DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

THE UNITED STATES' UNUSUAL RECOVERY FROM PANDEMIC RECESSION

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DOLLAR: Hi, I'm David Dollar, host of the Brookings Trade podcast "Dollar and Sense." Today, my guest is Gian Maria Milesi-Ferretti, a senior fellow in the Economic Studies Program at Brookings. Gian Maria recently posted an interesting article entitled "A Most Unusual Recovery" that analyzes how the U.S. recovery from the pandemic recession differs from the recovery in other advanced countries and strikes me it also differs from past U.S. recessions and recovery periods. So that's the topic for today, the unusual recovery in the U.S. I think it's a good topic for our last broadcast of 2021 and provide some preview for 2022. So welcome to the show, Gian Maria.

MILESI-FERRETTI: Thank you, David. Very happy to be with you here.

DOLLAR: So, let's start by characterizing the recovery in terms of real GDP for the U.S., EU and Japan, the main advanced economies, where is output relative to where we were pre-pandemic?

MILESI-FERRETTI: I think that the best comparison is the one to the last quarter of 2019, the last quarter that was pandemic-free. And as of the end of the third quarter of this year in the U.S., the level of GDP is already a bit higher than it was in the last quarter of 2019. So, we've exceeded the pre-COVID GDP level. And in this, the U.S. is ahead of other G7 countries. The euro area is close to its pre-COVID level of activity. I think we should reach it by the end of the year. There is a lot of heterogeneity within the euro area, so some of the small countries, the Netherlands, Austria, Belgium, Finland, are already above the pre-COVID level. But you have Spain among the large countries, which is quite some ways below, and that drags down the euro area aggregate. For Japan, Japan was actually ahead of the pack early on because it had better success in controlling the pandemic. But 2021, which has been a year of strong recovery in the U.S. and the euro area, was actually flat or, if anything, a small contraction for Japan because of the belated increase in cases. So quite a differentiated picture out there.

DOLLAR: So, the United States is back to the output level it had pre-pandemic. Some European countries you described are also back, Europe as a whole soon we'll be back on average, but these were all growing economies. So a different question is where are they relative to trend? Where are they relative to where they would have been if things had continued on without the pandemic or recession?

MILESI-FERRETTI: So for the US, from what we can infer with tracking data for the last quarter of the year, which of course is not over yet, the level of GDP should reach its pre-COVID trend by the end of 2021, which is very, very early on and much earlier on than many had predicted, particularly from the vantage point of last year and particularly thinking that COVID is very much still with us. We've had a variety of waves coming in. So that's for the U.S., pre-COVID trend within 2021. For the euro area, it's unlikely to happen within 2021 because it may take a few quarters longer. And the main reason is this new wave of cases. I think Europe is more sensitive to rising cases in terms of public health measures and some restrictions to mobility and activity, less so than before but still more than the U.S. And it is quite possible that the fourth quarter and the first quarter of next year are going to be a big week because this new wave has hit some countries, notably Germany, but others now too a bit hard. So it may take a few quarters more. It may reach the trend back during sometime during 2022 or maybe early 2023.

DOLLAR: One of the main points of your article is that the composition of recovery is different, particularly comparing the U.S. with the other advanced economies, especially in terms of private consumption. So what's going on there?

MILESI-FERRETTI: So, on that specific metric as opposed to the GDP one, the U.S. is way ahead of the others. To give you a sense, private consumption is some three-and-a-quarter percent above its pre-COVID level already in the third quarter of this year. That means U.S. consumption is basically where we would have expected it to be without the

COVID pandemic. And that’s quite extraordinary. While elsewhere, we are actually two or three percentage points below the pre-COVID level, so we are talking about some five or six percentage points difference in levels of consumption across the G7.

What has changed a lot, of course, is the composition of private spending. So here we have consumption of goods, which is up very sharply, 15 percent in the aggregate and 20 percent for durable goods. And that is actually after a nasty third quarter for car purchases, because a shortage of semiconductors hindered car production and sales. So at the end of the second quarter, actually consumption of durables was like 30 percent above the pre-COVID level. So what is the offset of that is, well, of course, consumption of services, which is the vast majority of consumption in the aggregate, is still below the pre-COVID level. And here the most affected sectors as of the third quarter, if we compare levels to levels, are transportation—people travel but less than before—and recreation services, so people took less entertainment. Food and accommodation have recovered, but those two categories are particularly weak.

DOLLAR: So it’s natural for this surging consumption in the U.S. to have a large effect on international trade. And so how did differences in imports and exports also show up among these economies?

MILESI-FERRETTI: Indeed, they show up very clearly in the trade data. So fundamentally, the U.S. is an economy that is a large net importer of goods and a net exporter of services. And with a boom in demand for particularly consumption goods, U.S. imports are up very, very sharply. We’re talking about 10 percent for imports of goods overall and for consumption goods excluding cars—which are, as I mentioned, affected by their own specific woes—was almost double that. So we’re talking about something like 18 percent increase in the volume of imports of consumption goods, excluding cars.

