The Outlook for the Economy and Federal Reserve Policy

Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Economists on the Economy
Council for Economic Education
New York, NY
(via videoconference)

June 17, 2020

Introduction

Let me start by thanking Nan Morrison and the Council for Economic Education for the opportunity to speak today. I have the pleasure of serving on the council's board so I have seen firsthand the important work the council is doing to increase economic and financial literacy in the country. As the council's mission statement explains, equipping students with this knowledge can help them make better decisions for themselves, their families, and their communities. It is noteworthy that despite the burdens of the pandemic, the council has found creative ways to carry on its mission, including its support of teachers, the National Economics Challenge, and this speakers' series.

Today, before we open it up to questions, I'll give you an update on the economy and on the Federal Reserve's policy response. As always, the views I'll present are my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The Current Economy

The coronavirus pandemic is a global public health crisis that has inflicted pain and hardship on people all over the world. This is an unprecedented situation and unprecedented actions have been taken in response. The country took aggressive social distancing measures to limit the spread of the virus, resulting in a shutdown of much of the economy starting in March. This was an investment in public health that bought some time for the healthcare system to increase its capacity to care for the sick, for doctors and scientists to learn more about the disease itself, and for the country to begin to develop tests and treatments. But at the same time, the effect of the shutdown on the economy was swift and severe.

[FIGURE 1] In the first quarter, real output declined at a 5 percent annual rate, with real consumption down almost 7 percent and nonresidential business fixed investment down nearly 8 percent. These declines reflect what occurred in a single month, March. Earlier this month, the National Bureau of Economic Research's Business Cycle Dating Committee determined that economic activity peaked in

February and that the U.S. economy entered a recession. I anticipate that the second quarter will show the most severe effects of the pandemic shutdown on economic activity. Most private-sector forecasts for second quarter GDP growth range from minus 25 down to minus 40 percent, measured at an annual rate. I agree that second quarter growth could be the largest quarterly decline on record.

[FIGURE 2] The decline in activity led to both headline and core inflation readings moving down in March and April. I expect inflation to decline further this year because the sharp pullback in demand will outweigh any upward pressure coming from limited supplies of certain goods and services.

In recent weeks, states have begun to relax some of their stay-at-home restrictions, and we are beginning to see some positive signs in the data. Retail sales rebounded significantly in May, with sales up in all major categories. In the Fourth District, which includes Ohio and parts of Pennsylvania, Kentucky, and West Virginia, some activities have picked up faster than our business contacts had expected. Tourism activity increased after Memorial Day and foot traffic at retail stores in the region moved up. Even so, about 40 percent of our contacts do not expect activity to recover to pre-pandemic levels for at least a year.

As more regions and sectors of the economy reopen, rates of growth are going to look very good, but we are digging out from a very deep hole and it is more informative to think in terms of levels.

One of the most positive pieces of news we've received is the employment report for May. Instead of rising as most economists expected, the unemployment rate fell. And instead of losing jobs, payrolls increased by 2.5 million jobs. This is great news and points to some stabilization in the labor market after two months of deep declines. I am hoping we will continue to see positive reports over coming months as more of the economy opens up.

But it is also important to put May's report into perspective.

[FIGURE 3] In April, the unemployment rate surged to 14.7 percent. In May, it fell to 13.3 percent, still considerably above its previous peak in October 2009, in the aftermath of the Great Recession, and well above the 3.5 percent it was as recently as February. In May, 21 million workers were unemployed compared with 6 million in February. That is about one in 12 Americans aged 16 or older. This is worse than in October 2009, when about one in 15 people were unemployed.

[FIGURE 4] The gain of 2.5 million jobs in May was a record monthly gain, but it is only about 11 percent of the job losses in March and April.

[FIGURE 5] In fact, the level of employment is near the lows we saw right after the Great Recession. So that means the economy has lost almost all of the jobs it added over the entire expansion of 10-plus years. Employment is 13 percent below February's level.

The deterioration in the labor market is even sharper than these numbers indicate. Many people left the work force at the beginning of the shutdown and they do not show up in the unemployment rate, and many workers had their hours cut. Our survey of firms in the Fourth District indicates that while layoffs began to slow in May, firms have recalled workers more slowly than they originally intended to.

Moreover, the improvements in May were not evenly shared. Indeed, half of the net private-sector job losses since February have been in the leisure and hospitality and the retail trade sectors, the two sectors ranked lowest in terms of average hourly earnings.

