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Optimism in the Time of COVID

Remarks by

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I want to thank the Institute of International Bankers for inviting me to discuss the outlook for the global and U.S. economies at what I believe is an important juncture in the evolution of what I refer to as the “COVID event”: the outbreak of COVID-19 and the government and social response to it.

First, I will discuss the global economy before turning to our domestic economy and its outlook. From there, I will discuss my views on monetary policy, including the new long-run monetary policy strategy recently announced by the Federal Open Market Committee (FOMC). And I will wrap up with a brief discussion on financial stability and regulatory issues.

International Economic Conditions

Let me start with a picture of the global economy. Although challenges remain, especially among some emerging market economies, significant support to households and businesses from central banks and fiscal authorities has contributed to a strong rebound in a number of advanced and some emerging Asian economies since those countries began to loosen restrictions. In these economies, the reopening of factories has led to a resurgence of industrial production. Retail sales are rebounding and in some countries are already above levels seen before the COVID event. However, international trade has been slower to increase.

The extent of the recovery in some jurisdictions has been surprisingly robust compared to many analysts’ expectations earlier this year. The momentum is feeding into many private-sector forecasts that suggest prospects are good for strong economic growth in the United States and other advanced economies over the rest of this year and

next. However, the hole that countries are in remains deep, and significant downside risks still exist.

Perhaps the most discussed risk has been that a “second wave” of the virus could trigger a return to widespread mobility restrictions and business closures. Several countries, including some portions of the United States, have seen a substantial resurgence of infections in recent months. This has been accompanied, however, by substantially lower hospitalization and death rates in most cases, and so far most countries have been able to address the resurgence without reinstating severe restrictive practices. Mobility indexes have been little changed in Europe and the United States, and the declines in Asia have been modest.¹ Businesses—which have adjusted operations and, in some cases, changed business models—seem much better adapted to remaining open. I am also hopeful that better testing, tracing, and treatment regimens, as well as improved understanding by the public about how to manage the risks of the disease, will allow firms, individuals, and governments to address public concerns about the virus while avoiding a second severe downturn or a protracted stagnation.

Still, the economic fortunes of households and businesses around the world remain at risk. Incomes and employment are likely to lag below pre-COVID event levels for some time, which would put stress on the finances of many families. Some people may remain reluctant to return to full engagement in social and economic life, weighing especially on the service sector. Even with support from monetary and fiscal policy, large numbers of businesses may close. These closures may lead to some longer-term scarring of the economy through lower investment, reduced capacity, and long-term

¹ Mobility indexes, which measure how much people move around outside their homes using cellphone geolocation data, tend to vary with economic activity.

unemployment leading some to drop out of the labor force altogether. While I am optimistic that recovery is underway and the worst outcomes can be avoided, these concerns suggest that policymakers around the world need to remain watchful and ready to act further.

Domestic Economic Conditions and the Outlook

Now let me focus on U.S. economic conditions and the outlook. The historic collapse in economic activity in March and April will take time to reverse. However, the economy has rebounded more strongly than almost any forecaster expected. That resilience reflects the economy's underlying strength upon entering the recession and demonstrates its inherent flexibility, as well as the dynamism of the American people. For example, the Census Bureau reports that applications by people seeking to start new businesses have surged this summer.²

The median of projections for 2020 by FOMC participants in September showed that both gross domestic product (GDP) and inflation had been revised up significantly from the median in the June projections.³ I expect that robust GDP growth over the rest of this year and in 2021 will lead to strong employment gains and move inflation closer to 2 percent. I would still caution that there is an unusually large amount of uncertainty now about any outlook, and I see the risks to the outlook as weighted to the downside. However, given the trends I previously discussed in the way countries are adjusting to the

² See the "Business Formation Statistics" page on the Census Bureau's website at <https://www.census.gov/econ/bfs/index.html>.

³ The advance release of table 1 of the Summary of Economic Projections, which will be issue with the minutes of the September 2020 FOMC meeting, is available on the Board's website at <https://www.federalreserve.gov/monetarypolicy/fomcproptabl20200916.htm>.

