Current Economic Conditions

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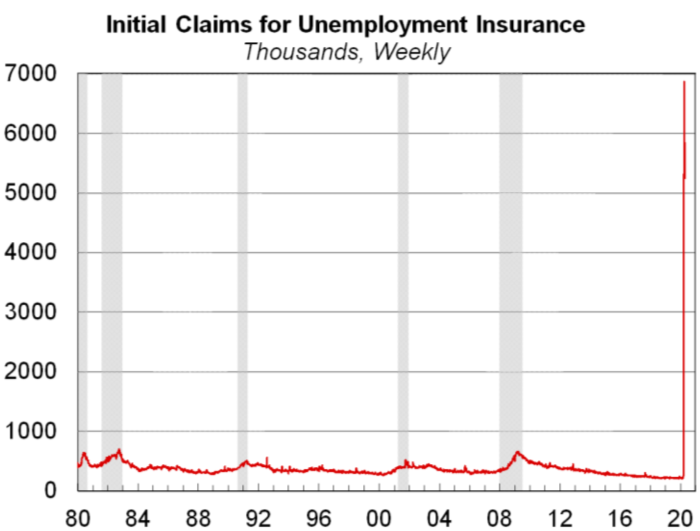
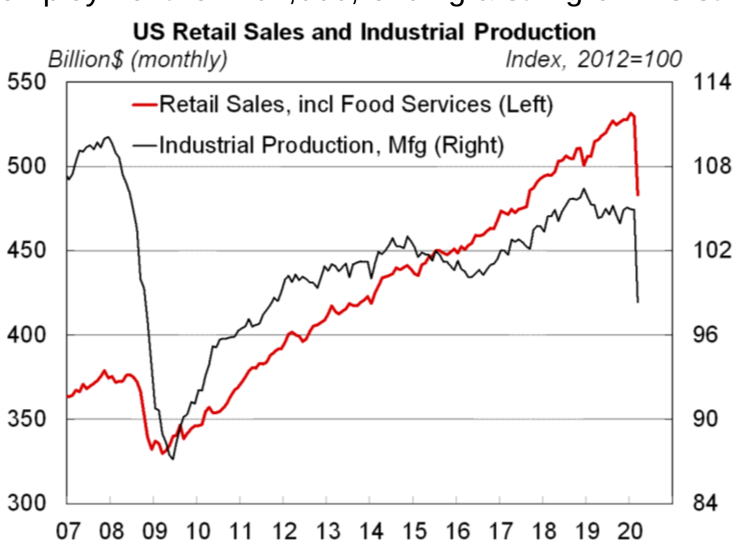
SOLITARY, POOR, NASTY, BRUTISH, AND SHORT



The economic impact of the COVID-19 pandemic, which did not show up at all in the economic data available a month ago, has become evident in the last few weeks. The impact first showed up in initial claims for unemployment insurance, the best weekly measure of U.S. economic activity. Data reported March 12 for the week ending March 7 showed claims at 211,000, close to an all-time low. A week later, they jumped to 282,000, the highest since September 2017 but still low by historical standards. The following week, after state-mandated business shutdowns took effect, claims surged to 3.307 million, nearly five times their previous record. Claims jumped to 6.867 million the week ending March 28 and totaled nearly 12 million over the first two weeks of April.

Data reported in the monthly employment report are collected the week that includes the 12th day of the month. Because the mandated business shutdowns started after that week in March, the March employment report, released April 3, was not expected to show a big impact from COVID-19. But payroll employment fell 701,000, ending a string of 113 straight monthly increases, and the unemployment rate jumped from 3.5%, a 51-year low, to 4.4%. This makes it clear that employers had stopped hiring and started laying off workers even before the mandated shutdowns. Other reports, which includes data for the whole month rather than from a single week, show a much bigger impact. Retail sales (including food services) fell 8.7% from February to March (seasonally adjusted); this was the biggest monthly decline since the data series started in 1992. New light vehicle sales fell from a 16.7 million seasonally adjusted annual rate in February to an 11.4 million rate in March. Industrial production in U.S. manufacturing fell 6.3% in March. This was the largest monthly decline since 1946, during the demobilization from World War II.



