

 **ECONOMIC CURRENTS**

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Dare to Dream: A Global Economic Roundup

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A summer day with friends and family gathered for a cookout. Lawn chairs strewn across the backyard. The sound of my neighbor's jazz quartet riffing in the distance. My husband is firing up the grill, experimenting with one of his new recipes. A glass of wine in hand and the confidence to share a warm embrace with our guests.

What I thought I would do once the pandemic subsided has changed. That reflects the reality that we may have to work harder to manage, rather than eradicate, a virus that is mutating faster than we can stem contagion with vaccinations. A bout of cancer has also sharpened my focus on what matters most to me. Casual get-togethers lifted my spirits and kept me sane in the pre-pandemic world. I still want to board a flight, explore the world and make new connections. That may take longer.

The company that I keep has tempered but not quelled my optimism. I have spent much of the last two weeks in meetings with economists and policy makers representing more than 25 countries and every major industry. They are not exactly the most cheerful people to hang with; economics is the dismal science. That said, there is a light at the end of the tunnel and a path to take beyond the pandemic; the concern is what happens next.

Will we overdose on stimulus and trigger an unwanted inflationary spiral? Or will the pent-up demand we release be transitory along with the supply shocks it triggers? How long will it take for employment to regain the jobs lost, let alone what might have been? How deep are the wounds inflicted by the pandemic? Will they leave permanent scars on the complexion of the labor force?

Executive Summary

Prospects for the U.S. and global economy are improving. Vaccinations are ramping up faster than many expected. We will have more than enough vaccines for anyone who wants one by May. Uptake remains an uphill battle, given the misinformation flooding social media.

The risk is that we reopen too early and suffer a fourth wave of infections before the vaccine can reach enough arms. An inability to contain the virus has already cost us more in stimulus and aid than other countries.

The U.S. is poised to lead the global economy out of the most recent wave of infections and double-dip recessions abroad. We will cross our previous peak in activity in the second quarter. Additional stimulus means we will move above the growth path we were on prior to the pandemic.

Employment lags overall growth and is not expected to recoup what has been lost to the crisis until well into 2022. Some workers will be displaced permanently. Inflation will pick up but concerns about overdosing on stimulus are overblown. The world is suffering from disinflation and the threat of deflation, not inflation.

The Federal Reserve would like a little higher inflation. That would allow it to raise rates. The goal is to eliminate the risk of deflation and provide leeway to cut rates during the next recession.

Those are just a few of the questions we pondered. Our meetings took place under Chatham House Rules, which means that I cannot cite any one person or organization. What I can do is share how the lessons learned shaped our forecast. A fall in hospitalizations and fatalities, and a ramp-up in vaccinations offer reasons for hope.

This edition of *Economic Currents* provides a roundup of our expectations for the U.S. and global economies. It is divided into three parts. The first lays out the potential timeline for reopening. The second provides a roundup of what that timeline means for the global outlook, with special attention for the U.S. The third assesses the risk of a surge in inflation. Bond market participants worry that fiscal stimulus, coupled with easy monetary policy, will deliver a costly surge in inflation. The risk of that is low. The greater concern is whether the Fed will retain the independence it needs to contain an unwanted inflation.

Section I A Timeline on Reopening

The drop in COVID cases and hospitalizations around the world has occurred more rapidly than expected. A combination of mitigation efforts, behavioral changes and ramp up of vaccinations for the most vulnerable have all helped.

Epidemiologists worry we are not out of the woods yet. The emergence of more contagious and more lethal variants that affect children as well as adults means we need to remain vigilant. States trying to reopen before milestones on contagion are achieved have upped the ante on another outbreak and lockdowns.