COVID event, I am optimistic that the United States can avoid the highly adverse outcomes that many feared would materialize.

Turning now to the labor market, unemployment was still at 8.4 percent in August and the labor force participation rate still down significantly from February. The extraordinary package of fiscal support in the CARES Act (Coronavirus Aid, Relief, and Economic Security Act) helped to support household incomes and to offset the effect of the huge job losses in March and April. But the act's unemployment provisions have expired, and most of the businesses that received Paycheck Protection Program (PPP) loans report that they have exhausted those funds.⁴ In addition, one area where increased understanding of the disease has, in many places, not led to general changes in practice is in the widespread school closures this fall. Many parents with children will be forced to work less, or not at all, which is going to be a hardship for them and weigh on the economy. So, I agree with Chair Powell that it will take continued support to sustain a robust recovery.

Although still unacceptably high, an 8.4 percent unemployment rate represents a considerable improvement from 14.7 percent in April and is already much lower than many thought possible this year.⁵ By comparison, after the onset of the Great Recession, it took more than two years to reduce unemployment from the peak of 10 percent to 8.4 percent. One reason for the faster turnaround this time is that many of the initial job

⁴ See Goldman Sachs (2020), "Survey: Disappointed and Frustrated, Small Business Owners Feel Left Behind by Congress" (New York: Goldman Sachs, September 8), <https://www.goldmansachs.com/citizenship/10000-small-businesses/US/infographic-left-behind/index.html>.

⁵ Accounting for employees who still were being paid but not working during April, the Bureau of Labor Statistics believes that the peak unemployment rate may have been about 5 percentage points higher than 14.7 percent. However, this measurement issue has decreased significantly to less than 1 percent in the most recent month.

losses, and subsequent job gains, were due to temporary disruptions that many businesses have overcome. However, some indicators point to slower improvement in the job market going forward.

Like employment, consumer spending has been much stronger than expected, even though spending on travel and many other categories of in-person services remains depressed. Retail sales were extremely strong from May through August, driven by demand for consumer durables such as automobiles, furniture, and home improvement. Home sales and construction also have increased sharply since then. For instance, new home sales rose in July to an annual pace of over 900,000 units, which is 16 percent above the recent peak in January 2020 and the fastest pace since December 2006.⁶

All of these facts lead me to believe the momentum in household spending is strong. Although consumer confidence remains lower than early this year, the resilience in big-ticket purchases indicates some underlying confidence among households that the economy will continue to improve. The strength in the consumer and housing sectors is being supported by Fed action to lower interest rates and support credit availability for creditworthy borrowers. In addition, the recent high rate of household savings likely represents a significant source of pent-up demand.

Now let me turn to the business sector, where the picture is more mixed. As in the household sector, the decline in many measures of business spending last spring turned out to be much less than was feared, and some indicators of business investment have turned around dramatically in recent months. However, there is considerable

⁶ See Census Bureau (2020), “Monthly New Residential Sales, July 2020,” Release CB20-123, August 25, <https://www.census.gov/construction/nrs/pdf/newressales.pdf>.

uncertainty over how businesses will deal with the cumulative effects of the COVID event on the economy.

As we all know, medium and small enterprises were, and continue to be, heavily affected by the COVID event. The PPP disbursed \$525 billion in loans to businesses through August 8, most of which will be forgiven when businesses are found to have met the requirements for keeping workers on the job at previous pay rates.⁷ Working with the Treasury Department, the Federal Reserve created several facilities that are providing support to large, mid-size, and small firms.⁸ These programs have improved credit market functioning through direct support to borrowers and lenders that use them and indirect support by creating a backstop against worsening conditions that boosts the willingness of private-sector lenders to extend credit.

