global growth and travel and tourism.
- Any surge in prices tied to supply shortages and triggered by the unleashing of pent-up demand is expected to be transitory.
- Workers lack the bargaining power they once had via union membership to negotiate the large wage gains that triggered wage-push inflation as in the 1970s.

Most economists agree on running the economy hot, with inflation picking up a bit, for the first time in nearly 40 years. They have an ally in the Federal Reserve, which has determined that a little inflation is worth the price if it includes more broad-based employment and wage gains. "I'm much more worried about falling short of a complete recovery, and losing people's careers and lives that they built…than about the possibility which exists of higher inflation. Frankly, we welcome slightly higher inflation… The kind of troubling inflation that people like me grew up with seems far away," Fed Chair Powell said during his January press conference.

Risks. A vicious cycle in inflation could still emerge if the recovery delivers a lot more wage gains than we expect. We would need to see a fundamental break in inflation expectations to trigger the kind of inflation we saw in the past. That is possible, just not probable.

Fed Holds the Line on Rates

The Federal Open Market Committee (FOMC) has made clear its stance on inflation. Members of the FOMC will gladly accept a modest overshoot in inflation and look through any transitory spike in prices to reach lower unemployment faster. They are looking for more inclusive employment gains that will allow those at the bottom of the pay scale to catch up on wage gains.

Fed Chair Powell has also made it clear that the FOMC would welcome a warming trend tied to a much more robust rebound in employment. They have more tools to counter an unwanted surge in inflation than a more systemic cooling. As he noted in his press conference following the FOMC meeting in January, that is a development he would appreciate.

Risks. A sustained rise in inflation would cause the Fed to raise rates, which would rein in inflation but raise the cost of debt. The latter is important because of the sharp increase in debt triggered by the crisis; what is currently serviceable may not be for long. Low interest rates have played a key role in delaying but not eliminating bankruptcies, which tend to lag business cycles.

Bond Yields Move Higher

Bond yields are expected to rise above 1% again in 2021 and edge above 1.5% in 2022. That is a big shift from where they are today but still well below the pace of nominal GDP growth. Why is that important? Because debt that costs less than the pace at which the economy is expanding is much easier to service than debt which is both rising and costing more to service.

Indeed, one of the largest offsets to the doomsday scenarios for federal debt laid out by CBO has been falling interest rates. Economic theory told us that inflation and debt costs would rise in a world where debt was more prevalent. What that theory missed was the reality of globalization and the privilege of having a reserve currency (the dollar) in a world awash in debt. We underestimated the disinflationary shock associated with globalization and the unprecedented pace of technological change.

Risks. No one knows the exact point when our debt burdens will become unbearable, which is why we should be thinking about ways to reduce the debt, the minute we clear this crisis. I have joined ranks with economists of all stripes to support more aggressive aid, stimulus and infrastructure investments but do so cautiously. I have deferred, not abandoned, my concerns about getting onto a more sustainable debt path.

The Federal Reserve, which has already expanded asset purchases aggressively, may choose or be coerced into doing a lot more. This was the case in the wake of WWII. Inflation spiked into the double digits as the economy slipped into recession. We were able to right the ship in part because the Fed stood its ground on its independence with help from an unlikely ally, a presidential appointee at Treasury.

I have a lot of faith in the integrity of new Treasury Secretary Janet Yellen and her understanding of the need for an independent Fed, given her tenure at the Fed and the criticism she endured. I don't trust the rhetoric emanating from either side of the political aisle when it comes to the Federal Reserve.

Bottom Line

The world that emerges from COVID will resemble but not replicate the world we left. That is becoming a fact of life. The mistake would be to assume the shifts we are enduring are transitory; some will be permanent. We will never look back and think we did too much to counter the drag and displacement triggered by the pandemic. We will regret not doing more when we could. We must do all we can to ensure the world on the other side of this pandemic is still familiar.

