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"Winners and Losers of the Pandemic Economy?"

(Project Syndicate, August 31, 2020)

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While it is true that bullish equity markets are out of step with the historic contraction in the real economy, to say that they are disconnected from it misses the point. In fact, the lofty valuations of companies with high intangible capital per employee make perfect sense in today's economy.

MILAN – Much economic commentary nowadays focuses on "divergence": while broad equity-market indices are at or near all-time highs, much of the wider economy struggles to recover from one of the most severe downturns ever. Whereas the Russell 2000 is still down 5.4% year to date, the S&P 500 and the Russell 3000 have fully recovered to their pre-pandemic levels, and the Nasdaq, which tilts toward digital and technology companies, is up some 26%.

Many have concluded that the market is unmoored from economic reality. But viewed another way, today's equity markets may be partly reflecting powerful underlying trends amplified by the "pandemic economy." Equity prices and market indices are measures of value creation for the owners of capital, which is not the same thing as value creation in the economy more broadly, where labor and tangible and intangible capital all play a role.

Moreover, markets reflect the future expected real returns to capital. When it comes to measuring the present value of labor income, there simply is no comparable forward-looking index. In principal, then, if there is a significant anticipated economic rebound, the outlooks for capital and labor income could be similar, but only capital's expected future would be reflected in the present.

But there is more to the story. Market valuations are increasingly based on intangible assets, not least the ownership and control of data, which confers its own means of value creation and monetization. According to one recent study of the S&P 500, stocks in companies with high levels of intangible capital per employee have recorded the biggest gains this year, and the less intangible capital per employee companies have, the worse their stocks have performed.

In other words, incremental value creation in markets and employment are diverging. And while this was true even before the pandemic, the trend has now accelerated. There are at least two reasons for this. One is the rapid adoption of digital technologies as part of the response to lockdown measures. The second is that many labor-intensive sectors (which normally add value mainly with labor and tangible capital) have been partly or totally shut down as a result of lockdowns, social distancing, and consumer risk aversion.

For example, the Dow Jones US Airline Index clearly took a large hit and has yet to recover. In normal times, this sector generates value mainly with tangible capital, labor, and fuel (though there are significant digital elements to its business, too).

To be sure, general market valuations have been supported by the US Federal Reserve and other major central banks' interest-rate policies. In the current context, highly accommodative monetary policies are principally aimed at creating space for governments to use debt to finance large fiscal programs in response to the COVID-19 shock.

But while ultra-low interest rates may provide some general support for today's market valuations, they do not account for the stark differences across sectors. After all, the part of the economy not represented by publicly traded stocks is also suffering (though there are, of course, private companies in digital sectors whose valuations and returns are similar to, or even higher than, the upper end of the intangible-capital spectrum in public markets).

More broadly, lower-income households and many small businesses with thin, fragile balance sheets have been left with no effective shock absorbers, and many of the labor-intensive sectors that generate significant employment in normal times (including hotels, restaurants, and bars) have been partly shut down. To address these trends, sovereign balance sheets are being used as a shock absorber for large swaths of the economy.

But not all swaths. Because the current crisis is actually boosting the value of certain companies, it is worth asking who owns the bulk of their stock. It certainly isn't the private households and businesses whose balance sheets are too weak to serve as shock absorbers. Today's high-valuation companies are owned by individuals and institutions with balance sheets that are already substantial enough to provide a cushion of economic resilience.

When the post-pandemic phase comes into view, labor-intensive sectors with lower intangible capital per employee may enjoy a period of outperformance as they bounce back. Yet even in this scenario, the economy's digital footprint is likely to expand, and the underlying trend favoring intangible capital and its owners will continue.

It is not surprising that intangible-capital-intensive sectors would have an advantage. For the most part, their cost structures are abnormally tilted toward fixed costs and low or negligible marginal costs. This makes some platforms massively scalable, which in turn confers significant power in terms of pricing and market access.

One could draw a few conclusions from these economic realities. For starters, the pandemic economy has accelerated the pre-pandemic trend favoring intangible-asset value creation through firms with relatively fewer employees. We can expect this trend to continue, albeit not at the heightened pandemic-induced pace. Traditional businesses will recover, but the disconnect between value creation across firms depending on intangibles per employee will persist and remain a major economic and social challenge.

The idea that markets and the economy are diverging reflects a narrow focus on particular indices. But no single index can offer a useful summary of overall market, let alone economic, conditions and trends. And in the pandemic economy, equity-market indices obscure even more than they otherwise would, owing to the large divergences in economic outcomes across sectors and for the people who work in them.

Finally, given the outsize contribution of digital intangible assets to value creation, it is hard to see a way to reverse the trend of rising wealth inequality. Because the balance sheets of those lower down the income and wealth ladder are largely devoid of assets with high intangible and digital content, the rewards of current economic and technological dynamics will pass them by.

"THE UNCERTAINTY PANDEMIC"

(Project Syndicate, Sept 3, 2020)

Kenneth Rogoff, *Professor of Economics and Public Policy at Harvard University and recipient of the 2011 Deutsche Bank Prize in Financial Economics, was the chief economist of the International Monetary Fund from 2001 to 2003. He is co-author of This Time is Different: Eight Centuries of Financial Folly and author of The Curse of Cash.*

Policymakers' most important task is to try to reduce the massive lingering uncertainty regarding COVID-19 while continuing to provide emergency relief to the hardest-hit individuals and economic sectors. But the insecurity fueled by the pandemic is likely to weigh on the global economy long after the worst is in the past.

