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Assessing COVID's Legacy:

Structural Change Watchlist

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Hopes that the lights could be turned back on as quickly as they were turned off in the spring of 2020 have faded with each additional wave of infections. The Delta variant is the straw that broke the camel's back.

COVID has taken a toll on both demand and supply, hitting countries and states with less access or less desire to take vaccines. It has crystallized the reality that the pandemic will become an endemic with seasonal outbreaks many times worse than the flu. Disruptions to supply look greater than those to demand, which means a little less growth and more inflation. (See Box.)

We are learning to manage the risks of living with COVID. That hasn't stopped the Delta variant from taking a toll. Hiring slowed dramatically in August. The hardest hit sectors were restaurants and bars, retail and health care. The number of people reporting that they couldn't work due to COVID layoffs increased, along with those who reported working from home. The ranks of those that couldn't work because they were sick swelled.

The longer outbreaks persist, the less the economy that emerges will resemble the economy we had in March 2020. Some parts of the service sector will never fully recover; others will flourish. Business travel is a casualty; technology is a winner.

This edition of ***Economic Currents*** takes a closer look at the structural shifts and how they are likely to reshape the economy. Structural shifts are often neglected but easier to identify than cyclical shifts as they have already begun to take root. The Delta variant has accelerated and amplified those shifts on a global scale.

Hesitation & Heat with Delta

The Delta variant has delayed when the recovery will exceed the previous trajectory on growth and diminished the dividends due to fiscal stimulus. The timing is bad. Supplements to bridge job losses due to COVID expired on September 6. Those shifts, coupled with acute shortages, will limit spending through the holiday season. (See Chart.)

We are expecting some catch-up in earlier losses as we move into 2022. Additional fiscal stimulus is not expected, although next year is an election year; stimulus checks were incredibly popular.

We can't rule out a stalemate over the budget before the start of the fiscal year on October 1. A continuing resolution on spending instead of a full budget would further suppress growth in the fourth quarter. Theatrics around the lifting of the debt ceiling could rattle financial markets.

Some of the funds that were allocated by the last stimulus package will show up in 2022. We have incorporated a bipartisan infrastructure package into the outlook. Those projects will not hit with gusto until 2025 and 2026.

Variants remain the greatest challenge to the outlook. Risks are to the downside on growth.

Federal Reserve Chairman Jay Powell has shown remarkable patience, opting for the economy to heal further before raising rates. That will be tested in 2022; we have moved back the first rate hike to 2023. Powell has already attempted to decouple the Fed's decision to taper from the decision to raise rates. The slowdown in growth is expected to delay tapering to year-end.

Top 10 List

The following is in no particular order of magnitude. It spans changes amplified and triggered by the pandemic but is only a sampling of the tectonic shifts underway.

1. **Populism Intensifies.** The pandemic has stoked political divisions. This should not come as a surprise to anyone who has studied the history of pandemics; a surge of misinformation and mistrust in established institutions is common when society is hit by plagues. Documentation of the distrust goes back centuries.

What does it mean? A further rise in nationalism, or preferential treatment to companies that produce in their own countries and barriers to the movement of goods and people across borders. Tariffs remain intact, pressure to regionalize and nationalize supply chains is escalating and restrictions on travel triggered by the crisis persist.

Those shifts will take a toll on demand as well, but could take longer than hoped to derail the upward pressure on inflation. Those shifts will accelerate consolidation and intensify competition for small and midsize firms.

2. **Divisions Deepen.** The Delta variant has divided the world between the vaccinated and the unvaccinated. Developing economies, which largely escaped earlier COVID outbreaks, have succumbed to this wave.

The U.S. and the U.K are exceptions, with the pace of vaccines lagging and infections surging. Places with lower vaccination rates and fewer mitigation efforts are suffering worse outbreaks with more stress on their healthcare systems.

