



## **The Post-COVID-19 Recovery: Three Scenarios**

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What will the recovery from the slump driven by COVID-19 look like? There are arguments for at least three different paths. We can call them: V, U, and L shaped. (A fourth, W-shaped, recovery can be seen as simply a variant of either V or U.) In each case, the letter describes (i) the path the overall economy is expected to take; and, (ii) importantly, defines the time frame of the recovery. Recovery can be best understood as getting back to and exceeding the previous levels of GDP. It does not necessarily mean back to the pre-COVID-19 growth path.

The next three sections of this paper describe the arguments for each of the three recovery scenarios. The fourth section asks what we might learn anything from the economic impact of the 1918/19 influenza pandemic. In a very brief conclusion, I make a guess at the probability, as of mid-May when I am writing, for each recovery scenario.

### *A. V-Shaped Recovery*

This scenario is the most optimistic. In this projection, the economy will rebound quickly, the recession, while likely deep, will be short-lived, although the United States will probably not return – or at least not quickly – to the pre-COVID-19 growth trend. We will, however, embark on new growth path with GDP expected to exceed the 2019 level by late 2020 or in the first half of 2021.

There are several points that favor this scenario. First, and probably most important, is consumer spending. The U.S. economy has been consumption-driven for the past three decades. Personal consumption expenditures account for almost 70% of GDP. The COVID-19 slump is primarily the result of a sharp decline in consumption. This dramatic drop in consumption has been driven by the restriction on personal movement, including social distancing, and the closure of many businesses and non-profits. Once these restrictions are relaxed, there will be pent up demand – for leisure, household goods, sporting events, food and drink, etc. And, because of the payments to families earning less than \$75,000 annually plus the enhanced payments from the four-month boost in unemployment insurance, there will be some disposable income available to satisfy this demand.

Even the favoritism to the ultra-wealthy in the form of write offs against some business profits (available only for households with incomes over \$500,000) and the shoveling of money into the pockets of large corporations may strengthen the case for the V-shaped recovery. Since the top 10% of households account for 30-35% of total consumption spending, their post-pandemic consumption decisions could drive a rapid recovery.

There is also a psychological dimension here: many people, especially those who indulged in “retail therapy” pre-pandemic, will be so overjoyed to have the chance to get out and about that they may even spend at a higher rate than usual. (Of course, doing so has more negative long-term debt implications.) The result could even be some limited, local, and short-term shortage of some goods – but not oil. In fact, the likely ongoing oil glut will reduce the price to travel – either by car or, as airlines seek to entice customers back, by air. Thus another avenue of consumption will open.

In short, this model predicts that a consumption-led downturn will be followed, quickly, by a consumption-led recovery.

A wide array of commentators and policy leaders have argued that the V-shaped recovery is the most likely outcome of the COVID-19 slump. Certainly, the stock market’s recent behavior suggests that many investors see much the same path. From early February to mid-March the S&P 500 fell more than 1000 points, but it has now (mid-May) recovered about half of that decline. (It is less clear what the bond market is saying. Yields have continued to decline, suggesting little future demand for capital.)

Both Treasury Secretary Steven Mnuchin and former Treasury Secretary Lawrence Summers have articulated this view. Economic commentators Paul Krugman and Dean Baker have also made the case for this path to recovery. The V-shaped recovery scenario also appears to be favored by the International Monetary Fund, although with Vs of different slopes for various countries. The recent Congressional Budget Office projections look like a V-shaped recovery, with the expectation that 2021 GDP will exceed 2020 and almost equal that of 2019. And Trump, of course, wants it to become reality.

### *B. U-Shaped Recovery*

This scenario shares some of the argument of the V-shaped recovery, especially the focus on consumption. However, the U-shaped recovery argument highlights some weaknesses in the V-shaped recovery argument and also assesses the psychological and economic impacts somewhat differently. There are several good reasons for this more pessimistic scenario.

