Michelle W Bowman: The economic outlook and prospects for small business

Speech (via webcast) by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the Economic Club of Oklahoma, Oklahoma City, 22 March 2021.

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Thank you, Doug, and thank you to the members of the Economic Club of Oklahoma for the opportunity to speak about a subject of vital interest to all of us—the outlook for the U.S. economy in 2021. Our nation has made considerable progress since COVID-19 hit the economy with great force a year ago, but we still have further to go, and risks remain.[1]

As we all know, starting in late February or March of last year, widespread economic and social lockdowns and other effects of the COVID-19 pandemic caused the swiftest and deepest contraction in employment and economic activity since the Great Depression. Money markets, the Treasury market, and other parts of the financial system seized up, and there were fears of another severe financial crisis. The Federal Reserve stepped in quickly to assist, reviving several lending facilities used in the previous crisis and creating several new facilities. We also cut short-term interest rates to near zero and began purchasing large quantities of Treasury and agency securities to help sustain the flow of credit to households and businesses. Congress and the Administration also worked together to provide effective and timely support. Calm was restored in financial markets, and employment and output began growing in May, but it was a very deep hole to fill. Rapid progress over the summer gave way to slower growth over the past winter as COVID-19 infection rates surged. But in recent weeks, with steep declines in virus-related hospitalizations and deaths, the outlook has brightened. Job creation had stalled over the winter months but picked up in February, with an increase of around 380,000 jobs. The pace of vaccinations has accelerated, COVID-related restrictions on economic activity are beginning to ease, and the latest round of stimulus is boosting consumer spending.

Despite the news of the spread of more-contagious COVID-19 variants, efforts to increase vaccine shipments and recently announced plans for distribution to the broader public are encouraging and, if successful, give me some confidence that our economic performance will continue to improve quickly over the remainder of the year.

My outlook for the economy is broadly in line with the median of projections of other members of the Federal Open Market Committee (FOMC), published following our meeting last week. Most of my FOMC colleagues expect the economy to grow between 5.8 percent and 6.6 percent in 2021, and the median projection is that the unemployment rate will fall to 4.5 percent by the end of the year. My own expectation is for strong growth and a rebound in the labor force participation rate once the economy fully reopens. This would include schools resuming fulltime in-person learning, which would enable parents who reduced their hours or left the workforce to oversee virtual education and childcare to return to fulltime work.

As of February, the level of payroll employment is still 9-1/2 million below the pre-pandemic peak and more than 11 million below where it would have been based on the trend before the pandemic. I believe that job creation will continue, but I still see considerable uncertainty about the strength of that improvement and how long it may take to reach the Federal Reserve's maximum-employment goal. I am also concerned that the extended period of economic restrictions will contribute to further business closures. Severe restrictions on mobility and commerce were implemented in many areas to control the spread of the virus, but they came at a very high economic cost. There is some evidence, which I will discuss in a moment, that small businesses fared better in states with less-stringent restrictions. While the headline unemployment rate has continued to fall, the number of people who report being unemployed for more than six months has continued to rise, suggesting a risk of scarring—meaning that some

individuals could see an erosion of their skills and their connections to the labor market.

Although economic activity in the travel, leisure, and hospitality sectors has continued to lag the recovery, there have been some bright spots elsewhere. Two that are particularly important for Oklahoma are agriculture and energy. Commodity prices for some crops have increased dramatically in the past few months, particularly soybeans and corn, reflecting higher export demand and some limits on global supply. Increased prices are providing better cash flow and improved credit terms for farmers. Agricultural manufacturers and other suppliers are reporting order backlogs through the summer months, and there are some reports of firmer or increased prices for farmland.

Meanwhile, the recent surge in oil prices has returned West Texas Intermediate back up near the levels of early 2020, when it began to fall sharply. The rebound in prices reflects the improved outlook for the global economy given significant progress toward widespread vaccinations in many countries. This recovery has not had a dramatic effect yet on businesses engaged in or supporting oil and gas extraction, but there are signs of a turnaround. So far this year, retail gasoline prices have been rising sharply, and the North American rig count is now the highest it has been since last April.

