From the desk of Komal S. Sri-Kumar, Ph.D.
September 10, 2020

How to Achieve an Economic Recovery

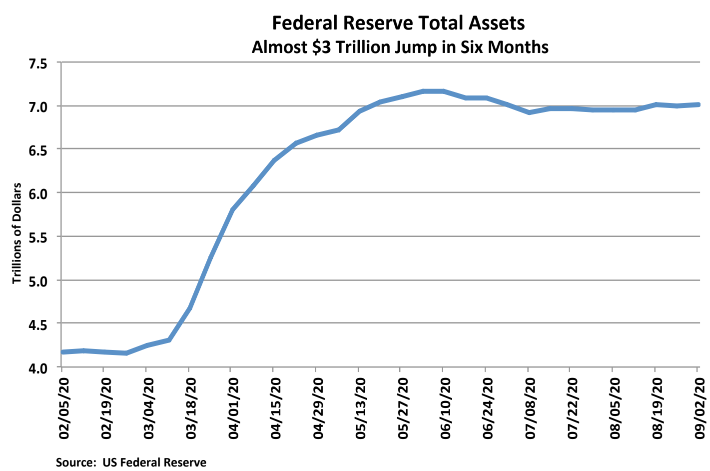
Where We Were

The US economy underwent a severe contraction in the months since March, with the unemployment rate surging from a 60-year low in February to the highest level in over 70 years in April. Weekly initial jobless claims that had been in the neighborhood of 200,000 for the better part of five years shot up to almost 7 million at the end of March. The suddenness of the economy's downshift stemmed from the rapidly spreading coronavirus, a global pandemic that caused closures of cities and businesses, resulting in massive layoffs of workers by businesses that found their sales revenues abruptly plunge close to nothing.

With the pandemic's incidence being worldwide, the global economy abruptly switched from growth to recession. Governments poured massive resources to counter the downturn. According to a McKinsey & Company calculation[1], worldwide fiscal stimulus amounted to $10 *Trillion* in just two months. In the United States, the Coronavirus Aid, Relief and Economic Security (CARES) Act passed by Congress toward the end of March authorized some $2.2 Trillion in a relief package that was the largest in history.

The program is intended to aid American businesses by providing low-interest loans to small businesses, and grant payments focused on individuals with annual incomes less than $99,000 ($198,000 in the case of joint-filers). Most adults received relief payments of $1,200 that helped provide for spending on essentials during the initial months after the pandemic struck. Large companies, including those considered vital for national security, received $500 billion in loans. For smaller companies, $350 billion was authorized to provide low-interest support loans, to be partially or fully forgiven if the payroll was maintained. $150 billion set aside for assistance to state, city and local governments was the third leg of the tripod of US federal aid.

The US Federal Reserve supplemented the assistance from the Treasury with its own measures. The Federal Funds target rate, which had been in the 1.5 – 1.75% range at year-end 2019, was reduced in stages to just 0 – 0.25% by March 16. The central bank's holdings of assets, that had been declining as part of the Fed's effort to normalize its balance sheet, went through a sharp increase following purchases of Treasurys and mortgage-backed securities. Total assets currently stand at just over $7 trillion, up almost 70% from $4.2 trillion at the end of February.



Deciding that reductions in interest rates and bond purchases (known as Quantitative Easing), a staple of the post-2008 recovery exercise, were not sufficient this time around, the Federal Reserve took on the responsibility of purchasing other forms of debt. On April 9, the central bank announced that it would purchase "fallen angels" – corporate bonds such as those of Ford Motor Company which had dropped from investment- to noninvestment-grade status – to "increase liquidity in the corporate bond market." Concluding that even this was insufficient, a measure introduced on May 12 enabled the purchases of corporate bonds in the form of exchange-traded funds.

In case markets still did not fully comprehend the Fed's intention to keep the monetary tap open, Chairman Powell signaled in his virtual Jackson Hole speech on August 27 that authorities would be tolerant of the inflation rate exceeding the official target of 2% before any tightening occurred – a message that investors took to mean that interest rates would continue to be at a near-zero level for several *years*, and that there may be further increases in the central bank's balance sheet to enable the overshooting of the inflation rate.

