Current Economic Conditions

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YOUR MONEY OR YOUR LIVES

In the most sudden and unexpected economic downshift I've ever seen, the U.S. economy has gone from surprising strength in January and February to a sharp decline in March, the result of the spread of the COVID-19 coronavirus. While the downshift has not shown up in the data yet, declines in air travel, the cancellation of cruises, conferences and sporting events, school closures, productivity losses as employees work from home, and the hit to retailers, restaurants, and theaters as people have (belatedly) heeded warnings to stay home and avoid crowds implies that economic activity has collapsed and that it will remain weak for at least another month or two. From an economic standpoint, the only real question is whether the decline in economic activity will last long enough to qualify as a recession.

Economic data for January and February show the economy was in good shape before the coronavirus spread to the United States. Payroll employment grew by 273,000 in both months, more than twice what is needed to absorb growth in the adult population. The unemployment rate fell back to 3.5%, a 51-year low, in February. Initial claims for unemployment insurance, the best weekly indicator of economic activity, remained low through the week ending March 6. Light vehicles sold at a 16.9 million seasonally adjusted annual rate in the first two months of the year, in line with last year's selling rate. Retail sales in the first two months of the year were up 6.5% year-over-year. Consistent with the strong economy, the S&P 500 hit an all-time high on February 19. It has since fallen about 30%.

The sharp decline in economic activity is the result of decisions, made by some and imposed on others, to choose the health of our citizens over the health of the economy. This is the decision of a humane society, and one that is wealthy enough that it can afford the economic hit. Shutting down segments of the economy that require social contact won't stop the spread of the virus but could slow it enough to keep it from overwhelming the healthcare system. (In Italy, hospitals could not accommodate all who were ill, and many were denied care.) It could also keep some people alive long enough to benefit from treatments being developed or a vaccine that likely won't be available until 2021. Because the death rate from COVID-19 is so low among young people and so high among the elderly, the health benefits from the decline in economic activity are skewed towards the elderly. Those of us who are over 60 should be grateful for the economic sacrifices that younger Americans are making for our benefit. (College students that have been sent home are making a HUGE sacrifice for the benefit of their professors.)

The Federal Reserve has cut the federal funds rate by 1.5 percentage points in response to COVID-19, taking it to a range of 0-0.25%, and has increased purchases of Treasury securities. Rate cuts will help home building, which was already surging in response to prior cuts, and will benefit homeowners who refinance their mortgages but will do little to help the economy more broadly. What the Fed needs to do is to guarantee lines of credit to keep good companies from going bankrupt because of an exogenous (and temporary) shock. (These companies wouldn't be at such risk if they weren't so highly leveraged, and they wouldn't be so highly leveraged if interest deductions didn't subsidize debt finance at the expense of equity finance, against the advice of every good public finance economist from both sides of the aisle. Allowing homeowners, businesses, and investors buying stocks on margin to deduct interest expenses from their taxable income is a bad policy that contributes to every asset bubble and its subsequent bursting.)

The House of Representatives has passed a COVID-19 relief bill that would provide nutrition assistance to the poor and elderly, fund unemployment insurance, mandate health insurance coverage of testing for the virus and fund testing for those without health insurance, and require companies with fewer than 500 employees to provide two weeks of paid sick leave at full pay and 12 weeks at two-thirds pay. It would provide tax credits to offset the cost of the paid leave. Paid sick leave is important, not because of anything it would do for the economy but because it would allow infected people to stay home rather than going to work because they needed paychecks or feared losing their jobs. The bill would be a small positive, and the Senate might follow with further stimulus, but we shouldn't fool ourselves. The economy will contract even if the policy response is optimal. (The bill doesn't include the payroll tax cut that President Trump wanted. Opponents argued a payroll tax cut wouldn't benefit people who lost their jobs and would move us closer to the point where the Social Security and Medicare trust funds ran out of money.)

The most effective response to the crisis, and the single best way of reducing the human and economic costs of COVID-19, would be to increase testing for the virus. If increased testing were to show the virus hadn't spread as much as feared, people would be less afraid a getting it. If it showed that mild (and previously undetected) cases were common, the death rate would fall, and people would be less afraid of dying from it. Either way, the fear that is paralyzing economic activity would diminish. Testing would also allow people who test positive to quarantine themselves until they are no longer contagious, greatly slowing the spread of the virus. The slow rollout of test kits so far is a national disgrace.

Now the forecast. Because January and February were so strong, growth in the first quarter of 2020 will still be positive. The second quarter, by contrast, will be terrible; real Gross Domestic Product and industrial production will fall sharply. Consumer spending will decline more sharply than in all but the worst recessions. Unemployment will spike. But the economy will eventually recover, either because the virus fades or because we reach the point where the loss of income and wealth forces us to reverse course and choose the economy over our health. I expect the recovery to begin by the fourth quarter. What I'm most uncertain about is whether the third quarter will be the beginning of the recovery or the quarter the bottom drops out. My current forecast is for real GDP to decline at a 6% annual rate in the second quarter – it could be even worse – and to be flat in the third quarter, but the third quarter could be much better or much worse than what I'm forecasting. The 1980 recession provides a useful template. That was the shortest recession on record, lasting only six months, but it included one quarter with a very large (7.9%) decline in GDP and a second quarter with a small (0.6%) decline. Two very strong quarters followed.

While the overall economy will decline in the second quarter, the impact across sectors will be very uneven. Retailers with a strong online presence will do much better than those that rely solely on physical stores. Theaters and live sports will suffer but online streaming services could benefit. Companies that make building materials could benefit from strong homebuilding, while metals and machinery manufacturers will be hurt by the sharp decline in oil drilling that will result from the collapse in oil prices caused by a big decline in oil demand and the subsequent price war between Russia and Saudi Arabia.

The decline in oil demand reflects the global impact of COVID-19 on economic growth. Nascent accelerations were interrupted in China and reversed in Europe, and Japan has fallen back into recession. Global GDP growth in 2020 will likely fall below the 2% threshold that marks a global recession. Still, anyone who sees the coronavirus primarily in economic terms needs to reexamine his or her priorities.