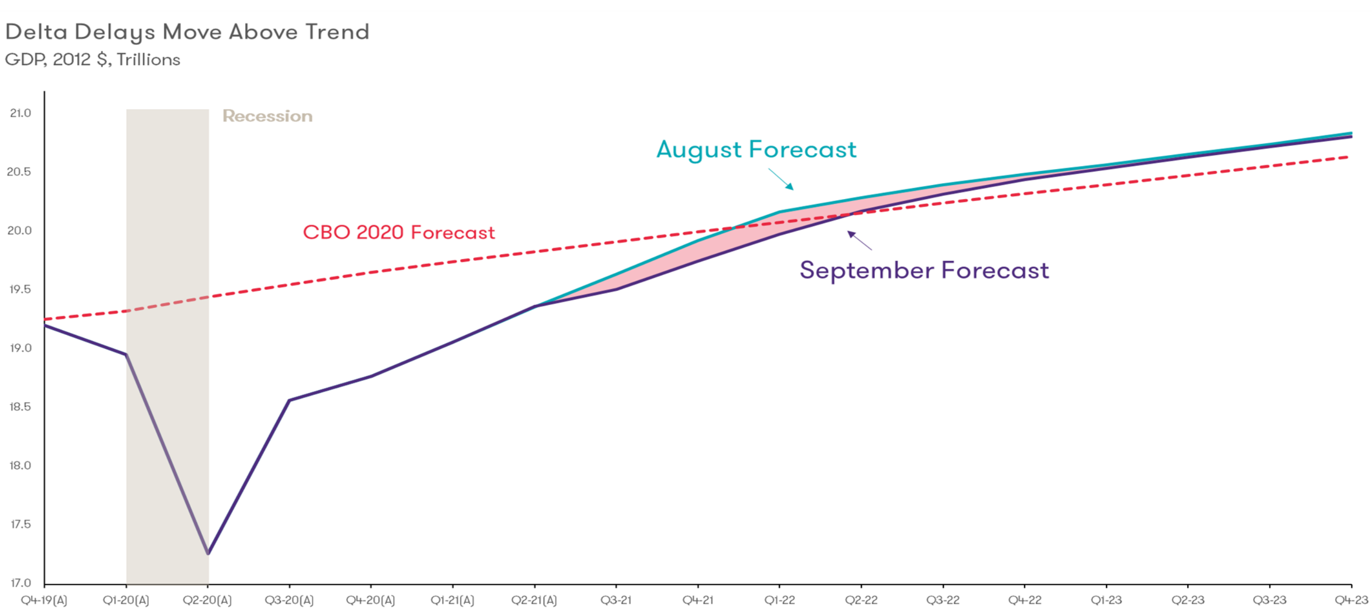
Schools are our Achilles heel as Delta has reached children. Vaccines for children are expected to be approved within weeks; the challenge in the U.S. is uptake.

Businesses of all sizes, universities and other places that allow people to congregate are sorting themselves between those with vaccine mandates, masks and/or proof of negative COVID tests and those without. People will decide to show up or not depending upon how they view the risks of congregating.

Those shifts could impact migration patterns. CNBC changed the **methodology** of its evaluation of top states in which to do business to include “metrics on the battle against Covid-19, healthcare in general, and the corporate push for inclusiveness.”

3. **Debt Loads Mount.** Sovereign debt ballooned as countries scrambled to offset the economic losses and misery triggered by the pandemic. That helped alleviate the stress of the pandemic on individual and corporate balance sheets, especially in wealthier countries.

Chart 1



Recent research suggests the aid provided to companies was poorly targeted; firms that needed the funds the least received the most. Nonetheless, it curbed firm failures in developed economies. Less was achieved in developing economies.

Much of the surge in sovereign debt in emerging markets ended up on bank balance sheets. That has upped the risk that a sovereign debt crisis could morph into a financial crisis, which could wash up on our own shores.

4. **Financial Market Fragilities.** Financial markets melted down when the pandemic first hit. The seizure in the Treasury bond market was abrupt and particularly worrisome, given the outsize role that Treasury bonds play in the global financial system.

Hence, the Fed's interventions with another round of asset purchases started in March 2020; it prevented the pandemic-induced recession from mutating into a financial crisis, but failed to correct many of the vulnerabilities that were exposed.

Concern over financial market stability both at home and abroad took up a disproportionate amount of the discussion at the Kansas City Fed's annual Jackson Hole Symposium. Many former central bankers, as well as former and current chief economists for the International Monetary Fund, warned of the risks to financial stability.

Financial markets appear to be "priced to perfection" in an imperfect world, while the bubble in housing prices is becoming global in scope. Junk bond issuance has soared, while mergers and acquisitions are accelerating the consolidation of firms and buoying the fortunes of Wall Street and consultants.

5. **Black Swans Flock.** COVID, climate change and geopolitical tensions have collided, amplifying the risk of an external shock, often referred to as a black swan. This means that businesses and governments will have to allocate more of their resources to hedge against the risk of disruptions.

Hurricane Ida and renewed terrorist threats are just examples. That leaves fewer resources for investing in infrastructure and research and development, all of which represent the foundation of growth going forward.