It has been easier to implement monetary easing than to advance fiscal measures that require acts of Congress. Since the $600 supplementary weekly benefit payments for the unemployed ended on July 31, the Trump administration and Congress have been unable to agree on subsequent measures. The administration and the Republican majority in the Senate believe that the $600 amount is too large, and a disincentive to return to work. The Democrat-led House of Representatives points to the pain still being endured by the jobless. The two sides are also far apart on aid to local governments whose tax revenues have plunged due to business failures and loss of individual incomes. Although the Federal Reserve has expanded its program to purchase local governments' debt, a full-fledged fiscal effort has been lagging.

Where We Are or, Are We in Recovery?

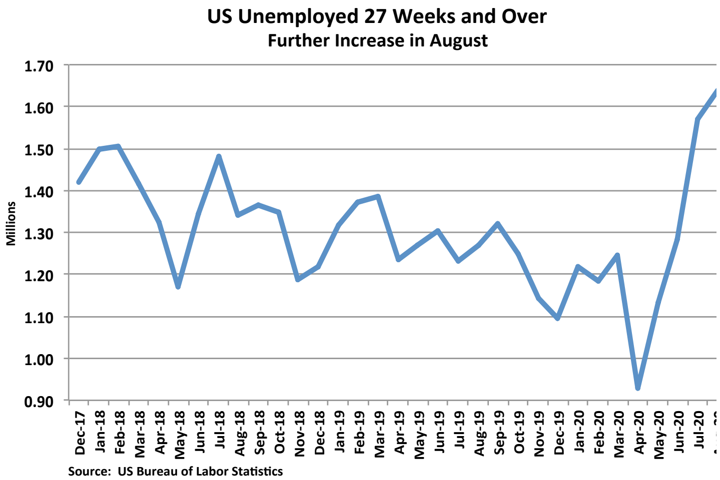
As I write this report, there are signs of green shoots on the economic horizon. The housing sector is one of them. As the Federal Reserve's easing worked its way to lower mortgage rates, and as more individuals work from home, US existing homes sales rose by 24.7% month-on-month in July to 5.86 million, the fastest pace since 2006. A "flight to the suburbs" by households was another tailwind for home sales. And since housing is often a leading indicator of the economy the developments were viewed as positive. On the jobs front, the report released on September 4 showed that the unemployment rate had fallen to 8.4% in August from 10.2% in July. 1.37 million unemployed workers found jobs, and the labor force participation rate rose to 61.7% from 61.4% in the prior month.

Neither of these developments should provide comfort that a sustainable economic recovery is under way. Low mortgage rates and suspension of foreclosures have helped housing but the sector cannot depend on these stimulus measures indefinitely. Reductions in work force that companies plan to implement – even in the ranks of upper income, white collar workers -- after some of the federal assistance runs out on September 30 would be a headwind for housing. Already, total nonfarm employment is lower than in pre-pandemic February by 11.5 million despite the job creation in August.

Furthermore, a factor that was a major influence on the recent improvement in employment statistics could itself be a precursor of the deterioration to follow. The recent rehiring of furloughed workers stemmed in good measure from the reopening of cities and states from covid-induced restrictions. On the other hand, increased incidents of the virus due to the reopening have themselves caused a secondary wave of shutdowns. For example, Florida and Texas officials increased restrictions on businesses following a resurgence of the virus due to premature openings. California ordered the shutdown of indoor dining in restaurants and bars statewide in July, even of those that had previously been allowed to reopen due to a low incidence. In turn, the renewed closure of establishments is contributing to the transformation of workers from a temporary loss of jobs to one that involves being laid off permanently.

The second wave of business closings is having, and will continue to have, a depressing impact on small firms that form the bulk of the US economy. Proprietors who could tolerate a short-term closure are more likely to shut down permanently if they have to undergo a second (or third) state-ordered ban on activity. The deadlock in Congress on renewing assistance, and the expiry of the $600 unemployment assistance with no replacement in sight, suggest that the economy's path is more likely to resemble a "W" than a "V" – after a rise in real GDP in the third quarter from the steep decline in the second, expect the economy to turn down again in subsequent quarters.