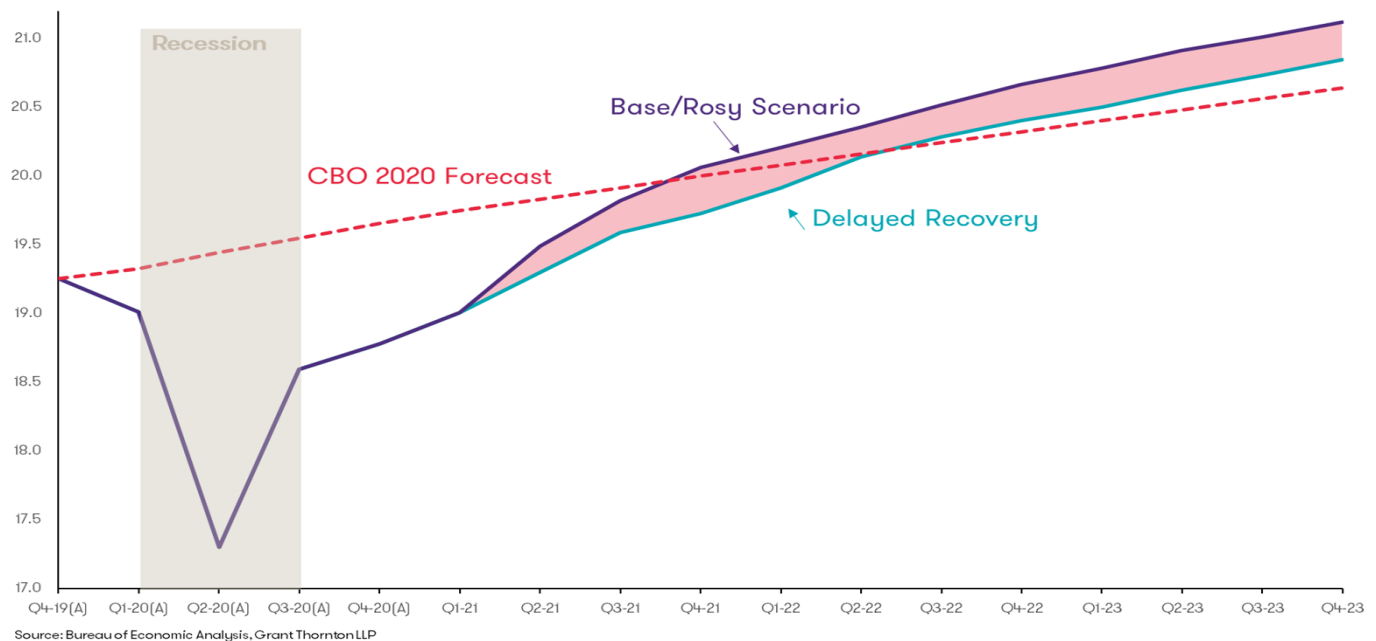
Countries that more effectively contained outbreaks were able to reopen and stay open longer than those that did not. One of my foreign colleagues dines in restaurants frequently and even gives briefings to live audiences, things that are little more than a distant memory for me.

Much of Europe, the U.K. and Japan suffered a W-shaped pullback in economic activity during the late fall and early winter. The spread of more contagious variants was rapid and costly. The U.S. dodged that bullet with another round of aid and stimulus in late December. Retail sales and employment rebounded in January after contracting at the end of 2020. Stimulus checks are the primary reason for those gains.

The goal is for businesses to remain open once they reopen, to recall workers and to keep them in their jobs longer. The new administration has promised there will be enough vaccines by May to vaccinate any adult who wants one.

Chart 1

Stimulus Gets U.S. Above the Pre-Pandemic Trend
GDP, 2012 \$, Trillions



Uptake is a problem. We need to vaccinate much of the adult population to achieve the 70% herd immunity required to suppress transmission. That is a heavy lift.

Most polls suggest that the willingness to take a vaccine has risen from about 50% to more than 60% of adults in recent months. Positive news on clinical trials is credited for those gains. However, [research](#) in *The New England Journal of Medicine* shows that uncertainty about taking a vaccine remains high.

One problem is that pollsters often collapse categories of responses; only about 40% of adults say they will “definitely” get vaccinated, while 21% say they will “probably” get vaccinated. The largest concern is [misinformation](#), which is harder to quell. Getting children vaccinated will be another challenge. The same people who refuse vaccinations for themselves are likely to oppose them for their children.

Resistance to the vaccine is not unique to the U.S. The shift from working toward herd immunity, to managing instead of eradicating outbreaks, is not helping.

“Vaccine nationalism,” or hoarding of vaccines, is another hurdle. Some 16% of the world’s population in the world’s wealthiest countries own 50% of the current vaccine supplies. Even wealthy countries such as Canada and Japan have had trouble getting access because of constraints imposed by the countries that produce them. This could delay the resumption of international travel and commerce.

