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Title:	The General Economic Outlook
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Summary:	We know the economy will recover in 2021. Everything else is uncertain. How fast will we get the pandemic under control? How fast will consumers regain their confidence? Will Congress pass another aid bill? Professor Larry DeBoer takes a leap into the unknown, with a general economic outlook.

The Economy Now

The pandemic hit the United States in March, and the economy largely shut down. It began to re-open starting in May. Output partially recovered. Gross Domestic Product adjusted for inflation dropped by a record 9% on a quarterly basis in the second quarter, but grew 7.4% in the third quarter. Output is down 3.5% from the fourth quarter of 2019. For comparison, at its worst during the Great Recession, real GDP was down 4% from its previous peak.

We fell into a deep hole. We're climbing out. But we're still in the hole.

The New York Federal Reserve's weekly economic indicator shows what has happened since the end of September. It's based on ten measures that are published each week, including weekly applications for unemployment benefits, tax withholding, railroad traffic, steel production, retail sales, and others. It's indexed to estimate the change in real GDP from the year before. The index was -2.8% for the week of November 14, but that was down from -2.2% the week before.

Our rapid climb appears to be slipping. The resurgence of the virus and the expiration of many CARES Act provisions at the end of the year may stall our recovery in this quarter and the next.

COVID

The course of the economy over the next year depends on the course of the pandemic. When will we get the virus under control? Economists are not experts in epidemiology—despite what you may hear!

Here's what some of the actual experts say. The Center for Disease Control expects the first vaccine supply to be available by the end of this year. Infectious disease expert Dr. Anthony Fauci expects a vaccine by early next year. Both expect wide distribution by mid-to-late summer. A Gallup poll in late October found that 58% of Americans were willing to get the vaccine when it's available, up from 34% in July. Experts writing in the *New England Journal* *of Medicine* estimated that 60% to 70% of the population needs to be immune to bring the epidemic under control.

For this forecast, assume that the virus will controlled by the end of the third quarter, September 2021. Which implies, unfortunately, that the virus will be out-of-control into the Spring.

Consumer Spending

When consumers' incomes fall, or if they fear for their jobs, they'll keep paying the rent and buying food if they possibly can. They'll postpone purchases of cars, appliances and furniture instead, making do with what they have. During the Great Recession, 2007-2009, inflation-adjusted durable goods consumption fell 15%, non-durable goods consumption fell 4%, but services consumption actually increased slightly.

The COVID recession couldn't be more different. Compared to the fourth quarter 2019, durable goods spending was *up* 12%, non-durable goods spending was *up* 4% and it was service spending that was *down* 8%. Anxiety about "social consumption" was the reason, of course.

Retail sales expand on this story. Between February and October, online sales were up, clothing and electronics store sales were down. People avoided stores when online shopping was an alternative. Grocery store sales were up, restaurant sales were down. People worried about meals in public places. Oddly, motor vehicle sales were up, but gasoline sales were down. Many people bought cars to avoid public transportation, but many others were telecommuting, not driving. Building materials and garden equipment sales were up—people needed that new deck for their staycation.

Real GDP was $670 billion smaller in the third quarter 2020 compared to the fourth quarter 2019.

Two-thirds of this decline was consumption spending, and *all* of that was due to services. Consumption spending is the driver of this recession. Concern about social consumption is the driver of that drop. And the virus is the driver of that concern. The economy cannot fully recover until the virus is controlled.

There's little sign of returning consumer confidence yet. The University of Michigan's Consumer Sentiment Index fell from 101 in February to 72 in April. It recovered to 82 in October, but dropped back to 77 in the November survey. The virus is surging in mid-November, and it's unlikely that confidence will rise in this environment. Confidence should ramp up as the vaccine is widely distributed this summer.

When confidence returns, will people have the resources to increase their spending? The unemployment rate has fallen a lot, but will still be higher than usual by fall. Permanent job loss will be a problem as service businesses succumb to the pandemic. About one-third of the unemployed in October had been without work for more than half-a-year. But home values and stock values are rising, interest rates and household debt payments are low, and gasoline prices are not expected to increase very much.

Savings soared to 34% of disposable income in April, by far the highest rate in at least 50 years. CARES Act payments increased incomes, but apprehensive consumers scaled back their spending. With businesses shut down there were fewer goods and services to buy. The savings rate remains high in September at 14%.

Many of the CARES Act provisions run out at the end of the year, particularly extended unemployment benefits. Consumer spending will take a hit without a new aid bill. It seems unlikely that a bill will be passed before February, but more likely after that. It won't be as generous as the extraordinary CARES Act, but it should support spending in the spring. Spending may grow slowly until then.