Economic forecast — February 2021

	2020	2021	2022	2020:4 (A)	2021:1	2021:2	2021:3	2021:4	2022:1	2022:2	2022:3	2022:4
National Outlook												
Chain-Weight GDP[1]	-3.5	5.0	4.5	4.0	4.4	4.9	6.0	4.3	5.5	4.4	2.7	1.5
Personal Consumption	-3.9	5.1	5.0	2.5	7.1	1.6	3.6	4.9	7.3	6.1	3.2	2.1
Business Fixed Investment	-4.0	6.7	6.8	13.8	7.8	1.9	7.5	6.0	8.2	8.1	6.4	4.5
Residential Investment	5.9	10.3	-5.7	33.6	15.2	-3.3	-8.5	-8.7	-6.3	-2.5	-3.1	-4.8
Inventory Investment	-82	80	156	45	-12	69	118	145	164	161	158	142
Net Exports (bil $ '12)	-926	-1203	-1158	-1121	-1213	-1227	-1182	-1192	-1187	-1173	-1144	-1130
Exports	-13.0	9.9	7.9	22.0	17.6	7.7	6.6	8.3	9.1	8.1	7.1	5.2
Imports	-9.3	15.8	4.0	29.5	23.7	6.6	-0.6	6.7	5.5	4.0	1.8	2.0
Government Expenditures	1.1	3.2	-0.8	-1.2	2.5	13.1	6.7	1.1	-3.8	-5.4	-3.7	-1.9
Federal	4.4	8.2	-5.1	-0.5	4.4	32.9	12.8	-2.1	-12.9	-14.6	-10.2	-4.7
State and Local	-0.9	0.0	2.1	-1.7	1.2	1.6	2.6	3.3	2.9	1.2	0.6	-0.1
Final Sales	-2.9	4.2	4.1	3.0	5.5	3.3	5.1	3.8	5.2	4.4	2.8	1.8
Inflation												
GDP Deflator	1.1	1.9	1.9	2.0	2.3	1.3	1.7	2.0	1.6	2.3	2.0	1.9
CPI	1.3	2.1	2.1	2.3	2.6	1.2	1.7	2.9	2.0	2.1	1.9	2.4
Core CPI	1.7	1.8	2.1	1.8	1.5	1.5	1.9	2.1	2.1	2.2	2.2	2.2
Special Indicators												
Corporate Profits[2]	-11.3	0.5	7.8	-11.3	4.0	21.8	-10.3	0.5	1.5	-0.7	6.7	7.8
Disposable Personal Income	6.0	2.2	-2.5	-9.5	22.3	17.5	-26.3	-7.0	3.1	2.9	2.6	1.9
Housing Starts (mil.)	1.40	1.45	1.32	1.59	1.54	1.49	1.41	1.36	1.35	1.35	1.31	1.27
Civilian Unemployment Rate	8.1	5.7	3.7	6.7	6.3	6.0	5.5	5.0	4.4	3.8	3.4	3.3
Total Nonfarm Payrolls (thous.)[3]	-7317	3877	1131	1959	222	984	1347	1324	1302	1300	1110	813
Vehicle Sales												
Automobile Sales (mil.)	3.5	4.0	4.2	3.9	3.9	3.9	4.0	4.2	4.3	4.3	4.1	4.1
Domestic	2.5	2.7	2.8	2.8	2.7	2.7	2.7	2.8	2.8	2.8	2.7	2.7
Imports	1.0	1.3	1.5	1.1	1.2	1.2	1.3	1.4	1.5	1.5	1.4	1.4
Lt. Trucks (mil.)	10.5	12.9	13.3	12.3	12.6	12.8	13.1	13.1	13.3	13.3	13.3	13.2
Domestic	8.6	10.1	10.3	9.6	10.0	10.0	10.2	10.2	10.3	10.3	10.3	10.2
Imports	2.4	2.8	3.0	2.7	2.6	2.8	2.9	2.9	3.0	3.0	3.0	3.0
Combined Auto/Lt.Truck	14.0	16.9	17.5	16.2	16.5	16.7	17.1	17.3	17.6	17.6	17.4	17.3
Heavy Truck Sales	0.4	0.5	0.5	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil.)	14.4	17.4	18.0	16.7	16.9	17.1	17.6	17.8	18.1	18.1	17.9	17.8
Interest Rate/Yields												
Federal Funds	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10-Year Treasury Note	0.9	1.1	1.5	0.9	1.0	1.1	1.2	1.2	1.2	1.4	1.6	1.8
Corporate Bond BAA	3.7	3.3	3.5	3.4	3.3	3.4	3.4	3.3	3.1	3.3	3.6	3.8
Exchange Rates												
Dollar/Euro	1.13	1.18	1.19	1.19	1.23	1.23	1.23	1.23	1.23	1.24	1.24	1.24
Yen/Dollar	106.8	104.4	106.5	104.5	104.3	104.3	104.5	104.6	105.0	106.0	107.0	108.0

1. in 2020, GDP was $18.4 trillion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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