The monthly decline in economic activity in March was the worst since at least 1946. April will be much worse. Businesses that were shut down for 10 days to two weeks in March will be shut down for the entire month of April. The unemployment rate will jump to the mid-teens, the highest level since 1940. (The jump in the headline U-3 unemployment rate will understate the rise in unemployment, since people who don't look for new jobs because they anticipate being called back to their old jobs aren't counted as unemployed. The U-6 “underemployment” rate will rise much more.) The decline in retail sales will set another new record. Light vehicle sales could fall to a 6 million annual rate as buyers continue to avoid showrooms, either because of fear of the virus or economic uncertainty. The April decline in industrial production in manufacturing could surpass the previous record decline of 12.1% in August 1945.

The decline real Gross Domestic Product in the second quarter will be the largest quarterly decline since quarterly data began in 1947, and the magnitude of that decline would have been unimaginable just a month ago. If a quarter of the economy is shut down for two months (or a third is shut down for a month and a half), real GDP is reduced by 16.67%. But GDP growth is reported at an annualized rate. If you annualize a 16.67% quarter-to-quarter decline, you get a -51.8% annual rate! Until now, the biggest quarterly decline was 10% in the second quarter of 1958. If a forecast for second-quarter GDP growth doesn’t seem implausibly bad, someone is probably not annualizing correctly. Even if the economy begins to recover soon, as I expect, and returns to pre-recession levels quickly, which I don’t expect, the decline in annual GDP this year will be the largest since an 11.6% decline in 1946.

The federal government, including the Federal Reserve, has injected an incredible amount of money into the economy via fiscal and monetary policy. This might prevent a wave of bankruptcies that would hamper the economy’s ability to recover from this recession, but it won’t ignite a recovery. The timing and trajectory of the recovery will depend much more on medical developments than on government policies. CEOs told President Trump last week that shutdowns can’t be lifted until testing capacity (for the virus and for antibodies) is “adequate.” They know that reopening businesses that don’t lend themselves to social distancing without the capacity to test all employees will likely lead to a resurgence in COVID-19 cases. That could lead to new shutdowns and would shake confidence in the economic recovery. Ultimately, complete recovery from the recession won’t happen until an effective treatment or vaccine (or herd immunity) removes the fear of airplanes, cruise ships, restaurants, sporting events, theatres, and other places where people congregate. (Barring a miracle cure, the best-case scenario is that mass testing for antibodies reveals that many of us have had COVID-19 without knowing it and now have some level of resistance or immunity. That would give us “herd immunity” and significantly slow the spread of the virus.)

If businesses reopen in May, the level of economic activity could hit bottom as early as this month. If the National Bureau of Economic Research places the business cycle peak in February and the business cycle trough in April, this would be, by far, the shortest recession on record. But that’s of significance only to economists, who define a recession as a period when economic activity is contracting and include the recovery from the recession in the ensuing expansion. To non-economists, especially those who run businesses or who lose their jobs, the recession lasts until economic activity returns to its pre-recession peak, i.e., the recovery is part of the recession. Even if the recession technically ends with a business cycle trough in April or May, most people will feel like they’re in a recession until fear of COVID-19 fades, and even then, only if businesses are not permanently damaged and are financially able to reopen.

Economists often describe the shape of a recession/recovery using a letter: a V (quick recovery), a U (delayed recovery), a W (double-dip recession), or the dreaded L (no recovery). I don’t think any of those shapes work this time. Businesses that can operate without close human contact will rebound quickly. That will give us a quarter with a very strong annualized growth rate but that leaves the level of economic activity well below the pre-recession peak. Then we’ll get moderate growth, which won’t return us to the pre-recession peak, until a treatment or vaccine allows everyone to return to their normal activities and gives us a quarter or two of very strong growth. I expect that in the second half of 2021.

Thomas Hobbes, in *Leviathan*, described life in the state of nature without a “social contract” as “solitary, poor, nasty, brutish, and short.” Because of shelter-in-place orders, many of our lives are solitary, and most of us are poorer. The recession will be nasty and brutish, the worst since the Great Depression. Fortunately, I expect it will be short, at least how economists define recessions. But recovery will take a while. In the meantime, businesses need to focus on survival, not on quarterly earnings.