Despite those efforts and the pickup in household spending, many businesses are still under strain, representing an important source of downside risk. One concern is that many businesses already were highly leveraged going into the crisis, and taking on more debt as a bridge until commerce normalizes may not be a viable option, even with favorable repayment terms. Many corporate bonds and leveraged syndicated loans were downgraded between March and June, and default rates on corporate bonds rose significantly over that period as well. However, corporate defaults have slowed in the

⁷ See U.S. Small Business Administration (2020), *Paycheck Protection Program (PPP) Report* (Washington: SBA, August), https://www.sba.gov/sites/default/files/2020-08/PPP_Report%20-%202020-08-10.pdf.

⁸ Specifically, the following facilities were created: the PPP Liquidity Facility, as well as the Commercial Paper Funding Facility, the Primary Market Corporate Credit Facility, the Secondary Market Corporate Credit Facility, and the Main Street Lending Program. See Board of Governors of the Federal Reserve System (2020), *Report on Outstanding Lending Facilities Authorized by the Board under Section 13(3) of the Federal Reserve Act* (Washington: Board of Governors, July 31), p. 3, <https://www.federalreserve.gov/publications/files/pdcf-mmlf-pmccf-smccf-talf-ppplf-mslp-20200803.pdf>.

past couple of months, and, so far, delinquency rates on business loans at banks have increased only marginally. This development, in part, highlights banks' ability to work with borrowers that have been hurt by the COVID event as laid out in supervisory guidance provided by the federal banking agencies.⁹

Another downside risk in the business sector is the strains to commercial real estate (CRE), particularly in retail and hospitality properties. CRE was a prominent concern before COVID, although one that seemed quite manageable. Since then, vacancy rates have risen significantly and rents have fallen sharply, putting at risk the high valuations that our May *Financial Stability Report* flagged as a vulnerability.¹⁰

The sharp decrease in output and employment, as well as continued slack in the economy, have put downward pressure on wages and the prices of goods and services affected by the COVID event. The 12-month increase in the price index for personal consumption expenditures (PCE) dropped to about 0.5 percent in April. Although the recovery since then has helped prices retrace some of those declines, PCE inflation was still only 1 percent for the 12 months ended in July and is likely to end 2020 well below our 2 percent longer-run target.¹¹

Indicators of future inflation do not point to rapid acceleration. Market measures of inflation expectations decreased sharply earlier this year before recovering to their previous levels recently, and inflation expectations in some surveys of professional

⁹ See Board of Governors of the Federal Reserve System (2020), "Agencies Provide Additional Information to Encourage Financial Institutions to Work with Borrowers Affected by COVID-19," press release, March 22, <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200322a.htm>.

¹⁰ See Board of Governors of the Federal Reserve System (2020), *Financial Stability Report* (Washington: Board of Governors, May), <https://www.federalreserve.gov/publications/files/financial-stability-report-20200515.pdf>.

¹¹ The FOMC defines inflation at the rate of 2 percent, as measured by the annual change in the price index for PCE, as most consistent over the longer run with the Federal Reserve's statutory mandate.

forecasters have ticked down. The Committee will be closely watching for a further recovery of inflation and signs that inflation expectations remain well anchored as we set monetary policy.

Monetary Policy, Short Term and Longer Term

In the near term, with both employment and inflation significantly short of the FOMC's economic goals, the prescription is for a sustained aggressive use of monetary policy to support the economy. In March, the FOMC cut the federal funds rate effectively to zero and began purchasing large quantities of Treasury and agency mortgage-backed securities. Over the following weeks, the Federal Reserve Board used our emergency authority to establish 13 lending facilities to provide support to households, financial firms, nonfinancial businesses, nonprofit organizations, and municipal governments. We also took steps, including extending dollar swap lines to other central banks, to address strains in global dollar funding markets.

Taking a step back, beginning in 2019, the FOMC undertook a public review of the conceptual framework for how we approach monetary policy. And last month, the FOMC updated its Statement on Longer-Run Goals and Monetary Policy Strategy, which I will call the "consensus statement."¹²

I want to emphasize the very public and deliberative nature of this policy review under the leadership of Chair Powell and Vice Chair Richard Clarida. Through a series of 15 public *Fed Listens* events, we received input from a broad spectrum of people:

¹² See Board of Governors of the Federal Reserve System (2020), "Federal Open Market Committee Announces Approval of Updates to Its Statement on Longer-Run Goals and Monetary Policy Strategy," press release, August 27, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200827a.htm>.

small business leaders, union workers, retirees, prominent outside researchers, and others.¹³ The FOMC also had the benefit of extensive research and analysis from Fed staff and debated the issues at a series of FOMC meetings.¹⁴ This process set a new and very high standard for transparency and accountability for the Fed, and we have committed to conducting such reviews roughly every five years.