U.S. exports instead are still well behind pre-COVID levels. And here, one factor is that the recovery in spending that we've seen in the U.S. is nowhere as fast elsewhere. We just mentioned this earlier when you asked me about consumption—consumption in other countries it's quite a bit below. But it's also a matter of composition of exports—the U.S. tends to export more investment goods, and the investment recovery again has not been in trading partners as robust as the recovery and consumption.

In terms of global trends, as you would expect when you have very strong demand for goods, countries that do well are countries that specialize in the production of goods, that have, a lot, particularly, manufacturing. And countries that have benefited particularly from that and also from the composition of this demand for goods are China and Taiwan, for instance, Korea as well. But the growth rate in exports for China and Taiwan has been really very, very strong.

Now I mentioned manufacturing in the aggregate, but within manufacturing those that are specializing in production of transport equipment have been doing a bit less well because of the woes in supply chains, particularly related to semiconductors. So countries that produce cars or also the aerospace industry—give you concrete examples, Germany for cars, France for aerospace and cars—have done considerably less well on the export front in part because of these bottlenecks for semiconductors, and in part because air transport has suffered mightily with this crisis.

DOLLAR: You know, it's interesting what you were saying about China. We do not import automobiles from China, so that semiconductor supply chain problem, not really relevant. But then we import a lot of other consumer durables from China. Appliances, furniture, lots of electronics where semiconductors have been a bit of an issue. But obviously, China's managing to produce and export a historic level of electronic products. So it's kind of a perfect storm for accelerating that U.S.-China trade.

So we see these very interesting differences in the path of consumption and imports and exports among the advanced economies. So how do we explain that? You mentioned some of the characteristics of these economies already, and maybe go a little bit into more detail. But then also your policy must play some role in why we see different patterns of recovery.

MILESI-FERRETTI: I would say there is a mix of factors that matter. One obvious factor is the differences in the intensity of the pandemic across countries, and not just intensity, because the U.S. had a pretty nasty one, but also the extent of COVID-related restrictions to mobility and hence to demand. A second factor that actually is absolutely crucial in understanding the depth of the COVID shock is the composition of economic activity. So, countries that rely more on contact-intensive services suffered more. And of course, this matters for consumption because with lower incomes comes lower consumption. And indeed, I have some work which shows that the share of tourism in the economy pre-COVID is really the most important variable in explaining cross-country differences in the intensity of the shock. And I mentioned earlier the example of Spain, which is a country with a lot of tourism revenues and has really suffered mightily.

So I mentioned pandemic restrictions, composition of output. But of course, policy matters too, and to a significant extent. And I would say all countries had very accommodative monetary policies and fiscal as well, but the extent of accommodation was different. The U.S. had a particularly powerful fiscal stimulus in terms of overall magnitude. And fiscal support was still quite substantial in advanced economies, but less so than in the U.S. And again, a case in point is Spain, which is again a country that really sticks out among the large European countries in terms of the gap of economic activity from its pre-COVID trend.

One should say that in Europe, some of the stimulus comes a little bit later because the disbursement of funds from the European Union for this next generation, for finance a greener economy, structural transformation, digitalization, health systems, and all the like are going to be spent, I would say, more extensively starting 2022. So, in terms of fiscal prospects the fiscal support is going to be stronger in the euro area in the next few years compared to what it would have been otherwise without the pandemic.

DOLLAR: One of the things I found interesting in your article, Gian Maria, was the section on government consumption. This is the measure of what I think of this kind of real government spending on the military, and local governments included, of course, so teachers, health care workers, fire firemen and women. There the U.S. have the smallest increases, I read your figures. So the U.S. had the big fiscal stimulus you just described, but it actually had the smallest expansion of government in the sense of government consumption. So how do we reconcile that?

MILESI-FERRETTI: What you had in the U.S. in terms of fiscal support was especially very sizable transfers which boosted the disposable income and spending of the recipients but they don't directly contribute to GDP, they contribute to GDP indirectly. If you think of, for instance, of health spending costs in the U.S., there is more spending in the private sector than the public sector. So, that mix would change across countries.

And within the U.S. if we were just to look at non-defense spending by the federal government, that is up quite sharply, like seven percent higher. So it would rank within the other group. But the U.S. has relatively high defense spending compared to, say, European countries. And obviously defense spending was not the main beneficiary of more fiscal largesse during this period. That was not the main challenge. So there is that aspect which matters.

But also state and local governments in the U.S., which are an important part of consumption, have been quite guarded in their spending decisions. It's up, but only marginally compared to pre-COVID levels. And I think the reasons are not entirely clear because the revenues have been actually quite strong, because disposable incomes have been quite strong. State and local governments expected a dramatic decline in revenues with this crisis, which did not materialize. But on the spending front, they've been overall relatively conservative. So I would say those are the main reasons.