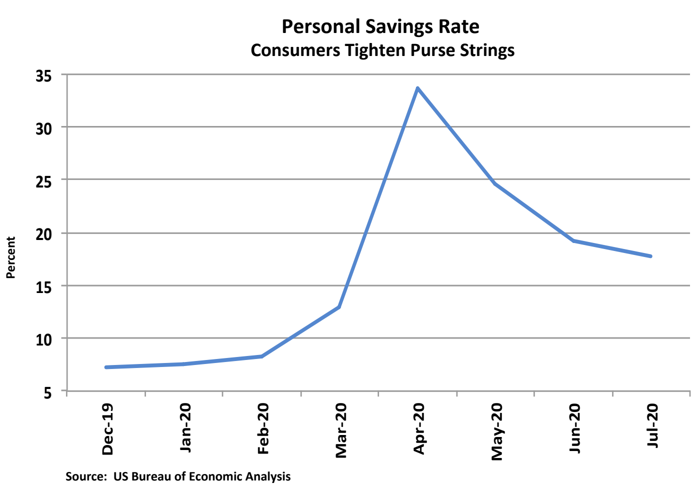
Two statistics on the jobs front bear this out. Those considered by the US Bureau of Labor Statistics to be "permanently" unemployed rose from 2.9 million in July to 3.4 million in August. The last time this figure was so high was in 2013. A related figure, those unemployed for 27 weeks or longer, has been on a relentless rise since covid hit, and currently stands at 1.6 million. Workers who have been unemployed for too long lose their ability to be reabsorbed into the workforce, especially when the economy is undergoing covid-induced structural shifts.



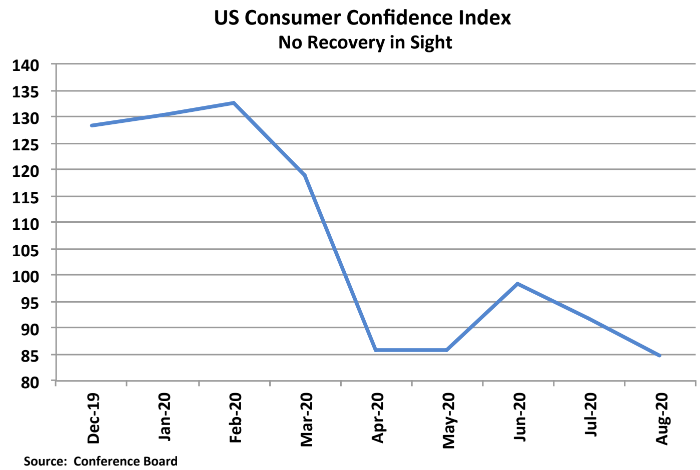
A true economic recovery needs to not only lower the unemployment rate and raise the labor force participation rate, but also begin the process of enabling the long-term unemployed to become productive members of the society again. There is little indication that this transformation of the labor market is in process.

<u>How to Create a Recovery: What to Watch For</u>

The Savings Rate -- When the pandemic hit, the US personal savings rate surged. Defined as the percent share of disposable income that is not consumed, the savings rate rose from 8.3% in February to 33.7% by April.



The suddenness of the hit on incomes and employment was such that consumers decided to cut back on spending, even on essentials. Consumer confidence, which cratered immediately after the covid hit, has defied predictions and continued to fall to even lower levels through August. And since consumer spending accounts for about two-thirds of US gross domestic product, the decline in consumer confidence is playing an important role in holding back economic recovery.

