



The Risks to a Robust Recovery

by Campbell Harvey of Research Affiliates, 8/13/20

In this brief Q&A, Cam Harvey outlines seven risks that have the potential to derail the economic path forward. The risks themselves are interconnected and each risk has multiple dimensions. Interested readers can always find Cam's latest views of the economic and financial implications of COVID-19 and related material in his [media library](#). Also, follow Cam on [LinkedIn](#) and [Twitter](#).

Question: Cam, you point out seven risks with the potential to threaten a robust economic recovery. Could you begin by describing the first three?

Harvey: Sure. Let me first state that I still believe in the possibility of a robust recovery although the damage the economy has sustained will prohibit an immediate reversion to pre-crisis levels. To be prudent, we should go through the exercise of listing the risks to the recovery and assessing their economic and financial implications.

The first risk is what I call *rose-colored glasses*. People often look at data and interpret it in ways that are far too optimistic. This tendency is related to the human bias of overconfidence. One example is that we become careless in following social distancing practices or wearing masks, causing a surge in new cases of coronavirus, which is exactly what we are seeing now.

Next, we face the risk of a *biological setback*. Biological uncertainty has multiple dimensions. For instance, we may face disappointing results in the vaccine trials, problems with pharmacological (treatment) solutions, lack of progress on antibody research, and an unfavorable mutation of the virus, all of which could unexpectedly reduce the viability of vaccines currently in progress. While I am confident we will have a widely deployed viable vaccine by early 2021, much uncertainty on the biological front remains. Both the cause and the antidote to this crisis are a function of biology, reinforcing just how fragile the economic path forward is.

The third risk is *debt overhang*. This risk can be toxic for economic growth, impacting companies, consumers, and government. Firms that have weathered the crisis, but taken on excessive debt in the process, are unlikely to get needed financing. Think of a company with a project expected to deliver 30% profit growth, exactly the type of innovative projects the economy needs, but the company is turned down by its bank because it has too much debt.

Excessive debt also affects consumer behavior (partially due to the rose-colored glasses phenomenon). The frugality needed to repay this debt can reduce consumer spending and slow economic growth. The same goes for governments. The US national debt is approaching \$200,000 per taxpayer. Although government spending can lessen the blow of an economic downturn, it inevitably translates into lower future government spending as the debt comes due for payment. Often important projects for long-term value creation, such as infrastructure and basic research funding, are likely the first to be slashed. Debt overhang is a global phenomenon.

Question: This leads us to potential policy mistakes and unexpected inflation. How do you assess the economic and financial implications of these risks?



Harvey: The overwhelming *policy mistake* is not properly balancing the economic and health costs of this crisis. The current cost of the crisis is in the ballpark of \$10B per day.

We simply cannot afford to continue to muddle our way through. In my view, we are not investing enough in vaccine research and production support or in the massive testing and tracing technology we urgently need to diminish the impact of a second wave, which if unmitigated by testing and tracing capabilities could drive us back to depression-like conditions. We need production facilities ready to go and large-scale preproduction of multiple vaccine candidates because we know from prior experience some candidates will be discarded. The United Kingdom recently announced it has secured early access to 90 million vaccine doses. Other countries should be doing the same. Currently, only about 8% of the crisis-related spending is focused on vaccine, pharmacological solutions, and testing. That is far too little.

Large-scale fiscal spending supplemented by unprecedented money creation solves some short-term problems at the cost of a big long-term problem: *unexpected inflation*. We should not embrace the European (or worse, Japanese) model of monetary control and the world of negative interest rates and lethargic or zero growth that goes along with it.

Some say that because the quantitative easing (QE) deployed during the global financial crisis was not inflationary, we can borrow and print money now, and we will see no impact. I would not recommend extrapolating from a single data point. This time around, the amount of QE is unlimited, and we are seeing increasing political consensus that we should just create money and spend irrespective of the implications for future inflation. Not knowing what the Fed may do, and how far it may go in increasing its balance sheet, increases the risk of unexpected inflation.

It is a mistake to believe we have an infinite line of credit; that line of thinking is known as Modern Monetary Theory (which is neither modern nor a theory). In fact, a bill currently in Congress proposes that the US Treasury instructs the US Mint to produce two platinum coins each worth \$1T. The Fed would then buy them. If we follow this route, we would be paying with higher inflation in the future.

The equity and bond markets have discounted the possibility of a surge in inflation. Raising taxes to pay for debt is toxic for any politician, so inflation solves the dilemma: monetize the debt by creating inflation and blame the inflation on the COVID-19 virus. Inflation is a serious long-term threat and is regressive, hurting people who can least afford it.

Question: In conclusion, let's turn to the last two risks. Could you describe your concerns about an October surprise and what you mean by a fire drill?

Harvey: A surprise is, by definition, a surprise. The United States has a long history of political *October surprises*—before the 2016 election we had three separate surprises. My worry is more about an economically oriented shock that could derail the recovery.

A longer-term risk I see is that policy makers view this pandemic as a one-off, once-a-century event. Pandemics are not new. Some consider them black swan events, but historically they are not that rare. The last big pandemic was 102 years ago.

It is incumbent on our policy makers and all of us as individuals to undertake basic risk management. We need to plan for the next pandemic, for this type of risk is not going away. We can mitigate this risk by taking action in the near term. Let's think of COVID-19 as a *fire drill* so we can be prepared for the possibility that the next pandemic could be more devastating.

Investing in technologies that can potentially develop a vaccine sooner rather than later is critical for the next time. We now know firsthand the extent of the human and economic damage from a pandemic. With the right policies, we can substantially mitigate the cost of the next one. The risk is that we fail to view this time around as a fire drill to prepare for the next pandemic with the result being that the damage next time could be critically worse.

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