We expect the U.S. economy to reopen more rapidly. The risk is that could trigger another surge in infections driven by more contagious variants this spring and summer. That has left us with two scenarios for reopening. One allows for a robust and sustained reopening. The other includes a fourth wave.

Section II

U.S. Leads Global Gains

The global economy is expected to grow at a 5.8% pace in 2021 after contracting an estimated 3.7% in 2020. Much of the growth occurs in the second half of the year. The first quarter was the weakest with lockdowns to prevent the spread of more contagious variants.

China is doing better, driven by strong gains in manufacturing. The country became a larger player in the global economy last year when it grew its export base. China is hoping to capitalize on those gains going forward. Consumer spending is still lagging; spending during the Lunar New Year was particularly weak. The government has renewed efforts to curb credit growth and guard against asset price bubbles.

The number one concern in every meeting I attended was what China may do to Taiwan. The fear is that China could do to the world’s computer chip supplier what it did to Hong Kong. That would ensure its dominance of the global supply chain. Chip shortages have already caused backlogs and production cuts in the manufacturing sector, most noticeably in vehicles.

The shift back to services from goods spending should allow for some resolution to current supply chain bottlenecks, but it will stress resources in the service sector. It is important to note that pent-up demand in the service sector will be unleashed differently than we have seen in the goods sector during previous recoveries. Haircuts skipped and meals not eaten in restaurants during lockdowns can’t easily be recouped.

The U.S.

The U.S. is expected to lead global growth as stimulus offsets the cost of missteps on the road to herd immunity. It would cost less if we didn’t have setbacks triggered by premature openings and repeated lockdowns. Growth could hit 6.4% in 2021, a whopping 1.4% more than we estimated a month ago. That would make it the strongest year since 1984, as long as we don’t suffer a fourth wave. Good news on the progress of vaccines and a larger stimulus package are the reasons for the upgrade.

Chart 1 compares that rosy scenario with an interrupted pace of reopening over the spring and summer. Additional stimulus has put us on track to exceed the trajectory of growth we were on before the pandemic. That will be a major milestone if we can achieve it.

Employment will take another year to reach its previous peak. We are still 9.5 million jobs in the hole, mostly in the service sector. This is at the same time that the share of workers enduring long-term unemployment (more than 27 weeks) or forced to accept part-time work has swelled.

Employment surprised to the upside in February. However, many misread those gains. Revisions to December employment revealed an economy that was starting to contract, underscoring the fragility of the recovery. Another round of stimulus was required to reverse those losses in January and February.

Revenge Spending

Consumers are expected to lead overall gains with what many are terming “revenge spending.” That is spending on all the things we couldn’t buy when we were stuck at home. That is not the same magnitude of pent-up demand we see when we try to catch up on goods spending. It is nonetheless significant and will no doubt shift our priorities from upgrading our homes and buying big-ticket items back toward services.

Most of the savings built up during the crisis was concentrated in the wealthiest households. They do not spend as much out of their saving as everyone else. They may take more luxurious vacations, but are unlikely to take more vacations.

Uneven vaccination strategies across countries and the risk of more contagious variants suggest domestic leisure travel will pick up more rapidly than business and international travel. I am booking travel for 2022.

Housing Moderates

Rising mortgage rates, coupled with some return to offices, suggest that the boom in home buying and building will cool. First-time buyers are replacing vacation home buyers. That trend should accelerate as more supply comes on line.

Some baby boomers have held off listing their homes for fear of contagion during the pandemic. Those listings, combined with a completion of construction backlogs and an easing of impulsive purchases, should boost inventories, which dropped to a record low in 2020. Increased supply should alleviate bidding wars and the surge in prices.

