THE HAMILTON PROJECT

FRAMING ESSAY | JULY 2020

How the Pandemic Is Changing the Economy

Wendy Edelberg and Jay Shambaugh

MISSION STATEMENT

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by fostering economic growth and broad participation in that growth, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. We believe that today's increasingly competitive global economy requires public policy ideas commensurate with the challenges of the 21st century. Our strategy calls for combining increased public investments in key growth-enhancing areas, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers — based on credible evidence and experience, not ideology or doctrine — to introduce new and effective policy options into the national debate.

The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

How the Pandemic Is Changing the Economy

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JULY 2020

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Introduction

The COVID-19 public health crisis, the economic shock triggered by the pandemic, and public policy, business, and individual responses to the pandemic together have provoked the sharpest and fastest economic downturn in U.S. history. Four months after the shutdown started, many sectors of the economy remain entirely shuttered, while others are struggling to open by the fall, and still others are operating at sharply reduced levels. Both the pandemic and the fiscal policy response have ebbed and flowed, and as a result the economy remains fragile.

At the depth of the downturn, the U.S. economy experienced its greatest job losses since the Great Depression, with the unemployment rate and unemployment filings rising faster than they ever have in such a short span of time (see figure 1). Additionally, gross domestic product in the second quarter of 2020 is forecasted to decline at the fastest rate ever recorded (Federal Reserve Bank of Atlanta 2020).

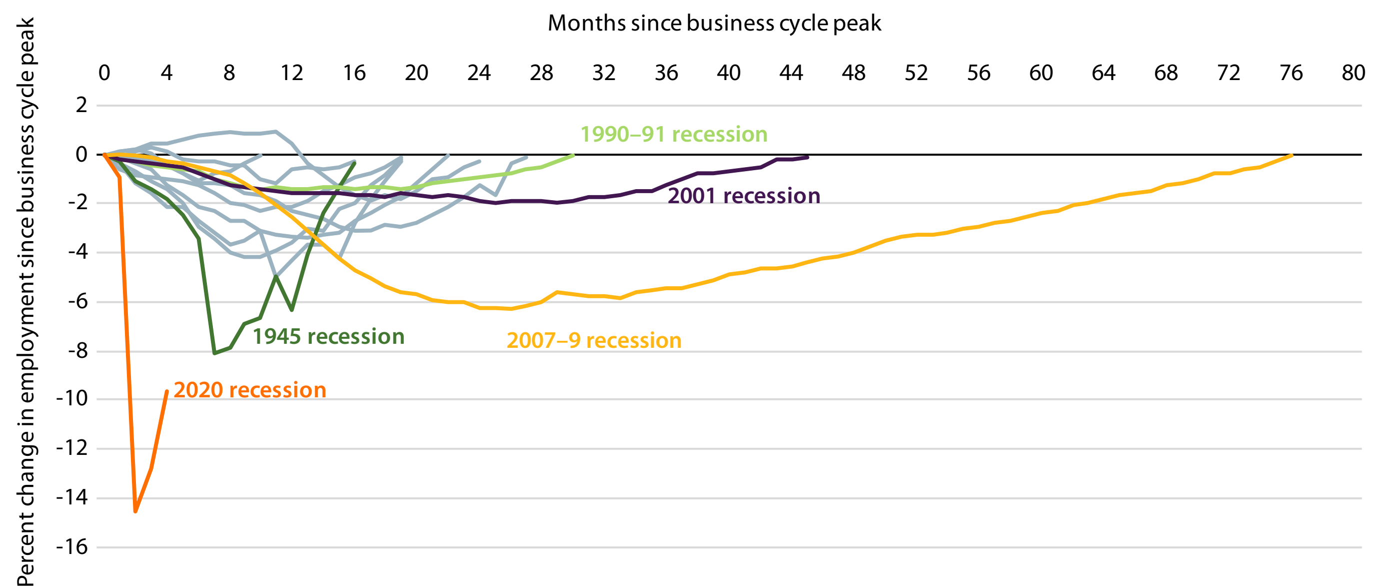
Even if the health emergency were to recede quickly and if public health policy were to be effective, the United States will face challenges for years resulting from this shock. First and foremost, there have been and will continue to be large-scale losses of life and health. To date, more than 134,000 Americans have died from COVID-19 (Centers for Disease Control and Prevention 2020). Millions more have been infected, and many of those who are infected and survive will face long-term health repercussions. The health burdens have not been borne equally. In particular, older Americans and the Black American community have been hit particularly hard (Ford, Reber, and Reeves 2020; Williamson et al. 2020). The continued spread of the coronavirus throughout the United States suggests that the challenges to restoring normalcy to our lives and to public health conditions will remain unresolved for some time.

