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The Economic Path Forward

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Transcript

It's great to talk to you today. What I want to discuss is the economic path forward. We have had this systemic risk realization, and the question now is how much long-term damage has been done to our economy? We know the human damage is tragic. But what about the economic damage? What will this recovery actually look like?

I have been interested in recessions for quite a long time. Some of you know that my dissertation at the University of Chicago discovered a relationship between the slope of the yield curve and future economic activity: when long-term interest rates go below short-term interest rates to create the so-called yield-curve inversion, this precedes economic recessions. Actually, I was a bit surprised I graduated given that my sample was only four (observations) recessions; I was four out of four. Indeed, some committee members were a little skeptical, however, the economic foundation of the idea was sound.

What usually happens is that you publish a scientific research paper and the effect gets weaker or it goes away. That was not the case for my dissertation. The next three yield-curve inversions preceded recessions, including the Great Recession. So, let's fast forward to June 30, 2019. The yield curve inverts for a full quarter and I go on the record saying Code Red: The yield curve has inverted since 1967 seven times followed by seven recessions. We need to take it seriously this time. We did not in 2007. People were listening to me—and I was not alone. Duke University has been surveying CFOs across the country and the world for the last 25 years and over 50% of those CFOs thought there would be a recession in 2020. That percentage increased to 80% if you included the first quarter of 2021.

Expectations were that economic weakness was ahead, but then a systemic event, the COVID-19 virus, hit, and we went into recession. We will never know if the yield-curve prediction would have been accurate, because the counterfactual is impossible. We do not know what the world would have looked like without COVID-19. But, nevertheless, we are in recession.

And this recession is a remarkably easy one to date. The dating committee of the National Bureau of Economic Research often dates the beginning of the recession *after* the recession is over. There is a lot of uncertainty about the date of the beginning and the date of the end. Well, this time, there is no uncertainty. The peak of the business cycle was February 2020—and then we went off a cliff.

What is different about this crisis and other recessions? Again, we are now talking about eight recessions, not that many. Each one is different. But almost all of the

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recessions are induced by economic or financial factors. So, for example, the Great Recession was induced by a financial event. Our banks were acting like hedge funds. They had extreme leverage. Then an event happened, which did not seem like a really big event in real time, but given their leverage, they got into trouble.

Then, the policymakers, afraid of the aftershocks to the economy, in trying to mitigate the damage had to bail out these financial institutions. At the time, and even right now, it was kind of repugnant to dole out billions of dollars to companies that did a poor job of risk management. Indeed, that sort of incentive just causes a replication of the same bad behavior in the future. But it was done. And it was relatively easy to do. You can summon the 25 CEOs of the largest financial institutions to a meeting and just hand them their bailout checks.

This crisis is different. The number one thing that is obvious is that this recession does not have a financial cause; its genesis is biological. We cannot point a finger at a particular sector or a particular set of firms and say, "It's your fault." Indeed, the whole concept of bailout does not make any sense. In the last recession we were bailing out firms that had poor risk management. This particular crisis is more like giving aid in terms of bridge financing to high-quality companies, companies that are profitable, that are making capital expenditures, growing their workforce. Then they get hit by, essentially, a natural disaster.

I want to return to the natural disaster analogy later.

The cause of this crisis is biological. The end of this crisis is also biological. The two main forces that will end this crisis are 1) a pharmacological solution to decrease the fatality rate if you get this virus and 2) a vaccine. A vaccine, effectively, is the "all clear."

Compare this to the Great Recession. We had no idea how long it would last. It went on and on. Indeed, the official end of the Great Recession is September 2009, yet unemployment continued to increase after that. Indeed, unemployment did not get back to the level it was in 2007 until May 2016—nine years later. And it was really confusing for policymakers because no one knew if we were still in recession or not. Growth was anemic. Interest rates were kept low for a very long period of time, and people talked about a lost decade of growth. Many compared it to the Great Depression.

This crisis is far different. And it is different because the uncertainty is different. Yes, it is true that at the beginning of this crisis we saw exponential curves of new infection cases, and people were fearing the worst. However, we have learned a lot more with time. We have learned that the initial infection fatality rates were vastly overstated, because many people contract the virus and have no idea they have it.

We also learned that epidemiology has a long history in academic publishing, whereby we see exponential growth at the beginning and then we hit an inflection point and it starts to decrease. These virus patterns are very common. So, we learned a bit about epidemiology. And, of course, the two key things that will mitigate the biological threat are the pharmacological mitigation of symptoms and/or a vaccine. Many drugs are being tested, and we have got a number of vaccines in trial.