[FIGURE 6] The unemployment rates among blacks and Hispanics have been chronically above those of whites and Asians. Over the long expansion, we had finally seen some progress being made on that front, as the gap in unemployment rates narrowed. But the pandemic has increased the disparities. All groups have experienced an increase in their unemployment rate since February, but the increase was less for whites than for the other groups. And in May, the unemployment rate for both blacks and Asians continued to edge up rather than fall. It is particularly distressing that much of the sacrifice over the pandemic period is being borne by the most vulnerable in our economy: lower-income and minority workers and communities, and the smaller of the small businesses.

[FIGURE 7] And it shines a bright light on long-standing economic inequality that needs to be addressed if the economy is to perform up to its potential. Like the Council for Economic Education, I believe that education is a path to better economic outcomes for individuals, households, and the country at large. Our work force has become more educated over time. But the likelihood of completing a degree varies by race. Graduation rates for whites, Hispanics, and Asians have risen over time, but those of blacks remain well below those of these other groups and have shown no progress over time. Economic well-being rises with education, so if more is not done to ensure that blacks who enter college have the support to complete their degrees, economic inequality is likely to continue to rise.[1]

The Economic Outlook and Policy

Let me now turn to the outlook and policy. Macroeconomic forecasting is particularly challenging at this time. With states relaxing stay-at-home restrictions, I expect economic activity to pick up in the second half of the year. But there is considerable uncertainty about what the recovery will look like after the

[1] See Loretta J. Mester, "Community Development and Human Capital," remarks at the 2015 Policy Summit on Housing, Human Capital, and Inequality, Federal Reserve Banks of Cleveland, Philadelphia, and Richmond, Pittsburgh, PA, June 19, 2015 (https://www.clevelandfed.org/en/newsroom-and-events/speeches/sp-20150619-community-development-and-human-capital.aspx). And see Board of Governors of the Federal Reserve System, "Report on the Economic Well-Being of U.S. Households in 2019, Featuring Supplemental Data from April 2020," May 2020 (https://www.federalreserve.gov/publications/2020-economic-well-being-of-us-households-in-2019-preface.htm).

economy reopens. The shape of the recovery will depend on the path of the virus and our ability to handle its spread through testing, contact tracing, treatment, and risk-focused restrictions on activity. It will also depend on the behavior of households and businesses and how comfortable they feel in re-engaging in economic activity. The Cleveland Fed's daily national survey of households suggests widely varying views about the pandemic and how people plan to behave. About 60 percent of the respondents think the pandemic will last a year or less, and on average, this group says they are likely to return to their pre-pandemic usage of bars and restaurants, public spaces, public transportation, and crowded events. The other 40 percent of the respondents expect the pandemic to last more than a year, and on average, this group says they will not engage in these activities to the same extent they once did, even after the pandemic has ended.[2] It will be important to continue to monitor household and business attitudes in assessing the outlook.

The other important factor that will determine the path of the recovery is how successful policy actions are in ensuring that the temporary disruption in activity we have seen so far does not cause lasting damage to the economy and that the recovery has enough support to be sustained.

Let me discuss some of these policy actions and then talk about the outlook. Both the federal government and the Federal Reserve took significant actions quickly to provide households and businesses with relief during the shutdown. Fiscal policymakers made grants to individuals, certain businesses hit hardest by the pandemic, and states and municipalities. They have expanded unemployment benefits and have funded the Paycheck Protection Program, which provides small businesses with loans that turn into grants if they maintain their payrolls. As the magnitude of the need has come into better focus, the federal government has increased its level of support. Although the amount of support has been sizable, so is the

[2] The Cleveland Fed's website provides updates of these survey results each Wednesday on the Consumers and COVID-19 page, https://www.clevelandfed.org/our-research/indicators-and-data/consumers-and-covid-19.aspx.

depth of the economic downturn. In my view, further direct fiscal support will be needed for states and municipal governments and for households most affected by the pandemic.

The Federal Reserve is not legally able to make grants, but it has taken significant actions and has committed to using its full set of tools to support the economy, guided by our congressional mandate to promote maximum employment and price stability.

Early in the pandemic, the Fed began taking actions to help ensure that financial markets have enough liquidity to continue to function well. Well-functioning financial markets are what allow credit to flow to households and businesses and monetary policy to effectively transmit to broader financial conditions. So when conditions became strained, the Fed began buying Treasury securities and agency mortgage-backed securities and conducted operations in the repo market to ease those strains. At our meeting last week, the FOMC said that over the coming months, the Fed would increase its holdings of Treasuries and mortgage-backed securities at least at the current pace.

The Fed has also set up emergency lending facilities, with the backing of the U.S. Treasury, to serve as a backstop to other key credit markets, including money market mutual funds and the commercial paper market. The Fed is also ensuring that our central bank counterparties abroad have access to dollar funding. Although volatility and risk spreads have not returned to pre-pandemic levels, there has been a significant lessening of stress and an improvement in market functioning in many markets since these actions have been taken.