But in contrast to the broadening improvements in many sectors of the economy, an area I continue to be concerned about is the outlook for U.S. businesses, particularly small businesses, which have borne the brunt of the effects of the pandemic. We are now more than a year into the pandemic, and many small businesses are continuing to struggle in their efforts to remain open. Recently, the Bureau of Labor Statistics (BLS) released counts of business closures for the second quarter of last year, when most face-to-face businesses were largely shuttered.[2] In that quarter, the closure rate for establishments showed a sharp increase to 9 percent, compared with an average of about 5 percent during 2019.

As part of the fiscal stimulus package passed in June last year, the Paycheck Protection Program (PPP) and other government supports helped many businesses withstand the extended period of inactivity over the spring and summer. Many of the shuttered businesses were at least partially reopened in the second half of last year. But as virus cases surged toward the end of 2020, many state and local governments reimposed restrictions on business activity, and others postponed plans to lift their existing restrictions.

Even today, more than a year later, some sectors, like restaurants, leisure, and tourism, are continuing to face major effects from pandemic-related social distancing, forced closures, and capacity limits. These restrictions may have been helpful in containing the pandemic, but they appear to have disproportionately impeded small firms' ability to maintain their operations and revenue sources, leading to substantial cash flow pressures. Small businesses will be helped in the near term with a new round of PPP lending, which included adjustments to terms that will make forgiveness of these loans less onerous than before. Even with this, financial pressures on many small businesses remain acute, and I am concerned that a growing number of small businesses have already been closed permanently or are on the verge of failure.

The BLS data are not yet available beyond the second quarter of last year, so, from that source, it's difficult to assess the full extent to which the COVID-19 pandemic resulted in permanent business closures. But research by the Board's staff using nontraditional data sources finds that, in 2020, business exits were especially elevated among small firms and particularly in industries most sensitive to social distancing.[3] The authors found that the permanent exit rate of restaurants in 2020 was about 50 percent higher than average historical rates.

On a related note, I would emphasize that, up to this point, the national data on business loan delinquencies and bankruptcy filings have not been especially concerning. That said, small businesses are often unincorporated, and many go under without declaring bankruptcy or

defaulting on loans. In fact, many small business owners rely on credit cards or home equity loans for financing, so their failure to make timely payments would not be reflected in data on business loan delinquencies.

Elsewhere, evidence of small business finance fragility is shown in Federal Reserve survey data. In the latest reading from the Small Business Credit Survey conducted in October 2020, 80 percent of firms reported seeing a decline in revenue over last year, and two-thirds of those reported declines of at least 25 percent. Since then, there have been indications that things have gotten worse. For example, in February, survey data from the National Federation of Independent Business indicate that a net majority of small businesses reported declines in earnings over the past three months, and a net majority expect their sales to worsen over the next three months.

These economic data align with conversations that I have had with bankers across the country, which consistently point to the emerging credit challenges among small and medium-sized businesses as a major source of concern. Bankers note that the substantial support from the Paycheck Protection Program and other fiscal policies have postponed, but not eliminated, these financial pressures. The bankers I speak with have also noted that, while monetary policy has successfully delivered favorable borrowing conditions, many firms are reluctant to take on debt or additional borrowing because of the highly uncertain business climate. Recent data from the from the Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices tell a similar story: The January edition of that survey showed a majority of banks reporting weaker demand for commercial and industrial loans to firms of all sizes.

The sharp, and largely voluntary, pullback in consumer spending that followed the onset of the pandemic was undoubtedly a major trigger for the financial struggles that businesses are now facing. But in addition, there is evidence that the economic restrictions imposed by many state and local governments have played a role in the deteriorating health of small businesses. Using data from the Small Business Pulse Survey conducted by the Census Bureau, the Board's staff found that, in states with tighter restrictions on business activity, small firms were more likely to report large declines in their business operations. Firms in relatively restrictive states were also more likely to report that they expect to operate at reduced capacity for an extended period, and they were more likely to expect to need financial assistance in the next six months. While obviously not conclusive, the visible relationship between state-level economic restrictions and small business damage is both striking and concerning.

You may be tempted to ask why I am so focused on small businesses. For one, it is because the roughly 32 million small businesses in the United States comprise an important source of job growth in the macroeconomy, and they have an outsized impact on their local communities. Over the past decade, small businesses created 10.5 million net new jobs, accounting for roughly two-thirds of overall net new job creation. This, as I see it, is why the potential for a wave of small business failures is one of the main risks to my expectation that our economy will make further substantial progress toward our goal of full employment. Moreover, from my vantage point as a former community banker, I see other potential negative consequences: Because small businesses often form the backbone of the communities where they are located, their disappearance could have profound and long-lasting community-level effects as well.