CAMBRIDGE – The next few months will tell us a lot about the shape of the coming global recovery. Despite ebullient stock markets, uncertainty about COVID-19 remains pervasive. Regardless of the pandemic's course, therefore, the world's struggle with the virus so far is likely to affect growth, employment, and politics for a very long time.

Let's start with the possible good news. In an optimistic scenario, regulators will have approved at least two leading first-generation COVID-19 vaccines by the end of this year. Thanks to extraordinary government regulatory and financial support, these vaccines are going into production even before the conclusion of human clinical trials. Assuming they are effective, biotech firms will already have some 200 million doses on hand by the end of 2020, and will be on track to produce billions more. Distributing them will be a huge undertaking in itself, in part because the public will need to be convinced that a fast-tracked vaccine is safe.

With luck, rich-country citizens who want the vaccine will have received it by the end of 2021. In China, virtually everyone will have been vaccinated by then. A couple of years after that, so will the bulk of the world's population, including those living in emerging and developing economies.

This scenario is credible, but realizing it is far from assured. The coronavirus could prove more stubborn than expected, and the first-generation vaccines may be effective only for a short period, or have worse-than-anticipated side effects.

Even in that case, improved testing protocols, the development of more effective anti-viral treatments, and better adherence by the public and (one hopes) politicians to behavioral guidelines would lead to gradual normalization of economic conditions. It's worth recalling that the horrible 1918-20 influenza pandemic, which killed at least 50 million people worldwide – many in a deadly second wave of the kind we currently fear today with COVID-19 – eventually faded and disappeared without any vaccine.

But in a more pessimistic scenario, other crises – a sharp uptick in US-China trade frictions, a cyberterrorist attack or cyberwar, a climate-related natural catastrophe, or a massive earthquake – could occur before this one ends. Moreover, even the optimistic scenario does not necessarily imply a rapid return to end-2019 income levels. The post-pandemic expansion – if there is one – may take years to meet the modern definition of recovery (a return to initial per capita income) in the aftermath of a deep recession.

Although the pandemic has underscored the huge problem of inequality in advanced economies, poor countries are suffering far more. Many emerging markets and developing economies will likely be struggling with COVID-19 for years to come, and face the real possibility of a lost decade of development. After all, few governments have the capacity to provide emergency fiscal support on the scale that the United States, Europe, and Japan are doing. Prolonged recessions in lower-income countries will likely lead to an epidemic of debt and inflation crises.

But the COVID-19 crisis could leave deep and lasting scars in advanced economies, too. Businesses may be more skittish about investing and hiring, owing to concerns about a public-health relapse or another pandemic, not to mention the huge political volatility that the crisis has amplified.

Although there may be an initial “catch-up” surge of consumer spending in advanced economies, in the longer run, consumers are likely to save more. In an interesting paper presented at the recent annual Jackson Hole symposium, Julian Kozlowski, Laura Veldkamp, and Venky Venkateswaran argue that the pandemic’s cumulative long-term costs for the US economy are likely to be an order of magnitude greater than the short-term effects, partly because of a long-lasting heightened sense of unease among the public.

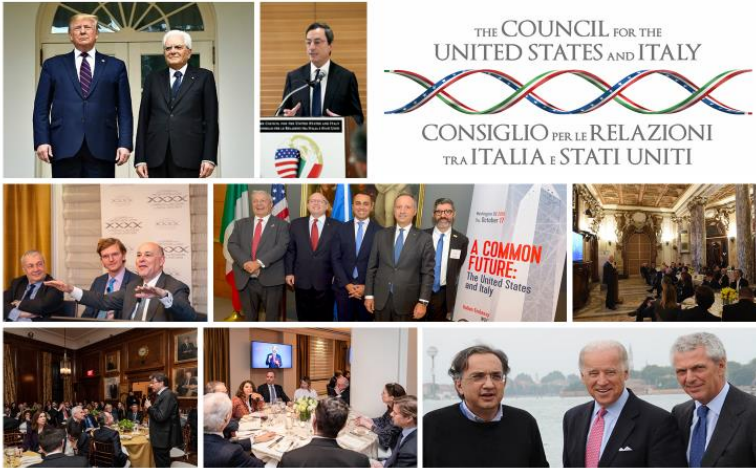
Their analysis, which I discussed at the symposium, is especially convincing with respect to consumers. Anyone with a parent or grandparent who lived through the Great Depression of the 1930s knows that this scarring experience affected their lifelong behavior.

In addition to its direct impact on investment and hiring, COVID-19 will impose longer-term productivity costs. By the time the pandemic is over, a generation of children, particularly those from lower-income households, will in effect have lost a year of schooling. Young adults who struggle to find their first job in a still-moribund labor market can expect to earn less in the future than they might otherwise have done.

There are some bright spots. Although the pandemic has triggered a collapse in the value of commercial real estate in many cities, it could lead to a huge wave of new building and investment in suburban areas, as well as in long-suffering small and midsize cities. In general, businesses that had been loath to allow telecommuting are now recognizing that it can work well and has many benefits. And although we shouldn’t hold our breath, the pandemic could spur policymakers to find ways to provide universal broadband Internet and give less privileged children much better access to personal computers.

The global economy is now at a fork in the road. Policymakers’ most important task is to try to reduce the massive lingering uncertainty while continuing to provide emergency relief to the hardest-hit individuals and economic sectors. But the insecurity fueled by COVID-19 is likely to weigh on the global economy long after the worst is in the past.

ABOUT THE COUNCIL FOR THE UNITED STATES AND ITALY



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