Business Investment Picks Up

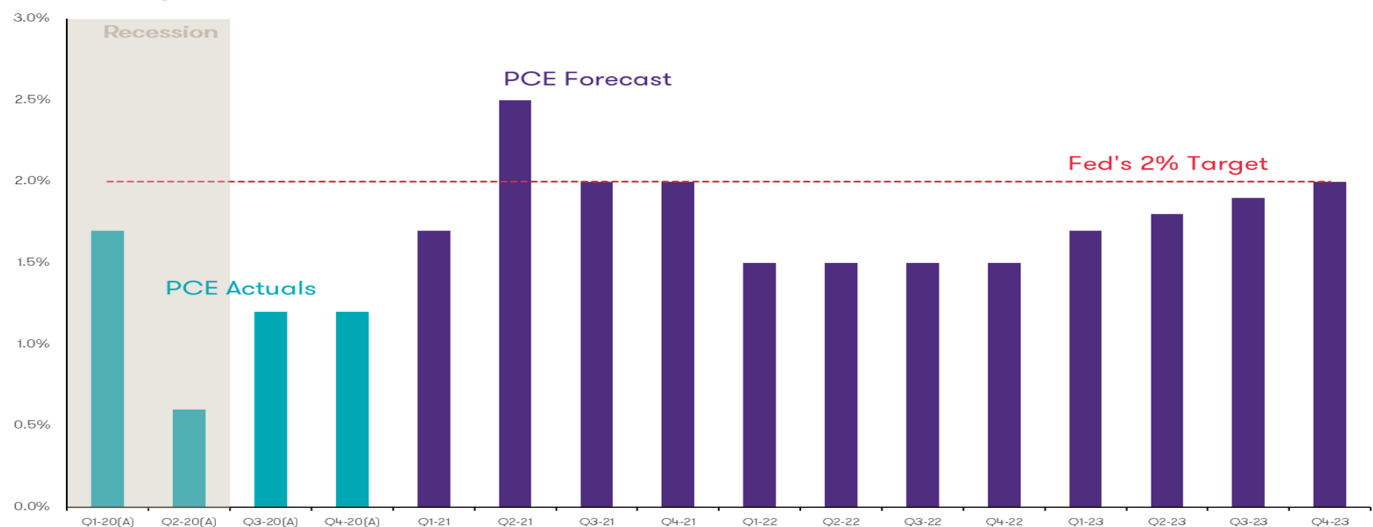
Investment in technology is expected to continue to overshadow investment in more traditional equipment. We are seeing a sharp increase in investment in new technologies, which are being used to improve online retail and to automate jobs in both the service sector and in manufacturing plants.

Commercial real estate is mixed. Most companies are trying to reduce their footprint in urban centers, which is having spillover effects on everything from downtown apartment rents to restaurants, bars and office space.

Chart 2

Inflation Fears are Overblown

Percent Change, 4Q/4Q



Source: Bureau of Economic Analysis, Grant Thornton LLP

Smaller office spaces in suburban markets have seen greater demand, along with industrial space. Warehousing is still a very big business to accommodate more online retail and the need by manufacturers to hedge against supply chain disruptions.

Government Spending Accelerates

The Senate approved a \$1.9 trillion stimulus bill with some changes from the House of Representatives' version. Moderate Democrats insisted on holding unemployment supplements to \$300 per week and extending them until September instead of October, phasing out \$1400 direct checks for some households and dropping the \$15 per hour minimum wage component. The package passed on a party-line vote.

Much of the aid will be used to fill financial holes triggered by the crisis, including backlogged rent and utility bills. Chicago landlords have already reported that stimulus checks were used by low-wage households to pay back and forward months of rent. Funds will be allocated to ramp up vaccination efforts and to safely reopen schools. That means smaller classrooms, more masking, upgrades to infrastructure and cleaning, including ventilation systems, and more personnel to help students recoup education hours lost to the pandemic.

Many low-wage households lost one year of education as dropouts surged. Those students will have to be brought back into the system, lest we suffer an even larger blow to potential economic growth. Math scores, which require more in-person learning, have suffered the most.

Transfers to the states, including much of the funding for schools, hospitals and even broadband, will take longer to disperse. One of the largest mistakes that casual forecasters make is on the timing of when outlays show up as spending by the government. We still have nearly one trillion that has been approved but yet to be spent from previous stimulus packages. It will take time, for instance, to spend the funds earmarked to expand broadband access to rural areas.

This is one of many reasons that checks directly paid to households have gained so much traction during the pandemic. It was often the only money that the most financially stressed households could access quickly to cover the basics of food and shelter.

It would have been better to have more targeted payouts but our antiquated state unemployment insurance systems failed us. There are funds to upgrade those systems and prevent the fraud that further bogged down the ability of states to allocate payments to those hardest hit by the crisis.