6. **Productivity Growth Surges.** On a more positive note, the crisis accelerated the adoption of new and existing technologies. That has tipped off an investment boom in technology, the likes of which we have not seen since the late 1990s when leapfrog investments were made to avert disruptions triggered by Y2K. (Google it.)

Those shifts will have payoffs, much as we saw in the early 2000s. Sadly, they are not evenly distributed. Firms with the scale to leverage new technologies will boost demand for highly educated workers, but displace less educated, low-wage workers with automation.

Cashless and contact-free transactions are becoming the norm. Even truckers, who have been in short supply for most of my career, are threatened; a small caravan of self-driving trucks is already on the road.

7. **Improvement for Low-Wage Workers Stalls.** The push to raise wages is driven by large firms. They have the scale to leverage technology to absorb higher costs.

The rise of "superstar firms," which includes retail behemoths, is the primary reason labor's share of the economic pie has fallen in recent decades. They more effectively automate, outsource and dominate their markets. They occupy industries that have little experience with unions and are large enough to erect hurdles to workers organizing.

In response, wage gains for low-wage workers are expected to slow after an initial surge in response to reopening. Wages in the leisure and hospitality sector decelerated in August in response to the Delta variant. Some workers will actually lose ground, given additional disruptions to the service sector in response to outbreaks. Business travel has been set back again.

> "Firms operating in China have found it easier to enter than to leave. China's control of the global supply chain has grown during the pandemic."

8. **Retirees Stay on the Sidelines.** Fear of contagion accelerated retirements and derailed the rise in labor force participation among those over the age of 65. Research by the Kansas City Fed suggests the numbers are significant. They estimated that we should have seen 1.5 million retirements between February of 2020 and June 2021; instead, we saw 3.5 million. That is two million fewer people in the labor force than we would have had, absent the pandemic.

The participation rate of teens is one area where we could see some improvement. Teen participation rates have been trending down since a peak in 1978 but recently reversed course. The teen participation rate moved above its pre-pandemic high in August but remains historically low. Employers will need to cast a wider net. Norms for teens need to shift for young people to join the labor force.

9. **Inequality Worsens.** Growth between and within countries is becoming less even. This widens the gap between the haves and have-nots and reduces our potential to grow both at home and abroad.

Those shifts underscore the need for governments and businesses to double down on efforts to foster diversity, equity and inclusion. Underrepresented groups have less access to opportunity; removing barriers is key to unlocking their and the economy's potential to grow. Talent discarded is talent lost.

Sadly, the pandemic hit marginalized communities harder than the overall population in terms of job losses, infections, fatalities and hate crimes. This is at the same time that students from low-income households suffered a bigger setback to education due to the shift online. That includes college students, who were forced to drop out when classes went virtual.

10. **China Shifts Gear.** Last but by no means least, I have never done a stuctural change watchlist that didn't include China; I started in the late 1990s.

China is slowing dramatically. Delta variant is just one factor. The government is implementing policies that undermine competition and limit growth in the country's largest and most innovative firms. This will place a significant drag on global growth and derail the jump in commodity prices.

President's Xi Jinping has longer term ambitions. He is exerting more control over his own population and expanding China's role on the global stage. How he achieves those goals matters. Firms operating in China have found it easier to enter than to leave. Breaking up is hard to do. China's control of the global supply chain has grown during the pandemic.

Bottom Line

Pandemics have a long history of exposing and amplifying the worst instead of the best in human beings. They exacerbate the divisions between the wealthy and the poor, spur xenophobia and cause widespread disruptions to supply and demand. They enable autocratic leaders who seek to shift blame, exert more control over their populations and erect barriers in policy that curb opportunities for marginalized communities.

They alter the structure of our economies and undermine our potential to grow. The challenge is to embrace that knowledge, correct course and focus on the only true enemy - the virus. I feel like a broken record. Change the course of COVID; change the course of the economy. I refuse to give up on the hope that we will learn from instead of repeating the mistakes of the past.