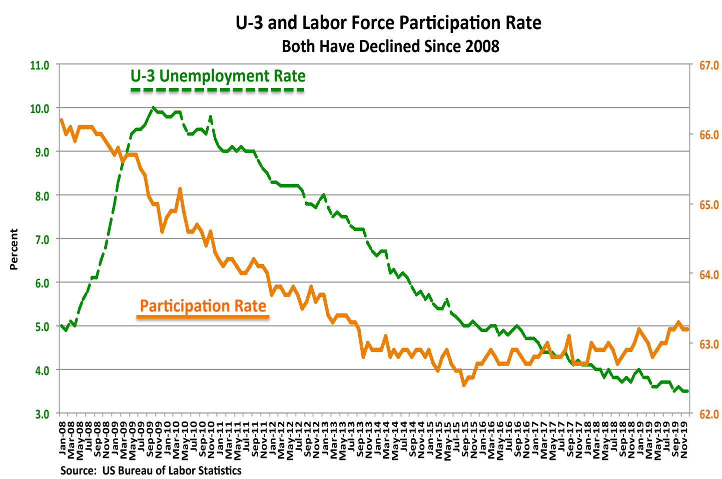


In addition, workers at lower income levels were among the first to be laid off, especially in the hospitality sector and in smaller enterprises. Since lower income earners save a larger portion of their earnings, the shift in income to the still-employed high salary earners boosted the savings ratio and worsened the recession. Collectively, reduced spending by consumers equates to lower income for the receiving parties, eventually implying a decline in gross domestic product.

A fall in the savings rate to a single-digit level would suggest that spenders are feeling more secure about their jobs and salary levels. It would also be a signal that lower income workers have started to participate in an incipient economic recovery. Steps to resume fiscal assistance to the unemployed and, over the medium-term, measures to train workers for the new post-covid economy, would go a long way to reduce the savings rate and boost the pace of economic recovery (more on this later).

Phillips Curve and the Inflation Bogey -- If the unemployment rate declines with an economic recovery, will that not cause inflationary pressures to increase? This concern is based on a concept called Phillips Curve which posits that there is a stable and inverse relationship between inflation and unemployment. On the other side of the debate, some have argued that the Phillips Curve is no longer in effect because the Federal Reserve has not managed to raise inflation consistently to its target level of 2% since the global financial crisis despite the U-3 measure of unemployment dropping to a 50-year low of 3.5% in the months before covid. Did the low unemployment rate not signal an unduly tight labor market? Should that not have caused inflation to surge?

Phillips Curve is alive and well despite – or, due to? – developments over the past decade. Despite the low U-3, the labor force participation rate did not rise to its 66% level just before the Great Recession began. It was 63.4% in February. If the participation rate earlier this year had been the same as in December 2007, the unemployment rate would have been significantly higher. In other words, rather than a tight labor market, the US has been experiencing a skill mismatch that has kept a number of workers who lost jobs in the last recession from regaining positions over the past several years.



Missing Element or, The Dog That Didn't Bark -- In "The Adventure of Silver Blaze," Sherlock Holmes finds the curious case of the dog that did not bark even as a prize horse was stolen from the stable in the middle of the night as a major clue in itself – the dog knew the horse thief.

That inflation did not pick up despite a manifold increase in the Fed's balance sheet since year-end 2008 provides a clue to the missing element. Average hourly earnings rose by 3.7% in January 2009 from a year earlier but never matched that level again anytime until the onset of covid. Near-zero interest rates and continued bond purchases by the Fed boosted valuations on risk assets but did little to create jobs for the unskilled and the semi-skilled. Since these groups of workers dominate the labor force in sheer numbers, hourly earnings rose on average by only 2.5 percent during the intervening years. Workers had to either accept lower paying jobs or work fewer hours. Neither of these moves would have been inflationary despite the surge in money supply.

<u>How to Create a Recovery: Structural Adjustments in Germany and Japan</u>

Neither monetary nor fiscal expansion alone can succeed in creating a lasting economic recovery. We have two experiences from recent decades that show that structural changes are necessary to achieve a lasting recovery. Simply put, a quintupling of the central bank balance sheet – as the Federal Reserve did between the end of 2008 and 2014 – cannot transform a plumber into a nuclear physicist. Education and training are the key.

The first experience is that of Germany's successful exit from its status as the "sick man of Europe" at the beginning of this century. The second is Japan not being able to meaningfully push up the pace of economic growth despite the "Abenomics" measures that Prime Minister Shinzo Abe introduced after he assumed office for the second time in late-2012. They both hold a lesson on how to create a lasting US economic recovery.

Germany was experiencing double-digit unemployment rates at the beginning of the 21st century. Fiscal deficits as a percent of gross domestic product exceeded the European Union-mandated 3% ceiling in each of 2002, 2003, 2004 and 2005 to no avail. In 2003, Chancellor Gerhard Schröder's government introduced labor market changes that were broadly known as the Hartz reforms. The crux of the reforms was the creation of a low-wage sector with government subsidies to employers who hired employee-trainees who not only worked for the companies but acquired new skills during the training process.