As I look further down the road, there are some tentative signs that the pickup in overall economic activity will eventually bring an improvement in conditions for small businesses. For example, the latest responses to the same Small Business Pulse Survey I mentioned earlier now indicate that expectations of small business failures—which were quite high during most of 2020—have dropped noticeably and are now tracking below the average rate of failures observed over the five years preceding the pandemic.

I spoke earlier about employment, and I will now turn to the price-stability side of the Fed's mandated goals for monetary policy. In recent months, we have seen consumer price inflation

moving up, and I anticipate that the 12-month rates in the next few months will very likely track above our 2 percent benchmark as the unusual softness in prices that we saw in April and May last year drops out of the calculation. The marked rise in food prices over the past 12 months has also pushed up the headline measures of price inflation. For many other categories of consumer goods, high order backlogs and tight supplies of key production inputs—like lumber and semiconductors—as well as logjams at the nation's ports and a shortage of truck drivers are likely to push up prices over the next several months. But I expect that these pricing pressures will be temporary, easing over the course of this year as supply bottlenecks are gradually resolved.

Beyond this year, some observers have expressed concern that a rapid recovery in aggregate demand amid substantial fiscal support and accommodative monetary policy could lead to undesirably high inflation. While I expect that the stronger economy will push up inflation somewhat, let me explain why I do not expect pricing pressures to be excessive and why I believe the Federal Reserve is likely to continue supporting the economy for some time through accommodative monetary policy.

Here I will point to what has in the past seemed to be a relationship between inflation and unemployment, known as the Phillips curve. Over the past several decades, despite large swings in unemployment, inflation has been extremely stable. As an example, up to the beginning of the pandemic, when the economy was growing and unemployment was at a 50 year low of 3.5 percent, inflation was still very low and stable. Economists often attribute this so-called flat Phillips curve to the fact that individuals' inflation expectations are well anchored and unlikely to respond to short-term pricing movements. Survey data on long-run inflation expectations tend to back up this idea. They have been remarkably stable over the past decade, and, although they declined moderately during the middle of last year, most measures have edged up again in recent months and now stand roughly at the levels observed during the pre-pandemic period.

With all of that said, given our lack of historical experience with both this level of substantial fiscal stimulus and highly accommodative monetary policy, my outlook for inflation is fairly uncertain. When making monetary policy decisions, we would be concerned about a significant increase in inflation above our 2 percent goal that was sustained for some time. But as my Fed colleagues and I have said many times, monetary policy is not on a preset course. I will continue to monitor economic developments carefully, and, if my outlook for inflation were to change materially, my assessment of the appropriate stance of monetary policy would change as well.

I will wrap up by noting that the economy has made great progress since last spring, and I am optimistic that will continue in 2021, but we still have significant ground to make up and new strains of COVID-19 could slow progress in containing the pandemic. Last year's sharp contraction in economic activity was like nothing we had seen before, and we are still assessing its impact. One unresolved question, in my mind, is how resilient small businesses will prove to be after the extended period of reduced activity.

What does all of this mean for the outlook for monetary policy? As we indicated in the policy statement released last week, my FOMC colleagues and I expect to maintain an accommodative stance of monetary policy until employment and inflation achieve levels consistent with our maximum employment and inflation goals. At this point, the economy is still a long way from those goals. We are making progress, but I think it will take some time for us to get there.

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[1] The views expressed here are my own and are not necessarily those of my Federal Open Market Committee colleagues. I would also like to acknowledge the valuable contributions of Federal Reserve staff member Wendy Dunn.

[2] The BLS counts an establishment as "closed" if it reports no employment (or does not report at all) in the third month of the quarter after reporting positive employment in the third month of the previous quarter. The BLS will eventually categorize closed businesses as "deaths" if they stay closed for four quarters. In recent years, the

annual establishment death rate has been around 8.5 percent.

3 See Leland Crane, Ryan Decker, Aaron Flaaen, Adrian Hamins-Puertolas, and Christopher Kurz (2020), "Business Exit during the COVID-19 Pandemic: Non-Traditional Measures in Historical Context," Finance and Economics Discussion Series 2020–089 (Washington: Board of Governors, October).