Economic forecast — September 2021

	2020	2021	2022	2020:4 (A)	2021:1 (A)	2021:2 (A)	2021:3	2021:4	2022:1	2022:2	2022:3	2022:4
National Outlook												
Chain-Weight GDP[1]	-3.4	5.6	4.2	4.5	6.3	6.6	3.0	5.1	4.8	4.0	2.9	2.5
Personal Consumption	-3.8	7.6	3.0	3.4	11.4	11.9	0.0	3.0	2.9	2.8	2.3	2.5
Business Fixed Investment	-5.3	7.5	5.9	12.5	12.9	9.3	0.3	7.9	6.7	5.9	5.4	5.7
Residential Investment	6.8	8.4	-4.5	34.4	13.3	-11.5	-9.6	-6.5	0.1	-2.1	-6.4	-2.0
Inventory Investment	-42	-78	130	89	-88	-169	-48	-4	72	130	162	157
Net Exports (bil $ '12)	-935	-1201	-1165	-1125	-1218	-1239	-1203	-1142	-1153	-1163	-1170	-1173
Exports	-13.6	4.7	6.8	22.5	-2.9	6.6	3.9	6.8	6.8	7.6	8.0	8.1
Imports	-8.9	11.7	3.5	31.3	9.3	6.7	-1.5	-2.5	5.8	6.3	6.1	5.8
Government Expenditures	2.5	1.0	1.8	-0.5	4.2	-1.9	2.5	1.6	2.8	1.7	1.9	0.8
Federal	5.0	1.4	-0.1	-3.1	11.3	-5.2	-0.2	-1.6	2.6	-0.2	0.5	-1.4
State and Local	0.9	0.7	3.0	1.2	-0.1	0.3	4.2	3.6	2.9	2.9	2.8	2.2
Final Sales	-2.9	5.5	3.1	3.4	9.1	7.9	0.6	4.2	3.3	2.8	2.3	2.6
Inflation												
GDP Deflator	1.3	3.9	2.9	2.0	4.4	6.0	5.6	3.9	1.6	1.6	1.9	2.5
CPI	1.2	4.2	2.8	2.5	3.7	8.5	6.1	1.2	1.8	3.1	1.3	2.5
Core CPI	1.7	3.4	3.2	1.8	1.2	8.2	5.5	2.7	2.3	2.4	2.3	3.1
Special Indicators												
Corporate Profits[2]	0.9	13.0	3.6	0.9	17.6	43.4	9.0	13.0	11.1	3.5	8.2	3.6
Disposable Personal Income	6.2	1.3	-3.0	-8.3	54.7	-31.0	-7.1	-5.3	-0.1	4.0	4.0	2.2
Housing Starts (mil.)	1.40	1.53	1.40	1.58	1.60	1.59	1.50	1.45	1.49	1.39	1.37	1.36
Civilian Unemployment Rate	8.1	5.7	4.6	6.7	6.2	5.9	5.4	5.4	5.0	4.9	4.4	4.0
Total Nonfarm Payrolls (thous.)[3]	-7321	4910	717	1869	828	1837	1690	555	614	473	838	942
Vehicle Sales												
Automobile Sales (mil.)	3.5	3.7	4.0	3.9	3.9	3.9	3.4	3.6	3.8	3.9	4.1	4.1
Domestic	2.5	2.5	2.6	2.8	2.6	2.6	2.3	2.4	2.5	2.5	2.6	2.6
Imports	1.0	1.2	1.4	1.1	1.3	1.3	1.1	1.2	1.3	1.4	1.5	1.5
Lt. Trucks (mil.)	10.5	11.8	12.4	12.3	13.1	13.0	10.3	11.0	11.5	12.3	12.8	13.1
Domestic	8.6	9.1	9.6	9.6	10.3	9.9	7.8	8.3	8.8	9.5	9.8	10.1
Imports	2.4	2.8	2.9	2.7	2.8	3.1	2.5	2.7	2.7	2.8	3.0	3.0
Combined Auto/Lt.Truck	14.0	15.5	16.4	16.2	17.0	16.9	13.7	14.6	15.3	16.2	16.9	17.2
Heavy Truck Sales	0.4	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.5
Total Vehicles (mil.)	14.4	16.0	16.9	16.7	17.5	17.4	14.1	15.0	15.7	16.7	17.4	17.7
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	1.4	1.6	0.9	1.3	1.6	1.3	1.3	1.4	1.6	1.5	1.9
Corporate Bond BAA	3.7	3.5	3.7	3.4	3.5	3.6	3.3	3.4	3.5	3.8	3.6	4.0
Exchange Rates												
Dollar/Euro	1.13	1.21	1.23	1.19	1.20	1.20	1.23	1.23	1.23	1.23	1.24	1.24
Yen/Dollar	106.8	108.9	109.6	104.5	106.2	109.4	110.0	110.0	110.0	110.0	109.7	108.5

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.