The swift and unprecedented downturn in combination with protracted closures will have long-lasting economic consequences. The global economy will suffer a recession with many emerging market economies struggling for a protracted time and trade patterns shifting. The policy landscape will look different as governments face higher debt levels and central banks face larger balance sheets and lower interest rates. And, the way economic activity is organized will likely change. In particular, the American economy will change if certain trends regarding firms' closures, labor force participation, and what it means to be "at work" continue.

- Widespread bankruptcies could fundamentally change the business landscape, leaving some sectors with greater concentration such that consumers and workers will face surviving firms that hold greater market power.
- Changes in how and where people work and an acceleration in automation could mean that the labor market itself will be different.
- Stark reductions in labor force participation among older people, younger people, and those with young children could also lead to persistent changes in the labor force.

FIGURE 1.

Percent Change in Employment Relative to Business Cycle Peak by Business Cycle, 1945–2020



Source: U.S. Bureau of Labor Statistics (BLS) 1945–2020; National Bureau of Economic Research (NBER) n.d.; authors' calculations.
Note: Figure shows the percent change in total nonfarm employment from the peak of a business cycle until employment returns to the level of the previous business cycle peak. Gray lines refer to business cycles from 1945–2020 not otherwise highlighted.

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Understanding these changes is a first step for policymakers who will be responsible for responding to these challenges. An effective response will require renewed emphasis on antitrust enforcement, changes to the labor market to ensure that those with less education are not left behind, and support for parents, caregivers, and those with compromised health to help keep them attached to the labor market in the face of enormous challenges.

How the COVID-19 Recession Is Different

Recessions often result from an imbalance in the economy—for example, overinvestment in a sector, asset bubbles, or excessive leverage by businesses and households—and a rapid change in expectations about the future. In such cases, recoveries can be slowed by the painful adjustment of the economy rebalancing. As part of that adjustment, previous research shows that deep and protracted recessions can have long-lasting negative effects as some individuals leave the labor force, some firms fail, and some firms forgo making investments.[1]

The COVID-19 recession was precipitated by necessary collective action taken to preserve the lives of Americans and to buy time to put responsive public health measures in place; a partial shutdown of the economy resulted from decisions by federal, state, and local governments as well as decisions by businesses and households. The nature of the shutdown led to a much sharper contraction than during prior recessions but also—so far—to a shorter period during which the economy was contracting. The unemployment rate began to fall just two months after it initially rose, and job gains in May were the fastest on record (BLS 2020). Retail sales bounced up in May after a sharp downturn in April (U.S. Census Bureau 2020a).

Still, the quick onset of the recovery has not meant a full rebound, and the resurgence of the virus in June and July may signal more ups and downs for the economy. Even if improvements in the labor market and spending continue to be significant, the U.S. economy will likely face a sharply elevated unemployment rate and sizable gap in output relative to precrisis levels for well over a year (Congressional Budget Office 2020). In addition, although the unprecedented policy support at the beginning of this crisis has been large enough to keep aggregate household income from falling, many households have been left with insufficient support. The uneven distribution of economic pain has contributed to spikes in food insecurity and financial stress for many low-income households (Bauer 2020; Bitler, Hoynes, and Schanzenbach 2020). Furthermore, because many of those income supports are temporary, more households will find themselves with insufficient assistance long before the labor market recovers (Nunn, Parsons, and Shambaugh 2020).

Slowing the recovery, the U.S. management of the virus has not been successful compared to most other advanced economies. Cases and deaths have grown, making reopening complicated and requiring backtracking in some states.