Trade Deficit Widens

More rapid growth in the U.S., coupled with lagging growth abroad, ensures that the trade deficit will continue to widen in 2021 and 2022. China has become an even larger export platform post-pandemic than it was prior. Part of that is due to the outsize role it plays in the production of PPE. Another reason is that moving manufacturing facilities back to the U.S. never occurred.

The largest near-term concern for trade is Taiwan, given its key role in the computer chip market. Most of the bottlenecks are expected to be cleared by midyear, barring a conflict with China over Taiwan.

Section III A Flare in Inflation?

Chart 2 shows our forecast for inflation over the next two years. A sharp deceleration in inflation at the onset of the crisis in 2020, coupled with a rebound in oil prices, sets the stage for a temporary jump in the Personal Consumption Expenditures (PCE) index. We expect it to move above the Fed's 2% target this year for the first time since 2018. Those increases should dissipate over the summer as year-on-year comparisons get easier.

Disruptions in the supply chain and strong demand, aided by another round of stimulus, virtually assure some kind of spike in certain prices. Airfares and hotel room prices at popular vacation destinations will no doubt jump the minute people feel safe enough to travel; algorithms that track supply and demand are designed to ensure they do.

The question is whether those increases will be temporary or systemic. There are more reasons to believe the former. Much of the surge in demand for services is expected to be tempered by a moderation in demand for goods. The shift should alleviate upward pressure on goods prices, while it allows some reflation in the service sector.

Price hikes have a hard time sticking unless they are accompanied by wage gains. That requires low unemployment with a lot more participation in the labor market than we are likely to see at the onset of the surge in demand.

Wage gains against the backdrop of strong productivity growth should show up more in profits than in prices. A rush to automate and the fact that we have learned to better use existing technologies should provide a temporary boost to productivity growth. This is what occurred in the wake of Y2K when the rush to upgrade computer systems boosted productivity even after investment faltered.

Separately, much of the rest of the world is still fighting decelerating instead of accelerating inflation. This will act as another offset to inflation in the U.S., despite recent weakness in the dollar.

A Too-Patient Fed?

Bond market participants have recently voiced a concern tied to a shift in strategy at the Federal Reserve. They see the Fed now seeking to spur inflation instead of suppressing it, after years of failing to reach their own 2% inflation target. This has stoked concerns that the Fed will allow a costly overshoot in inflation.

Upon review of the Fed's policy-setting rules, which started well in advance of the pandemic, officials discovered they were wrong in their estimates for full employment and inflation. Overall measures of unemployment understated the slack in the labor market, most notably among the most marginalized and discriminated-against workers.

Wages and inflation didn't firm until more of the prime-age labor market was participating and actually being hired. Even then, inflation pressure remained subdued.

In response, the Fed has adopted a more nuanced approach to its full employment and inflation targets. The goal now is "average inflation targeting," which allows for long periods of undershooting on inflation with shorter and more contained periods of overshooting.

The goal is to wait until inflation meets the 2% inflation target and appears to be on track to overshoot for a period, before raising rates. Fed officials will "look through" the jump in year-over-year measures of inflation due to weak inflation during the height of the crisis in the spring of 2020. They are also prepared to ignore a transitory rise in inflation that results from unleashing pent-up demand in services.

The Fed has said it would stop asset purchases and the expansion of its balance sheet before it raises interest rates. The timing will depend heavily upon how rapidly employment picks up. That could occur by the start of next year.

What could go wrong? Congress could become a little too comfortable with the Fed's low rate policies and undermine the Fed's independence once it gets back to raising rates. It wouldn't be the first time a government has usurped the independence of the central bank and triggered a worrisome rise in debt and inflation. At least a portion of the rise in Treasury bond yields in recent weeks reflects concerns about how we will pay for what we are borrowing during this crisis.

Bottom Line

We see a light at the end of the tunnel and with that light comes a sense of euphoria. The key is to not let that euphoria get in the way of achieving the final goal. That is not just seeing but crossing the finish line of the pandemic. We literally cannot afford another major setback in infections.

This is the moment when we could triumph, not least by averting another tragedy. I know, it is not easy to be patient and take the time to get the reopening of the economy right. After all the surgeries and cancer I have fought this year, the extra seems small relative to the payoff.