First, there is the clunky roll-out of the COVID-19 monies destined for small businesses (when did a business that employed 450 or so workers become “small”?), the problems with state-level unemployment insurance processing, and the limited nature of the direct consumption stimulus in the measures passed by Congress. (The latter issue is elaborated in the next section.) Each of these problems suggests that recovery will be slow and will include a period of low growth of both GDP and investment, even if there may be an initial burst of consumption spending.

Second, embedded in this argument as well is a very important psychological dimension. While undoubtedly some people will rush out to restaurants, bars, beaches and sporting events, a significant number will be slow to do so. Polling reveals a somewhat partisan divide, since Republican responders to polling (i) are less likely to be concerned about COVID-19 than Democratic responders (although a majority of both groups are) and (ii) Trump and his minions among elected officials and the media will be urging people to go back immediately. Or as George Bush said after 9/11, “Go out and shop.” But the numbers who actually do so are going to be limited by people cautiously watching for a possible recrudescence of the virus.

And the shopping experience will be different. The largest mall operator in the country, Simon Property Group, has announced mall reopenings – but with significant restrictions: no children’s play areas, security guards to remind people of social distancing, social-distance enforcement via spacing in bathrooms and other public facilities. Similarly, Macy’s, which plans to reopen all its stores in the next few weeks, will have “no touch” health and beauty counters, no ear piercing or bra fittings, and alterations will be temporarily suspended. Fitting rooms will also be limited. Finally, employees will wear company-issued cloth masks. Another example: Costco has announced that all entering customers must wear masks.

These policies will simultaneously change the experience of shopping and will remind customers of the continued COVID-19 risk.

Lastly, the actual \$1200 payment to an individual is one-time and small in comparison to loss of income. It may easily be absorbed in meeting expenses such as rent that were foregone during the height of the pandemic.

Overall, the U-shaped model predicts a slower revival of consumption than the V-shaped scenario assumes.

In my opinion, *The Economist* magazine in its “90% economy” scenario as well as some investment banks have made the strongest case for the U-shaped recovery argument.

Both the V-shaped and the U-shaped recovery scenarios share the notion that the COVID-19 economic collapse is primarily driven by a sharp contraction of consumption. Since we know –

or at least think we know – how to stimulate consumption, these are both fairly optimistic scenarios.

### *C. L-Shaped (Eventual) Recovery*

Another way of describing both the V-shaped and the U-shaped recovery arguments is to understand that both are rooted in the idea that the COVID-19 economic slump is an event much like a natural disaster. In natural disasters, consumption takes a hit in the areas impacted but can bounce back quickly because the underlying dynamics of production, finance, and distribution are relatively untouched. The L-shaped recovery scenario does not accept this analogy.

In contrast, in this scenario, COVID-19 has simply illuminated – and perhaps exacerbated – underlying structural problems that were already developing. These include: (i) lagging investment spending, especially non-residential investment; (ii) high levels of corporate debt; (iii) the longer-term effects of “economic scarring;” and (iii) deglobalization.

The starting point for the L-shaped argument as it applies to the United States is the failure of the economy to return to the pre-existing growth trend after the Great Financial Crisis (GFC). Instead, we have now experienced 13 consecutive years of real GDP growth below 3%, unprecedented in our historical record. This stretch of slow growth has largely been the result of weak levels of investment outside of real estate and lowered profitability compared to pre-GFC levels. As a result, companies have turned to issuing debt, either to support existing production levels or, more commonly, to finance stock buybacks and increase dividend payouts to shareholders. The result is corporate balance sheets that have little cushion to weather an economic collapse. And worse, many companies were already on the edge of precipice. The Bank for International Settlements estimates that 16% of U.S. publicly listed companies cannot cover interest on their debt, much less pay off the principle – and this was before the COVID-19 pandemic. The COVID-19 collapse of consumption will push many of these entities into bankruptcy.

