Current Economic Conditions

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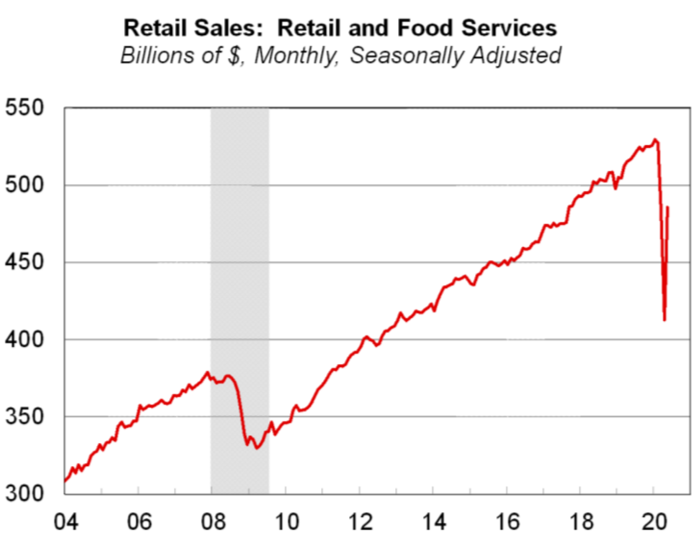
THE LAW OF SMALL NUMBERS

If you were to look only at month-to-month changes in measures of economic activity, you would conclude that May was the best month in the history of the U.S. economy. Payroll employment rose by 2.509 million, the biggest increase ever. The unemployment rate fell by 1.4 percentage points, the biggest decline ever. Retail sales rose 17.7%, the biggest monthly increase since the data series began in 1992. Industrial production in U.S. manufacturing rose 3.8%, the biggest increase since 1959. The seasonally adjusted annual rate of light vehicle sales rose 40%, from 8.7 million to 12.2 million.

These numbers were all better than expected and have forecasters to raise our second-quarter forecasts for real Gross Domestic Product. The economy has rebounded faster than we expected as states have lifted lockdown orders. However, the magnitude of the improvement in May is largely an illustration of the "law of small numbers": if you start from a very small base, any increase looks big, especially in percentage terms. Despite the stronger-than-expected May data, the level of economic activity remains well below its pre-recession peak. The rise in payroll employment recouped only 11.4% of the jobs lost in March and April. The unemployment rate in May was still a third higher than the highest rate reached in the Great Recession. Industrial production in manufacturing recouped only 15.2% of its March and April declines. Initial claims for unemployment insurance, which have fallen 78% over the last 11 weeks, remain more than twice their pre-2020 record high. Continued claims remain over 20 million.



Retail sales have rebounded much more than other data in response to the reopening of the U.S. economy. In May, they recouped 62.3% of the declines suffered over the prior three months. Although some of this strength reflects the impact of fiscal and monetary stimulus and growth in pick-up and delivery, which have partially offset losses in in-store sales, it also indicates that U.S. consumers are less risk-averse than I assumed and have returned to stores and restaurants faster than I expected. If this pandemic proves anything, it proves that people differ widely in their degree of risk aversion. While some of the difference in behavior reflects differences in the information people are receiving, people receiving the same information and at the same risk can react very differently. Because of regional differences in risk aversion, the pace of recovery in economic activity and the future incidence of COVID-19 could vary widely from state to state.

Despite the strong rebound in retail sales in May, the second-quarter decline in GDP will still be by far the largest ever. Retail sales data mostly measure purchases of goods. Most consumer spending involves purchases of services, and the service sector of the economy has been hit hard by the pandemic. But the decline in GDP, at an annualized rate, is likely to be in the 30-40% range, perhaps smaller, not in the 40-50% range I expected a month or two ago. This forecast revision says more about when and how the recovery began – sooner and more rapid than I expected – than on when it will be completed. Some business won't come back until there's a vaccine. Consequently, the upward revision to the second quarter growth rate means a downward revision to growth in the third and fourth quarters, especially if the price of the quicker-than-expected rebound is an increase in COVID-19 cases that causes people to become more cautious. (I am assuming that the bar for new state-mandated lockdowns is extremely high and that COVID-19 will affect the economy mostly through its impact on decisions made voluntarily by consumers.)

Barring an unexpected second decline, the recession is over. The National Bureau of Economic Research has determined that a business-cycle peak occurred in February. Given the strong rebound in May, the NBER is likely to place the associated business-cycle trough in April.

While economists focus on month-to-month and quarter-to-quarter changes in seasonally adjusted data, businesses focus on year-over-year changes, i.e., comparisons versus the same month or quarter in the prior year, which don't require special software for seasonally adjusting data. Despite May's rebound, industrial production in U.S. manufacturing was down 16.5% year-over-year. It is likely to remain below prior-year levels until March 2021. Real GDP will remain below prior-year levels until the second quarter of 2021. Industrial production and GDP probably won't return to their pre-recession peaks until 2022; the exact date of full recovery will depend on how quickly a vaccine is developed and rolled out.

The impact of the COVID-19 pandemic on businesses and their employees has been very uneven. Businesses that were deemed "essential" by state and local governments, including big-box retailers that sell food, have done much better than those not considered essential, including otherwise similar big-box retailers that don't sell food. Online retailers and those whose physical layouts facilitate curbside pickup have done much better than those that require customers to come inside. Businesses that require large numbers of people to congregate in close quarters have been especially hard hit. Restaurants are being allowed to reopen, but it's not clear they can allow or attract enough diners to be profitable.

As in all recessions, the poor, particularly urban service-sector workers living in large multi-generational households, have been hit the hardest. Those who are too poor to own a car have been especially hard hit. People with cars can get to work without risking exposure to the virus on subways and buses. They can also pick up extra income by delivering food and other goods for restaurants and retailers. Those without cars face both a bigger economic impact and a bigger risk of contracting COVID-19.

The recovery is likely to be uneven too. For the most part, those hit the hardest will recover the slowest, but there are exceptions. Vehicle production fell almost to zero in April and remained depressed in May, but vehicle sales have been stronger than expected, boosted by people who want to avoid mass transit. Production will recover. Single-family housing starts are likely to recover (much faster than existing home sales) as people leave cities, but May housing starts disappointed due to supply constraints.

Reopening has boosted economic activity more than I expected. I didn't think people would return to stores and restaurants as soon as they were allowed to. Many did. The result was a much bigger improvement in May retail sales than I expected and an earlier upturn in employment and industrial production than I anticipated. But relative to where the U.S. economy was at the business-cycle peak in February, it is still in a deep hole, and it will take a long time to crawl out of it.