The question we pose here is to what extent the changes in the economy that either started in or have accelerated since March are permanent. For this recession, it is a public health crisis rather than an obvious imbalance triggering the downturn. Conceivably, that could mean this shock leaves fewer long-term scars than the typical recession. On the other hand, the shock is so large that it could upend many sectors and practices in the economy. Therefore, the essential evidence to watch will not be monthly or quarterly growth rates: after a huge decline there can be sizable gains for months or quarters but the economy can still be quite depressed with millions out of work. Instead, we will be watching the level of the unemployment rate to see how many people are without earned incomes, the labor force participation rate to determine how many workers have left the labor market altogether, the number of new firms compared to years prior, and other indicators that can be compared to prior levels to determine whether the economy is back to prior activity (Edelberg 2020).

Potentially Persistent Effects of the Crisis

The unprecedented contraction in economic activity and the continued weakness in aggregate demand has had a seismic effect on the business sector. Already, the monthly rate of large corporate bankruptcy filings is approaching the peak levels last seen following the 2008 financial crisis (Brunnermeier and Krishnamurthy 2020). In addition, a rapid decrease in start-ups during the peak of the crisis has left the economy with tens of thousands fewer new businesses that could have become new employers. Other changes will be more structural: There will be some reallocation between sectors since certain sectors, such as the travel sector, may remain smaller for some time. In addition, as some firms fail and fewer new firms are created, the surviving firms will have a bigger share of the market and thus more market power. That, in turn, will exacerbate problems created by market power in product and labor markets.

The labor market may also experience longer-term changes. Of the roughly 18 million who reported being unemployed in June, roughly 3 million reported that their jobs were

permanently lost. The increase in permanent separations dwarfs the early losses in other recessions. In addition, recent research suggests that many of those who currently report being on temporary layoff will eventually experience a permanent job loss; that research suggests that roughly a third of job losses will eventually turn into permanent layoffs (Barrero, Bloom, and Davis 2020). Moreover, some communities are extremely distressed. In particular, the unemployment rate for Black Americans, which reached nearly 17 percent in May, has fallen more slowly than the aggregate rate and has fallen by less (BLS 2020). Those facts highlight how long it may take to bring the economy back to full employment. Finally, labor force participation rates have plummeted across many demographic groups. For example, the participation rate of men of prime working age (ages 25–54) fell from 89 percent in March to 86 percent in April (BLS 2020). The decrease interrupted what had been a relatively steady increase in their participation rates since 2015—after decades of decline. Whether the recent decrease suggests a resumption in the decline of labor force participation among this group remains to be seen.

Despite steep declines in business activity and employment, the response of investment has so far been relatively muted, according to available measures. For example, in May 2020 shipments of capital goods were down about 12 percent relative to the prior year (U.S. Census Bureau 2020c). In addition, private nonresidential construction put in place was down about 3 percent in May relative to the prior year (U.S. Census Bureau 2020b).

Going forward, however, changes in consumer demand and business practices will probably lead to notable changes in investment. Businesses may decide to increase their use of equipment and machines relative to their use of workers, through increases in automation and the like. Such changes will mean that when workers do return, the labor market might look different than it did precrisis. On the one hand, if workers are outfitted with more equipment and machines than before, productivity should be higher. On the other hand, if firms decrease their demand for labor, that would put downward pressure on wages. How the gains from productivity and automation are distributed is a question of labor market institutions and a challenge for public policy (see Moss, Nunn, and Shambaugh 2020 for discussion).

Description of Essays

A set of three essays from the Hamilton Project explores ways in which the shock could leave the economy fundamentally changed and offer ideas for policymakers to face these challenges:

David Autor and Elisabeth Reynolds (2020) ask whether the COVID-19 pandemic has changed the conventional wisdom about automation and inequality in the United States that has prevailed over the past four decades. They make four projections about a rapidly automating post-COVID-19 economy: telepresence, urban de-densification, employment concentration in large firms, and automation forcing, all of which would have significant, negative consequences for low-wage workers and economic inequality. On a more hopeful note, the authors conclude that rising inequality is not the only possible path forward, with the immense government investment of the past months suggesting the possibility of large-scale interventions to alleviate the costs of automation for those who lose employment.