The exercise helped lower the unemployment rate from almost 12% in 2005 to less than 7% by 2012. (It fell further to 5% in the first quarter of 2020.) Even more striking, worker training under the Hartz measures was key to eliminating the scourge of youth unemployment (for those aged 15 -24 years) that afflicts several European economies. German youth unemployment rate peaked at 15.5% in 2005 but fell to 6.2% by 2018.

Japan had the other – and opposite – experience. Abenomics had three policy arrows that intended to remedy the slowdown / recession that set in in 1990 – monetary and fiscal expansion, and a third arrow referring to structural changes. The final arrow recognized the reality of a declining, and aging, Japanese population, and would allow for targeted immigration of labor to mitigate the problem. One often-cited example was the arrival of Philippine caregivers to increase Japanese housewives' labor force participation rate and, thereby, the pace of Japanese growth. Also on the structural front, productivity would be enhanced by fostering competition in the various sectors.

In the almost eight years since the inception of Abenomics, real gross domestic product has averaged just 1% per year until just before covid. Neither an increase in the debt – GDP ratio from 219% in 2012 to an estimated 237% in 2019, nor negative Bank of Japan interest rates since January 2016, have succeeded in raising the growth rate. Any significant immigration of skilled labor has been held back by the Japanese concern over the homogeneity of the population.

How to Create a US Recovery: Worker Retraining is Key

Structural unemployment in the United States continues despite over a decade of monetary and fiscal easing. This, and the experiences of Germany and Japan with their stabilization programs, indicate how important it is to target post-covid US recovery measures at the level of individual workers rather than merely through broad-based monetary and fiscal expansion. In short, a durable recovery has to be built on the availability of a steady stream of skilled labor to suit the requirements of the post-covid economy.

In two articles written for the Milken Institute Review[2], Masood Sohaili and I suggested the introduction of a Universal Basic Income that all adult residents would be eligible for. It would be offset by the removal of a number of currently existing tax deductions to keep the fiscal impact manageable. Since all adults would receive it, the UBI will not be a "handout." An important objective of the UBI, Sohaili and I reasoned, would be to give the unskilled (or semi-skilled) laborers an advantage in negotiating with employers, having the resources to take some time off to develop new skills.

For its part, the next US administration needs to direct more of its fiscal incentives to companies that agree to hire and train workers for the new economy. Again, components of Germany's Hartz reforms can be employed in the US context. Such employers would get a subsidy for each worker they take on, and the workers themselves would accept a lower wage than otherwise to pay for their education / training. Once the training ends, the employees would be more valuable to their employers, with the new skills entitling them to higher wages than before.

Worker retraining would have another positive objective. It would raise wages of younger and lower-level workers and, in doing so, increase demand for both essentials as well as in sectors such as housing. A mismatch of skills has been a key reason why US average hourly earnings have remained plodding since 2009. They averaged just 2.5% per year from the start of the economic recovery through February 2020, barely above the inflation rate. The slow expansion in earnings was one reason why overall economic growth has been below potential over the past decade.

How to Create a US Recovery: Give Workers a Share in the Financial Upside

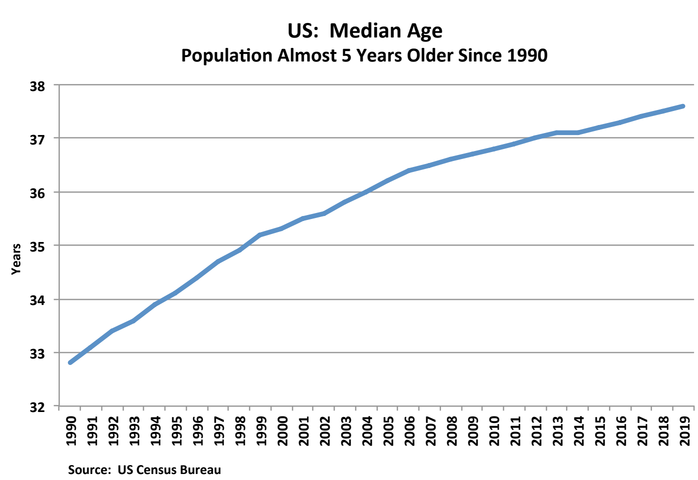
Corporate bailouts played an important role in post-2008 recovery measures, and they appear to be significant in ongoing efforts as well. While substantial amounts of taxpayer money was used to bail out large financial firms after 2008, and taxpayers are helping save large airlines and hotel chains today, the taxpayers receive no dividends from the bailed out firms.