DOLLAR: The whole issue of the fiscal stimulus, the size of the fiscal stimulus, has become somewhat controversial in the U.S. So I just thought it was interesting that the actual increase in government consumption was somewhat modest in the U,S, compared to the other advanced economies. So maybe good to inject some facts into the debate. We've covered some of the main components of GDP—private consumption, government consumption, imports-exports—the last remaining category of interest is investment or gross fixed capital formation. So what do we find there in terms of different patterns of recovery among the main economies?

MILESI-FERRETTI: There is again some difference across countries there. Overall, if I have to make like a very broad generalization, the pattern is a recovery in investment. So the level of investment does exceed virtually across the board. There are a couple of exceptions to the pre-COVID level. But if you think of the overall level of the capital stock, then matters are different. So we've recovered the level, but of course, there was a collapse in spending particularly during 2020. So this missing investment has not been made up yet. We've recovered the level, we haven't made up the shortfall. And here too, I mentioned heterogeneity across countries, but there is heterogeneity within investment categories, and that is quite interesting. If you look, for instance, at European data, what you see is that construction and investment in manufacturing and equipment, excluding the transportation sector, has done quite well. So, it's well above the pre-COVID levels.

The weakness in investment comes from the transportation sector. And, earlier I mentioned consumption of durables, and mentioned the woes of cars. Cars, transportation means more generally, are a consumption good for consumers, but are investment goods for businesses. And again, the shortage of semiconductors has affected the fleets of car rental services, road transportation, production of trucks quite substantively. And in the euro area, for instance, that level of capital spending is twenty-five percent below what it was pre-COVID. The other category actually I should have included in the transportation besides the road one is, of course, again aerospace, airplanes, Airbus for Europe that declining orders and production has been hitting capital spending. So when those woes hopefully go away, then we may expect a more rapid pickup in capital spending.

DOLLAR: The last question, Gian Maria, I want to go beyond your article a little bit and talk about consumer inflation. It's a big issue in most of these advanced economies, but it strikes me we see pretty differentiated experiences with the U.S. CPI inflation now running at about seven, EU I believe at four, and Japan, historically a low inflation country down around one. And so my question is, do these differences in the pattern of real recovery affect these inflation experiences and help us understand what's going on and what might evolve in 2022?

MILESI-FERRETTI: The short answer is yes, they do affect those price developments. Clearly, the consumption boom in the U.S. has put upward pressure on goods prices. And it is a stronger one than the one we've seen in Europe and in Japan, so it's quite natural to see more pressures there. But of course, there are other factors that matter too. And these range from global shocks, higher commodity prices, the supply chain bottlenecks, but also in the U.S. some supply-side difficulties due to a reduced labor supply compared to what, frankly, everybody, certainly including me, would have expected at this stage of the recovery. The combination of strong labor demand and labor supply shortages with participation still well below the pre-COVID levels is a combination that I certainly would not have expected.

And one last important factor is that not every economy was in the same spot in terms of cyclical developments, if you want, pre-COVID. So the U.S. started with a very, very low level of unemployment, while the euro area level was low compared to historical standards, but I'd say primarily because of Germany. And elsewhere you had a massive reduction in unemployment compared to, say, the pre-global financial crisis period. If you remove Germany, unemployment in the euro area was not that low. So clearly, the extent of existing slack may have been different across these economies.

I think Japan is always very hard to understand. On the price front, their unemployment was very low, but we hadn't seen any inflationary pressures and it still really sticks out in terms of inflation developments compared to virtually anybody else. Actually Asia in general had lower inflationary pressures. But, Japan is way lower than the other advanced economies.

DOLLAR: I'm David Dollar, and I've been talking to my colleague Gian Maria Milesi-Ferretti about his article on the unusual characteristics of the recovery from the COVID recession, particularly in the United States and advanced economies. The U.S. is actually doing very well by many measures, and certainly compared to other advanced economies. And very soon we'll be back on trend in. So that's quite encouraging. But the characteristics of the recovery help us understand some of the developments in international trade this year, particularly the large surge in goods imports into the United States and the increase in the U.S. trade deficit. So thank you, Gian Maria, for joining us.

MILESI-FERRETTI: Thank you, David, for having me.

DOLLAR: Thank you all for listening. We'll be releasing new episodes of Dollar and Sense every other week, so if you haven't already, follow us wherever you get your podcasts and stay tuned. Dollar and Sense is part of the Brookings Podcast Network. It's made possible by support from producer Fred Dews, our audio engineer Gaston Reboredo, and other Brookings colleagues. If you have questions about the show or episode suggestions, you can email us at podcasts@brookings.edu, and follow us on Twitter @policypodcasts.

Until next time, I'm David Dollar and this has been Dollar and Sense.