Betsey Stevenson (2020) argues that the economic damage of the COVID-19 pandemic is not being well captured by current labor market statistics that show the surge of workers who have experienced a temporary loss of work and income. The challenge is in assessing the permanent damage that will persist well after the pandemic is behind us. Although the unemployment rate declined in May and June, permanent job loss accelerated over this period. Reversing this trend and getting these folks back to work is the difficult task that lies ahead of us. Stevenson shows that the labor market effects have not been evenly borne across workers of different genders, races and ethnicities, and educational attainments. The scarring effects of the recession will likely lead to high long-term unemployment and weakened labor market attachment for years to come. Stevenson calls on policymakers to extend and expand support for those who are unable to work because of the pandemic, and to support what is perhaps the most critical industry in a modern economy: our child-care providers and schools.

Nancy Rose (2020) describes how the economic crisis in the wake of the pandemic is changing the business landscape, exacerbating concerns about the state of competition in the U.S. economy. She documents how some large, well-positioned firms have dramatically increased their market share, accelerating trends seen prior to the pandemic. Other firms are increasing cash reserves, ready to acquire competitors damaged by revenue declines, excess leverage, and financial distress. Rose predicts that with more firm exits and fewer new business entrants today, tomorrow's product and labor markets may be less competitive and productive. In the face of these challenges, antitrust enforcers will be pressured to approve acquisitions of weaker competitors, and to not look too closely at cooperative solutions meant to maintain revenues in the current economic climate. Rose argues that preserving competitive markets will require policymakers to have a renewed commitment to assertive antitrust enforcement.

Looking Forward

Many of the policy responses taken in March assumed a very short and temporary shutdown. Unemployment insurance was initially made more generous in anticipation of massive job loss, but the increased support was time-limited to only four months, presumably under the assumption that workers would either be hired back quickly or that people would easily find new work if their job loss was permanent. The small-business support of the Paycheck Protection Program was also temporary, encouraging firms to retain workers, but designed at first to cover two months of payroll (though subsequent extensions allow a longer payout).

The direct economic effects of the pandemic will be longer lasting than periods suggested by the initial policy responses. Moreover, the indirect effects, including persistent economic weakness, will likely last long after the public health crisis has been resolved. While it is too early to say what the final health or economic toll of the pandemic will be, forecasts suggest protracted pain that is especially likely without fiscal support. On top of that, firms could reorganize their business practices and workers might face a different labor market and be hampered in their ability to work after the shock, making their place in the economy look very different even after the recovery.

Policy needs to focus on pushing the economy back to its full potential and cushioning those most directly harmed by the downturn. But policymakers also need to prepare for the fact that—much as individuals are changed by extended periods of isolation or fear—the economy will not go back to exactly what it was before. In addition to the many policies that were needed prior to the pandemic to support broadly shared economic growth, in the wake of this health and economic crisis there will need to be a renewed emphasis on antitrust, on making sure a reimagined economy can provide far-reaching opportunities, and on ensuring that people have the support they need to participate in the labor force.

Authors

Wendy Edelberg

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Wendy Edelberg is the director of The Hamilton Project and a senior fellow in Economic Studies at the Brookings Institution. Edelberg joined Brookings in 2020, after more than fifteen years in the public sector. Most recently, she was Chief Economist at the Congressional Budget Office. Prior to working at CBO, Edelberg was the executive director of the Financial Crisis Inquiry Commission, which released its report on the causes of the financial crisis in January 2011. Previously, she worked on issues related to macroeconomics, housing, and consumer spending at the President's Council of Economic Advisers during two administrations. Before that, she worked on those same issues at the Federal Reserve Board.

Edelberg is a macroeconomist whose research has spanned a wide range of topics, from household spending and saving decisions, to the economic effects of fiscal policy, to systemic risks in the financial system. In addition, at CBO and the Federal Reserve Board, she worked on forecasting the macroeconomy. Since 2019, she has served as a member of the Australian Treasury Expert Panel, providing input to the Australian Treasury on forecasting issues. Edelberg received a Ph.D. in economics from the University of Chicago, an M.B.A. from the University of Chicago, and a B.A. from Columbia University.