I believe the new consensus statement lays out a strategy that is suited to the demands of setting monetary policy in our constantly changing economy. Let me begin by focusing on two key conclusions. First, over the past two decades, the prevailing level of interest rates in many advanced economies has declined, leaving central bankers with less room to cut interest rates when the economy slows. In addition, experience over the past few decades has shown us that the traditionally strong relationship between unemployment and inflation has weakened, perhaps considerably.¹⁵ We saw this weakening relationship in the United States, as the robust expansion before the COVID event led to historic and broad-based labor market gains. Not only did the unemployment rate drop to long-time lows, but the wages of low- and moderate-income workers also

¹³ Federal Reserve staff analysis on the *Fed Listens* initiative was presented and discussed at the December 2019 FOMC meeting and is part of the *Fed Listens* report; see Board of Governors of the Federal Reserve System (2020), *Fed Listens: Perspectives from the Public* (Washington: Board of Governors, June), <https://www.federalreserve.gov/publications/files/fedlistens-report-20200612.pdf>.

¹⁴ Summaries of the Committee's discussions are available in the minutes of the associated meetings, which can be found on the Board's website at <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>. An overview of the System staff's work in support of the review is presented in David Altig, Jeff Fuhrer, Marc P. Giannoni, and Thomas Laubach (2020), "The Federal Reserve's Review of Its Monetary Policy Framework: A Roadmap," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, August 27), <https://www.federalreserve.gov/econres/notes/feds-notes/the-federal-reserves-review-of-its-monetary-policy-framework-a-roadmap-20200827.htm>.

¹⁵ A comprehensive review of both of these points can be found in Chair Powell's 2020 speech at Jackson Hole; see Jerome H. Powell (2020), "New Economic Challenges and the Fed's Monetary Policy Review," speech delivered at "Navigating the Decade Ahead: Implications for Monetary Policy," an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, held in Jackson Hole, Wyo., August 27, <https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm>.

accelerated, and unemployment rates for historically disadvantaged groups fell to record lows. Yet inflation continued to run modestly below our symmetric 2 percent target, for almost the entire period, and long-term interest rates remained very low by historical standards.¹⁶ This recent experience in the United States, which has also played out elsewhere, has led to a growing consensus in the economics profession that the relationship between unemployment and inflation—commonly known as the Phillips curve—has flattened.

Therefore, given the considerable benefits that we observed when unemployment fell to very low levels in recent years, the Committee determined that a low unemployment rate, unless accompanied by worrisome developments in inflation or other risks that could impede the attainment of our goals, would not necessitate a policy response. We capture this change in the revised consensus statement by tying future policy decisions to “shortfalls of employment from its maximum level” rather than to “deviations” from the maximum level as in the previous statement. The new framework statement also highlights that the maximum level of employment is a broad-based and inclusive goal, and it reiterates that the Committee will review a wide range of indicators—not just the unemployment rate—in its assessments of that level. I believe these changes to the way the FOMC responds to labor market conditions will result in a stronger economy without jeopardizing our commitment to low and stable inflation. In fact, I think that meeting our longer-run goal of 2 percent inflation as defined by the 12-

¹⁶ A similar experience played out in the 1990s, as the Federal Reserve under Chairman Alan Greenspan saw unemployment decline to levels well below then-prevailing views of maximum employment, without a significant increase in inflation or unmooring of inflation expectations.

month change in the overall PCE price index, which is unchanged by this revision, will help achieve the kind of labor market outcomes we have experienced in recent years.

