Preventing a Pandemic Depression

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More than a decade ago, GEM Project economists constructed an extreme-instability model that demonstrated how monetary authorities prevented the 2008-09 financial crisis from morphing into a 21st-century depression. Today, that model has another important story to tell. This time it describes how the Federal Reserve, with much more help from fiscal authorities, has prevented the Covid-19 Pandemic from inducing depression. If you have a powerful model, you should use it – especially when there are still crucial lessons to be learned.

GEM Model of Extreme Instability

Shani Schechter and I constructed the extreme-instability model on two pillars of GEM analysis. First is the centrality of total nominal spending. We emphasized that demand disturbances can be stationary or, much more dangerously, nonstationary. Second is the importance of asset prices. It seemed to us the biggest 2008-09 clue relevant to building a useful theory was the extraordinary collapse in financial asset prices in the wake of the Lehman bankruptcy. Aggregate human and physical capital, the highly evolved market-oriented organization of the economy, and its robust capacity to generate and assimilate technological innovation largely supported the pre-crisis level of asset prices. Think of those factors as the fundamental determinants of financial-asset value. They were little altered by the financial meltdown. We understood that damage to investor/lender confidence had superseded the fundamentals and was driving the crisis. In the Great Recession, investors and lenders were no longer confident that a 21st-century version of the 1930s Great Depression would be avoided.

We also identified a theoretical contribution by Nancy Stokey as critical to understanding extreme instability. She demonstrated that, as investors/lenders become less certain about macro prospects, simple *inaction* becomes increasingly rational. Acquirers of financial assets respond to such uncertainty by moving to the sidelines, waiting for the emergence of a credible bottom for prices. (A maxim of veteran traders is not to try catching a falling knife.) Substantial investor/lender inaction motivated, and was then magnified by multiplier effects and mounting household apprehension, collapsing investment and overall spending. In the generalized-exchange framework, rational meaningful wage rigidity (MWR) especially translates contracting demand into forced layoffs and reduced production. Collapsing nominal spending, if not somehow contravened, is a sure bet to produce depression.

The heart of our theory models the relationship between the two opposing determinants of asset pricing. The practical instability question became whether or not the stabilization authorities' trend objective of full employment is credible. We posited a heuristic variable ($\acute{C}$) that calibrates breakdowns in the credibility of stabilization authorities' real-side goal. It gauges investor/lender sentiment that helps weight the relative contribution of fundamentals versus confidence in the choice between acquiring financial assets or retreating to the sidelines to await a credible pricing floor to emerge. The model's principal policy implication is that the Fed in the circumstances of collapsing asset prices and nominal spending should pull out all the stops to quickly restore its real-side credibility.

Preventing Pandemic Depression

A primary public-health response to severe pandemics is to shutdown the economy. Lacking modern experience with such consequential action, it was not clear how investors/lenders would respond. What was clear was a substantial persisting move to Stokey's sidelines would induce a collapse in total spending and a 21st-century depression. The really bad news is a modern depression would make its 20th-century forerunner look like a walk in the park.

Indicators of a brewing asset-price collapse were by the middle of March last year flashing red. Most frightening, trading in Treasuries – the federal government securities that are considered among the safest assets in the world and a bedrock of the entire financial system – had become disjointed as panicked investors moved to the sidelines or became active sellers. The modern Treasury market had never broken down so quickly and badly, even in the depths of the 2008 financial crisis.

The Fed called an emergency meeting on March 15. The Federal Reserve Bank of New York's asset portfolio staff summarized the crisis. It was bad, certainly reminiscent of 2008. Back then, Ben Bernanke understood the crisis and his call to action to the Fed staff that no action in support of collapsing asset markets was too big or too quick. In the emerging 2020 pandemic, the Fed knew what to do. That afternoon it sent a red-letter message to investors/lenders whose actions were questioning the credibility of its real-side commitment to trend full employment. It announced a huge bond purchase program — $500 billion in Treasuries and another $200 billion in mortgage-backed securities. The bond buy was just the beginning, followed by a relentless wave of asset purchases over a broad swath of markets that quickly convinced investors and lenders of the central bank's resolve to prevent depression. The risk of collapsing asset prices was contained. But the risk of a weak recovery, along the lines of what happened after 2008-09, remained high.

Preventing a Weak Recovery

Here we return to the first pillar of GEM instability analysis: the crucial role of total demand. The recovery from the Great Recession was painfully slow because total spending growth was weak, mostly for two reasons. First, damage to firm and household balance sheets in the severe 2008-09 recession resulted in a substantial build-up in debt, which weakened the spending rebound in the recovery. Second, it is difficult for the Fed, short of resorting to helicopter money, to directly stimulate spending. That task is much more readily accomplished by fiscal policy. But adequately sized fiscal stimulus was ruled out by Congressional majorities whose understanding of effective stabilization policy was shockingly shallow.

Fast forward to the Pandemic and the Congressional appropriation of trillions of dollars in economic aid. The fiscal actions appears to have prevented a huge debt build-up and, especially the last $1.9 trillion installment, assure sufficient spending from multiple sectors to jump start and sustain a rapid recovery as effective vaccines to their job. My reading of the tea leaves indicates that the overall and demographic-specific unemployment rates will reach the Trump lows in 2022. (I am not alone. For example, in May 2020 economists at Goldman Sachs predicted that the unemployment rate would be 12 percent at the end of 2020 and wouldn't fall below 6 percent until 2024. The same team now expects the rate to fall to 4 percent by the end of this year.)

The political consequences cannot be ignored. Any Trumpism comeback fueled by Republicans gains in the House and Senate has at least two big problems. First, the Covid-19 Pandemic will be over, with life returning to normal. The activist, science-oriented approach in 2021 will in retrospect play well in contrast to Trump foolishly lying about the virus and how best to deal with it. Second, the prized Trump claim that only he can produce a beautiful low-employment economy will be debunked by Biden's rapid economic recovery and its dramatically quick restoration of low joblessness.

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