During the highly leveraged trades that preceded the crash of 2008, financial institutions took large bets with borrowed money, some of it in the form of insured bank deposits. With leverage that could be as high as 30 to 1, the firms would benefit from a stock price surge and the traders would receive sizable bonuses if they bet correctly. When bets went the wrong way, the firms got bailed out and some highly paid traders just lost their jobs – to seek employment elsewhere. When the firms came back with massive backstopping by the Fed and the US Treasury, the taxpayers did not get a check for the capital gain!

In an opinion piece in the New York Times (3), Marianna Mazzucato of the University College – London calls this a process that involves a socialization of the bailout but not of the successes. A citizen's dividend, such as the one Alaska provides to its residents in the form of the Permanent Fund that depends on oil revenues would provide some upside to taxpayers.

How to Create a US Recovery: Immigration, Immigration and Immigration!

US population has been aging over recent decades. The median age rose from 30 years in 1980 to 32.7 years in 1990. The aging has continued, and the average American is now 37.6 years old. The reason for the increase is the falling Total Fertility Rate (or simply, the Fertility Rate, defined as the average number of babies born to a woman of child-bearing age during her lifetime). It was 1.7 in 2018 according to World Bank calculations, well below the 2.1 figure considered necessary to keep the population constant.



The rising median age and falling fertility rate have led to an increasing percent of the population that is older than 65 years – a development that leads to both lower productivity as well as to a rising share of the older population that needs to be supported by fewer and fewer younger workers. The remedy that the United States has used over its history, except for recent years, is to allow for the immigration of younger skilled workers.

There is a saying that immigrating young workers have not only a mouth to feed but also two hands to do the work that the older population is unable, or unwilling, to do. Unlike efforts to raise the fertility rate – such as subsidy payments provided by the French government for families to have more babies – immigration has the benefit of increasing production and productivity immediately.

Michael Bloomberg, then Mayor of New York City, had a ready-to-use prescription for the problem of scarce labor. Speaking to the US Chamber of Commerce in September 2011, he suggested that more visas be given for economic reasons. Specifically, foreign math and science students would get their US green cards along with their degrees. In addition to the skilled labor base, the Bloomberg proposal would reduce the risk that the new graduates would return to their home countries with their newly acquired skills to compete with US firms.

Concluding Remarks

There are three major points that this article means to address. First, a focus on the amount of monetary and fiscal expansion with much less attention paid to details will produce a recovery of poor quality as has been the case since 2008. It also runs the risk that the same errors will be repeated in a subsequent cycle. If excessive risk-taking by financial institutions is implicitly tolerated through bailouts, there is nothing to stop companies from repeating the process, contributing to the next downturn.

Second, the wellbeing of residents should be the ultimate goal of any recovery, and specific attention to improving living standards of workers will likely produce a recovery that is longer lasting and broad-based. A concept such as Universal Basic Income could be a way for workers to find the resources to improve their skill level and bargaining power.

The third point this article focuses on is an endorsement of the plea made by others, that benefits of a bailout go to taxpayers, not just the cost of bailing companies out.

All these have been factors that were weak – or totally missing – in past efforts by government to save enterprises and give rise to a recovery. This article is an attempt to redress the problem.

Komal S. Sri-Kumar
September 10, 2020

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[1]"Total stimulus for the COVID-19 crisis already triple that for the entire 2008-09 recession." McKinsey & Company, June 11,2020 https://mck.co/3m7A5FL

[2]"An Economic Case for Universal Basic Income." Milken Institute Review, August 2017; https://bit.ly/33b3yGi; and "A Letter to the Next President." Milken Institute Review, September 2019: https://bit.ly/33ezolE

[3]"We Socialize Bailouts. We Should Socialize Successes, Too." by Marianna Mazzucato, the New York Times, July 1, 2020

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