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Jay Shambaugh is the director of The Hamilton Project and a senior fellow in Economic Studies at the Brookings Institution. He is also a Professor of Economics and International Affairs at the Elliott School of International Affairs at The George Washington University. He has spent two stints in public service. Most recently, he served as a Member of the White House Council of Economic Advisers (August 2015–January 2017) where he was involved in policy related to international economics, macroeconomics, competition policy, energy and environment policy, housing, finance, technology, as well as other issues. He also served first as a Senior Economist for International Economics and then as Chief Economist at the White House Council of Economic Advisers (2009–11).

Prior to joining the faculty at George Washington, Shambaugh taught at Georgetown and Dartmouth. He is also a Research Associate at the NBER and has been a visiting scholar at the IMF. Shambaugh received his PhD in economics from the University of California at Berkeley, MA from the Fletcher School at Tufts, and BA from Yale University.

Shambaugh's area of research is macroeconomics and international economics. His work includes analysis of the interaction of exchange rate regimes with monetary policy, capital flows, and trade flows as well as studies of international reserves holdings, country balance sheet exchange rate exposure, the cross-country impact of fiscal policy, and the current crisis in the euro area. In addition to his book, Exchange Rate Regimes in the Modern Era (MIT Press, 2009), Shambaugh has published in The American Economic Review, The Quarterly Journal of Economics, and other leading journals.

Endnotes

1. See Boushey et al. (2019) for a discussion of the large impacts of recessions; see Cerra and Saxena (2017) and Reifschneider, Wascher, and Wilcox (2013) for a discussion of the long-term scarring of recessions on the economy.

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Abstract

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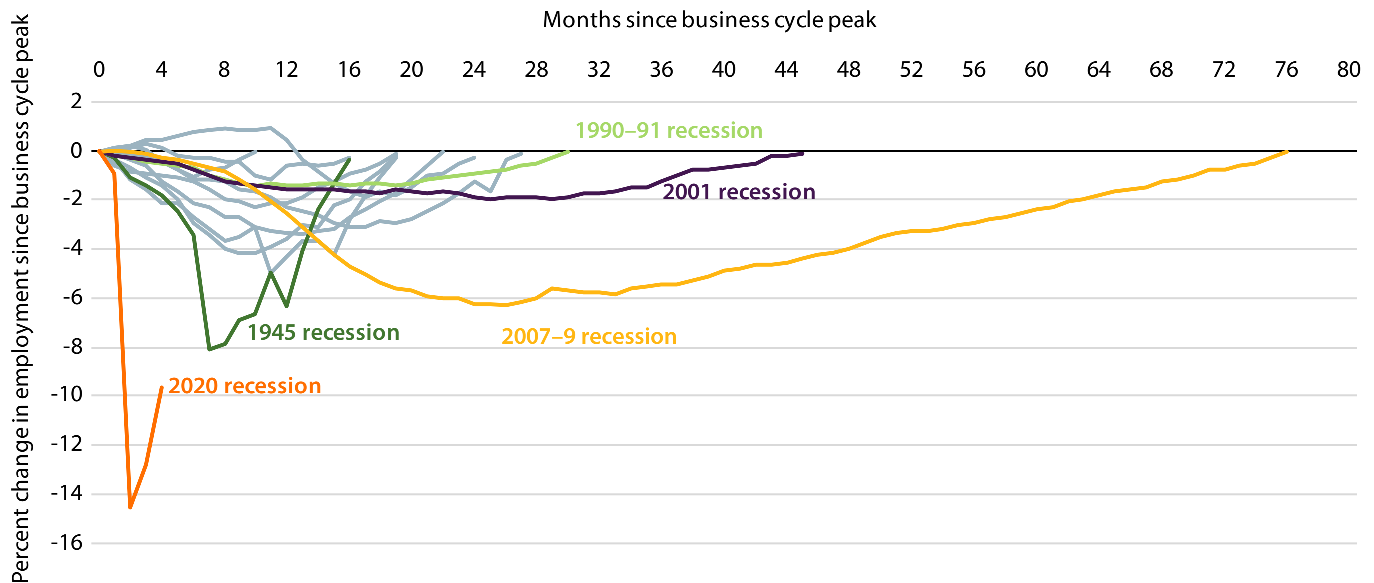

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