There likely will be a great deal of pent-up demand among consumers by this spring, after a year without restaurants and vacations. As the vaccine rolls out and confidence rises, the accumulated savings, low interest rates, modest gas prices and added government aid should allow consumers to act. Fourth quarter consumer spending growth is likely to be high.

Investment Spending

Investment spending is down just 2.9% since the fourth quarter. It was down 29% in the depths of the Great Recession. Investment has held up this time. Investment in business structures has fallen by 15%, but business equipment is down only 2%. Perhaps businesses are retooling to enable social distancing. Home construction is up 5%.

Capital goods orders have been growing since the drop-off in April, and are now higher than they were in February. Corporate bond interest rates are extremely low, financial markets seem confident, and oil prices are low but stable. Business investment should rise in 2021. With mortgage rates also very low, home prices rising and building permits above last year's peak, home construction should continue to grow too.

Exports and Imports

The volume of trade fell sharply with the pandemic. Exports decreased from 11.6% of GDP to 9.2%; imports fell from 14.1% of GDP to 12%. Trade grew in the third quarter, imports more than exports, so trade was a net drag on GDP growth.

As the world brings the virus under control, the volume of trade should rise. The exchange value of the dollar has fallen, down 8% against the euro and 4% against the yuan since February. This should aid export growth and inhibit import growth. Trade policy is uncertain with the new administration, but it's unlikely that tariffs can be reduced without arduous negotiations.

Government and Fiscal Policy

The CARES act was an extraordinarily quick and massive response to the COVID recession. Federal expenditures for fiscal 2020, which ended on September 30, increased by 47%, which was $2.1 trillion. The budget deficit as a percentage of GDP rose from 4.6% to 14.9%--the largest deficit percentage since World War II. Even though private income fell at an annual rate of 12% from February to April, CARES Act benefits increased total personal income by 10%. This helped support consumer spending.

Fiscal policy in 2021 depends on the relationship between the President and Congress. Will there be instant stalemate, or will the two parties find a way to compromise? Assume that compromise is possible. There will likely be a second stimulus bill, though smaller than the CARES Act, to provide support to the unemployed and state and local governments as the economy recovers.

Gross Domestic Product Growth

Add up consumers, business investment, government purchases and trade, and **real GDP should grow about 4.3% in 2021**. That would be the highest growth rate since 1999.

Unemployment and Inflation

Growth that fast ought to be enough to bring down the unemployment rate substantially. After the Great Recession, the unemployment rate fell about a percentage point a year from 2010 to 2015, while annual real GDP growth averaged only 2.2%. Growth nearly double that could bring the unemployment rate down two points below the current rate of 6.9%.

That seems unlikely. The labor force is down 3.7 million people compared to February. In the second half of 2021 many of these people will rejoin the labor force. If children go back to school in August, their at-home parents will begin looking for work. Many of their former jobs will have disappeared, and their skills will have eroded, so the job search may take longer. This will keep the unemployment rate from falling as much as real GDP growth implies.

Expect the **unemployment rate to be around 5.6% by this time next year**.

The inflation rate, measured with the Consumer Price Index over the previous 12 months, fell from 2.3% in February to 0.2% in May. It was 1.2% in October. Consumer spending will rise and unemployment will fall in 2021. Oil prices are expected to be stable. Expect the **inflation rate to rebound to 1.8% during the 12-months of 2021**.

Monetary Policy and Interest Rates

The Fed responded to the COVID recession with the most aggressive monetary expansion in its history, reducing its policy interest rate from 1.5% to near-zero in the first half of March. Financial markets had begun to panic in early March. Corporate bond interest rates spiked by March 20, but then fell quickly. By July rates were lower than at the start of the year. The Fed's quick action appears to have saved the day.

Here's the easiest forecast of all: the Federal Reserve will maintain the federal funds rate as close to zero as can be. So, **the short term Treasury bond interest rate will remain near zero**.

The 10-year Treasury bond rate is 0.9% in mid-November, down from 1.6% in mid-February, but up from 0.5% in early August. The bond rates since the recession are less than expected inflation, which means that, in real terms, lenders are paying the Treasury to hold their funds. This seems unlikely to continue as the economy recovers. Money will flow out of Treasury bonds as other investments begin to look more promising. Expect the **10-year Treasury bond interest rate to be 1.3% by the end of 2021**.

Conclusion

The virus calls the shots. The current resurgence means were probably in for a tough winter, with a slowdown in economic growth. If the virus is under control by the end of the summer, we'll have brisk growth with falling unemployment by the fall. What if the virus is *not* brought under control in 2021? Don't ask!