And that is a good segue into the other major change in the consensus statement that I want to address today. Even before the COVID event pushed inflation down to very low levels this year, PCE inflation had been running modestly below 2 percent for some time, and some measures of inflation expectations had decreased to the low ends of their historical ranges. These developments certainly bear watching, especially if inflation were to remain lower than it had been in previous years or if inflation expectations were to decrease further. A decrease in inflation expectations can lead to a downward spiral in actual inflation, which would further reduce already low equilibrium nominal interest rates and, among other consequences, leave the FOMC with less flexibility to address future economic slowdowns.

In order to better anchor long-run inflation expectations at 2 percent, the consensus statement makes a distinct change from the old approach. The Committee will seek to achieve inflation that averages 2 percent over time, which means that we will aim to achieve inflation moderately above 2 percent for some time following periods when inflation has been persistently below 2 percent.

In the previous consensus statement, the FOMC committed to a 2 percent longer-run goal for inflation that was to be “symmetric.” This wording already suggested some tolerance for inflation above 2 percent when it was consistent with meeting our employment mandate, and I certainly never viewed 2 percent inflation as a ceiling. One reason to be comfortable with inflation at times running moderately above 2 percent is that defining and measuring inflation are very much an inexact science. For that reason, I

have always considered alternative indicators of inflation—such as the Dallas Fed trimmed mean and, of course, core inflation—in my assessment of the likely longer-run path for the headline PCE price index. As a result, as long as inflation expectations remain well anchored close to 2 percent, modest deviations of any particular measure of inflation around 2 percent are not a first-order concern in my decision framework. In fact, I likely will be even more patient in reacting to small upward deviations, given the Committee’s move to focus on shortfalls of employment from maximum employment rather than deviations.

For those reasons, I supported the action that the FOMC took last week at our September meeting to update the forward guidance to be consistent with the consensus statement for these extraordinary times. Although we have seen the beginnings of a strong recovery, even optimistic forecasts suggest that it will take a long time to recover fully from this shock. Evidence suggests that our actions to date have had significant stimulative effects. By providing additional monetary policy accommodation through stronger, outcomes-based forward guidance, the Committee hopes to quicken the pace of the recovery.

Implications for Banks and Financial Stability

Now let us consider some of the implications of the COVID event for banks and for financial stability. Large U.S. banks entered this crisis in strong condition, and the Federal Reserve has taken a number of important steps to help bolster banks’ resilience. We took the unprecedented step of prohibiting share repurchases in the third quarter for

large banks while also capping dividends.¹⁷ In addition, we required all banks to reassess their capital needs in the face of continued uncertainty and resubmit their capital plans. Last week, we released a baseline and two hypothetical recession scenarios that will be used by banks and the Fed to assess the resilience of the sector, and we will release bank-specific results from our independent assessment before the end of the year.¹⁸

Nonbank financial firms, especially those engaged in liquidity transformation, experienced acute strains in March. Despite the apparent success of some nonbank regulatory reforms in the United States, such as efforts to increase the resilience of money funds, the Board of Governors again needed to provide significant emergency support. This is why, at the Financial Stability Board, I have put together a senior group of market regulators and central bank governors to develop a holistic review of the March stresses in nonbank finance. We will deliver that review to the G20 in November, together with a work plan on potential methods to address the vulnerabilities that may amplify stresses in funding markets.

Conclusion

In conclusion, the COVID event was an enormous economic shock in the first half of 2020, but a recovery is underway, and the world seems to be adjusting in ways that allow us to address public concerns about the virus without sudden stops in economic activity. A full recovery is still a good way off, however, and risks remain weighted to the downside. Policymakers will need to remain vigilant.

¹⁷ See Board of Governors of the Federal Reserve System (2020), “Federal Reserve Board Releases Results of Stress Tests for 2020 and Additional Sensitivity Analyses Conducted in Light of the Coronavirus Event,” press release, June 25,

<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm>.

¹⁸ See Board of Governors of the Federal Reserve System (2020), “Federal Reserve Board Releases Hypothetical Scenarios for Second Round of Bank Stress Tests,” press release, September 17,

<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200917a.htm>.