Economic forecast — March 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	6.4	4.3	4.1	4.8	10.6	7.0	4.9	3.0	2.9	3.2	3.0
Personal Consumption	-3.9	6.7	5.2	2.4	4.6	11.3	7.1	5.7	4.0	4.6	4.0	3.6
Business Fixed Investment	-4.0	8.7	6.4	14.0	7.7	9.6	10.9	7.0	4.8	5.0	5.5	5.7
Residential Investment	6.0	15.7	-7.1	35.8	20.6	9.2	-0.7	-8.5	-13.2	-10.0	-3.8	-3.1
Inventory Investment	-81	109	166	48	16	61	150	211	203	175	149	135
Net Exports (bil \$ '12)	-926	-1280	-1308	-1123	-1197	-1255	-1318	-1352	-1340	-1312	-1295	-1284
Exports	-13.0	7.9	7.2	21.8	7.0	9.2	8.4	9.1	7.5	5.7	5.3	5.1
Imports	-9.3	16.8	5.5	29.7	14.0	13.1	12.8	9.7	3.5	0.8	1.6	2.2
Government Expenditures	1.1	2.7	0.0	-1.1	9.0	6.9	0.2	-0.8	0.7	-2.2	0.0	-0.6
Federal	4.3	2.5	-2.1	-0.9	21.8	-9.4	-3.4	-1.7	-1.4	-1.0	-0.4	-1.6
State and Local	-0.8	2.9	1.3	-1.2	1.5	18.9	2.5	-0.3	2.0	-2.9	0.2	0.1
Final Sales	-2.9	5.4	4.1	3.0	5.5	9.7	5.3	3.8	3.1	3.5	3.7	3.2
Inflation												
GDP Deflator	1.2	2.2	1.9	2.4	3.0	1.7	2.0	2.0	2.0	2.0	1.9	1.9
CPI	1.3	2.0	1.5	2.5	2.6	1.1	1.8	1.4	1.5	1.5	1.5	2.1
Core CPI	1.7	1.8	1.9	1.8	1.6	1.3	2.1	2.1	1.6	1.9	1.9	2.0
Special Indicators												
Corporate Profits ²	-10.4	14.9	4.6	-10.4	4.4	31.9	3.3	14.9	13.7	1.3	2.8	4.6
Disposable Personal Income	5.8	3.9	-2.0	-10.0	26.8	29.2	-31.7	-4.2	3.6	3.1	3.6	2.6
Housing Starts (mil.)	1.40	1.61	1.42	1.59	1.61	1.69	1.64	1.52	1.43	1.42	1.43	1.40
Civilian Unemployment Rate	8.1	5.4	4.2	6.7	6.2	5.4	4.9	4.9	4.8	4.4	4.0	3.7
Total Nonfarm Payrolls (thous.) ³	-7317	5162	783	1959	722	2317	1491	632	724	872	916	618
Vehicle Sales												
Automobile Sales (mil.)	3.5	3.7	3.8	3.9	3.7	3.7	3.7	3.7	3.7	3.7	3.8	3.8
Domestic	2.5	2.5	2.5	2.8	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Imports	1.0	1.2	1.3	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.3	1.3
Lt. Trucks (mil.)	10.5	12.7	12.9	12.3	12.6	12.7	12.8	12.8	12.9	12.9	12.9	12.8
Domestic	8.6	10.0	10.0	9.6	9.9	10.0	10.0	10.0	10.1	10.0	10.0	9.9
Imports	2.4	2.8	2.9	2.7	2.7	2.7	2.8	2.8	2.8	2.9	2.9	2.9
Combined Auto/Lt.Truck	14.0	16.4	16.6	16.2	16.3	16.4	16.5	16.5	16.6	16.6	16.7	16.6
Heavy Truck Sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.5
Total Vehicles (mil.)	14.4	16.9	17.1	16.7	16.8	16.9	17.0	17.0	17.0	17.0	17.1	17.1
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	1.5	2.0	0.9	1.1	1.5	1.6	1.8	1.9	2.0	2.0	2.1
Corporate Bond BAA	3.7	3.7	4.2	3.4	3.5	3.5	3.8	4.1	4.3	4.1	4.1	4.3
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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