Again, this recession is different, because there are pretty solid expectations we will have a biological solution by the fourth quarter of 2020, potentially deployed in the first quarter of 2021. We see the light at the end of the tunnel; in other recessions that just was not possible. The clarity is so different than in other recessions. So what does this mean? It means that on different fronts the uncertainty drives different policy responses. The uncertainty drives different psychological responses.

For example, in the Great Depression, you lose your job. It is just very difficult to find work anywhere. And you lose your job for a very long period of time. In the Great Recession, let's say you're working for Lehman Brothers, you get laid off, well, you are not going back to Lehman Brothers because Lehman Brothers is gone. It is hard to go to another company because many of them are under stress. Who knows when you are going to get a job?

Well, fast forward to today. People are being told that they are furloughed for two months. And many expect to go back to their job. That is way different. Think of the global financial crisis and the debates in Congress about spending. One of the issues for

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policymakers was: How long is this going to last? We cannot spend all of the money because we might need to go back to the well if this is prolonged. In this particular crisis, there is a biological light at the end of the tunnel, which allows policymakers to use all their ammunition.

What are the potential risks? I would like to talk about a few of them. The economic numbers are awful. The official unemployment rate of 14.7% is vastly understated. I challenge you to do the math, and the math is really simple. The unemployment rate is just a survey number. So all you need to do is to start by taking the number of unemployed in February 2020. Then add in the initial claims for unemployment in March, April, and May. Next, divide by the February workforce. That's not 14.7%. It is 23.9%, at least. So, we are potentially headed to 30% unemployment.

Many say that is like the Great Depression, because in the Great Depression we had an unemployment rate of 25%. Technically, unemployment records only began officially being kept in 1948, but 25% is a reasonable estimate. The rate could be higher than it was in the Great Depression, but that does not mean that we are in another Great Depression. Again, the key to understanding this crisis is that the uncertainty is different. In the Great Depression, people were unemployed for a very long period of time. It was very discouraging. In addition, we did not have the social safety nets we have today.

But, more importantly, we can see the end to this particular crisis, and the attitudes are different. The second quarter in terms of economic growth will be stunning. It will be off the chart, maybe −30% on an annualized basis. In the third quarter, there will be little or no growth. But, by the fourth quarter, things will start to pick up, and we will see significant growth, and I believe that a vaccine will likely be fully deployed in the first quarter of 2021.

This recession is really unusual. I have called it the Great Compression. In a few weeks, we lost the equivalent number of jobs that we lost during the Great Recession—a lot of bad news that is really compressed.

What can go wrong here? And let me end with a kind of warning. What we do not want is structural damage to the economy. By that I mean that we do not want high-quality companies that were profitable, that were innovating, to disappear because of this natural disaster. If those companies exit it will delay the recovery, it will haircut future economic growth. Yes, those companies can be replaced with new companies, but there would be the fixed costs, frictions, of getting new companies up and running.

A lot of the policy response has been focused on mitigating the structural issues, so that high-quality companies can be in stasis during this crisis, and then reemerge. I worry these policies will not be successful, and we lose many of these businesses. This time it is much more complicated because this is not a situation of 25 financial institutions whose CEOs can easily be called into one room. There are 30.2 million small- and-medium sized businesses in the US.

The other thing I worry about, and this is really important, is that we have to pay for this. This is not like a regular natural disaster when a hurricane hits Louisiana or Florida and the rest of the country is okay. This is a natural disaster that hits everywhere. We are borrowing, and we need to pay it back. We are borrowing from the future.

How do we do that? Well, there are two ways to do it. Number one, we raise taxes, and that could have a negative impact on growth. But raising taxes is really difficult. Nobody wants to raise taxes. No politician wants to raise taxes; it is political suicide.

So, the other thing I challenge you to think about is the specter of inflation. After the Great Recession, many said that all this quantitative easing will cause inflation, but there was no inflation. I would be very hesitant to extrapolate from a sample of one data point. Just because we did not have inflation after the Great Recession doesn't mean we won't have inflation in this particular episode. Yes, it is difficult to conceive of future inflation because we are experiencing deflation right now, but it is a significant risk. Inflation impacts companies negatively and people negatively, including the people who can least afford it, who are in essence regressively taxed by inflation. I believe inflation is the major risk.

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