Like the V and U-shaped scenarios, the L-shaped scenario has a psychological dimension. But it is much more dire. Neither the V-shaped nor the U-shaped scenarios fully take into account the “economic scarring,” or hysteresis, that results from sudden loss of income or business revenue. Consumers and businesses will not suddenly regain confidence (the animal spirits that Keynes saw as essential to the investment decision), and finance will also be reluctant to lend in the face of economic uncertainty. China may be instructive here: although most factories are up and running, consumption remains weak. Instead, many Chinese consumers are, at least for the present, seeking to reduce spending and increase their rate of savings. And the U.S. savings rate just hit the highest rate since 1981. This behavioral change may be long lasting.

Finally, even prior to the onset of COVID-19, global trade growth was slowing significantly, barely keeping pace with world GDP growth. Trade will now contract, according to the World Trade Organization by as much as one-third. This contraction is driven by several factors. First, the collapse of global supply chains that caused shortages of basic health supplies in the U.S. (and elsewhere) will accelerate the deglobalization that was already underway. Second, a very likely hard decoupling of the U.S./China trade nexus will also reduce trade. But re-shoring that is going to occur in the U.S. will not produce the job boom that some expect; instead, as in past economic slumps, the trend of replacing labor with capital will accelerate: we will find how many additional jobs are subject to automation in a world of A.I.

The L-shaped recovery scenario is a very pessimistic one. It has been articulated by Nouriel Roubini (who correctly foresaw that GFC) and the Marxist blogger Michael Roberts. It is certainly implied in the April 2020 Brookings-FT Tracking Index report. While the L-shaped recovery argument accepts the probability that, as a very malleable system, capitalism will likely recover at some future time, that date is seen as well into the future.

#### *D. The 1918/1919 Influenza Pandemic*

In the spring of 1918 the United States reported its first deaths from what became known as “the Spanish flu.” The early impact was limited and the influenza strain seemed quite weak. However, a second wave occurred in the fall of 1918 and, by the end of the third wave in the spring of 1919, an estimated 675,000 people in the United States had died from the pandemic influenza. This dwarfed the losses in WWI of 53,000 in combat and an additional 65,000 due to the influenza. It also dwarfs COVID-19 totals, at least as of mid-May.

With this as context, what can we discern from about the economic impact of the 1918 pandemic that might apply to COVID-19?

The confluence of WWI and the 1918 pandemic makes it difficult to separate out the impact of each, and we also lack the detailed GDP and other statistics that we have today. However, a couple of things are clear. First, the 1910-1920 decade saw the slowest growth of real GDP per capita in the 20<sup>th</sup> century, even lower than the 1930-1940 decade and only a quarter of the rate in the war decade of 1940-1950. Second, in terms of the criterion set out in the introduction of a return to pre-pandemic levels of GDP, it was not until 1922/23 that real GDP and GDP per capita achieved the levels of 1918/19. Analysis at the city and state level also shows that the impact of the 1918/19 pandemic was lasting. The more impacted the city or state was, the greater the decline in manufacturing output, bank assets, and consumption of consumer durables. These more-impacted areas lagged the less-impacted areas well into the 1920s.

If the pattern of high pandemic impact/longer lasting economic decline occurs under COVID-19 there are some interesting – and perhaps concerning – implications for the United States. The 1918/19 pandemic in the United States was relatively light compared too much of the rest of the world. With 5.7% of global population, U.S. influenza deaths were only 1.7% of the world total of 30-40 million. In contrast, to date we, with about 4.5% of global population, have reported over 28% of COVID-19 deaths.

### *E. Conclusion*

There are strong arguments for each of the recovery scenarios. And, of course, policy decisions that will push the United States (and other countries) in one of another direction are only now being made.

So, in thinking about which recovery scenario is most likely, it is useful to keep in mind a quote attributed to Niels Bohr: “Prediction is very difficult, especially about the future.”

So, what are the odds? I don’t know, but here are my guesses (as of May 16, 2020).

- (1) V-shaped recovery: 25% chance
- (2) U-shaped recovery: 45% chance
- (3) L-shaped recovery: 30% chance