Another set of our emergency lending facilities focuses more directly on supporting the flow of credit to households, to businesses of all sizes, and to state and local governments.[3] Included in this group are the Municipal Liquidity Facility, which purchases short-term notes from states to help them manage cash-flow pressures, and the Main Street Lending Program, which supports lending to small and medium-sized businesses that were in sound financial condition before the onset of the pandemic. Based on consultations with both lenders and potential borrowers, the Fed has adjusted the terms on some of these programs to ensure that they will support the economy as effectively as they can while safeguarding taxpayer funds. And earlier this week the Fed announced it was seeking public feedback on a proposed expansion of the Main Street program to nonprofits, which provide vital services in the economy.

Because much of the flow of credit to households and businesses relies on the banking system, the Fed has encouraged banks to use its discount window as a source of liquidity and to work with their borrowers affected by the virus. The Fed has temporarily relaxed some of the regulatory requirements and supervisory oversight so that banks have greater capacity to lend.

Last, but not least, in March the FOMC reduced its target range for the fed funds rate to 0 to 1/4 percent. At our meeting last week, we maintained the funds rate at that level and reiterated that we expect to maintain this target range until we are confident that the economy has weathered recent events and is on track to achieve our maximum employment and price stability goals.

As more states relax restrictions on activity, the economy is moving from a shutdown phase, through a re-opening phase, and into a recovery phase. As this happens, the focus of Fed policy will expand from supporting market functioning and the flow of credit to supporting the recovery. I expect to see an

[3] In addition to the Municipal Liquidity and the Main Street Lending Program, these facilities include the Paycheck Protection Program Liquidity Facility, the Primary and Secondary Market Corporate Credit Facilities, and the Term Asset-Backed Securities Loan Facility. More information on the Federal Reserve's actions in response to the effects of the coronavirus on the economy is available at https://www.federalreserve.gov/covid-19.htm.

improvement in the second half of the year as the economy reopens. But after that, I believe it will take quite some time for economic activity and job levels to approach more normal levels. The improvement will vary across sectors, because even if people can resume some of their normal activities, they need to feel some reassurance that it is safe to do so. In some industries, like travel and leisure and hospitality, it will likely take quite a while longer for activity to pick up than in others. By the end of this year, I expect that output will still be about 6 percent below its level at the end of last year, and the unemployment rate, while down from its peak, will still be around 9 percent. I expect inflation to remain below our 2 percent goal for some time to come.

In my view, very accommodative monetary policy will be needed to support the recovery and the return to the FOMC's goals of price stability and maximum employment over time. My economic forecast is very similar to the median forecasts of the FOMC participants that were released last week, which show an economic recovery starting in the second half of the year and continuing over the next couple of years. Almost all of my FOMC colleagues agree with me that it will be appropriate for the fed funds rate to remain at its current level through 2022, the end of our projection horizon, in support of the recovery.[4]

Over the next several weeks as more states reopen, we will get further readings on the condition of the economy. The uncertainty surrounding the outlook is extremely high because we are in an unprecedented situation. Outcomes depend not only on appropriate economic policy but also on public health considerations. Epidemiologists tell us to expect periodic upswings in the number of cases until a vaccine can be distributed. We are seeing that today in some locations. People often say that the virus determines the timeline. I agree, but that does not mean we are helpless to affect the outcomes. Increased investment would speed up the progress on testing, contact tracing, and treatments, and help ensure that the healthcare system has adequate capacity. Better adherence to the guidelines on social distancing, mask

[4] See Press Conference Projection Materials, June 10, 2020 (https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20200610.htm).

wearing, and hygiene would help to control the virus's spread. These actions would make it safer for people to re-engage in activity and would allow for interventions to become more focused on helping those at highest risk from the disease, thereby supporting the recovery. And May's positive employment and retail sales reports remind us of the resiliency of the U.S. economy. Of course, if the number of cases of the virus is not well-controlled and the healthcare system gets overwhelmed, then the economic outcomes I have discussed could turn out to be much more dire, with people and businesses restricting their own activity even if states do not reinstate restrictions.

So at this juncture, I think it makes sense for monetary policymakers to continue to monitor the economy as the country begins to re-engage in economic activity, to continue to support the flow of credit to households and businesses and ensure the smooth functioning of financial markets, to remember that there are several different scenarios that could play out, and to stand ready to use all of our tools to mitigate lasting damage and to support the economy's recovery back to maximum employment and price stability.

Charts for “The Outlook for the Economy and Federal Reserve Policy”

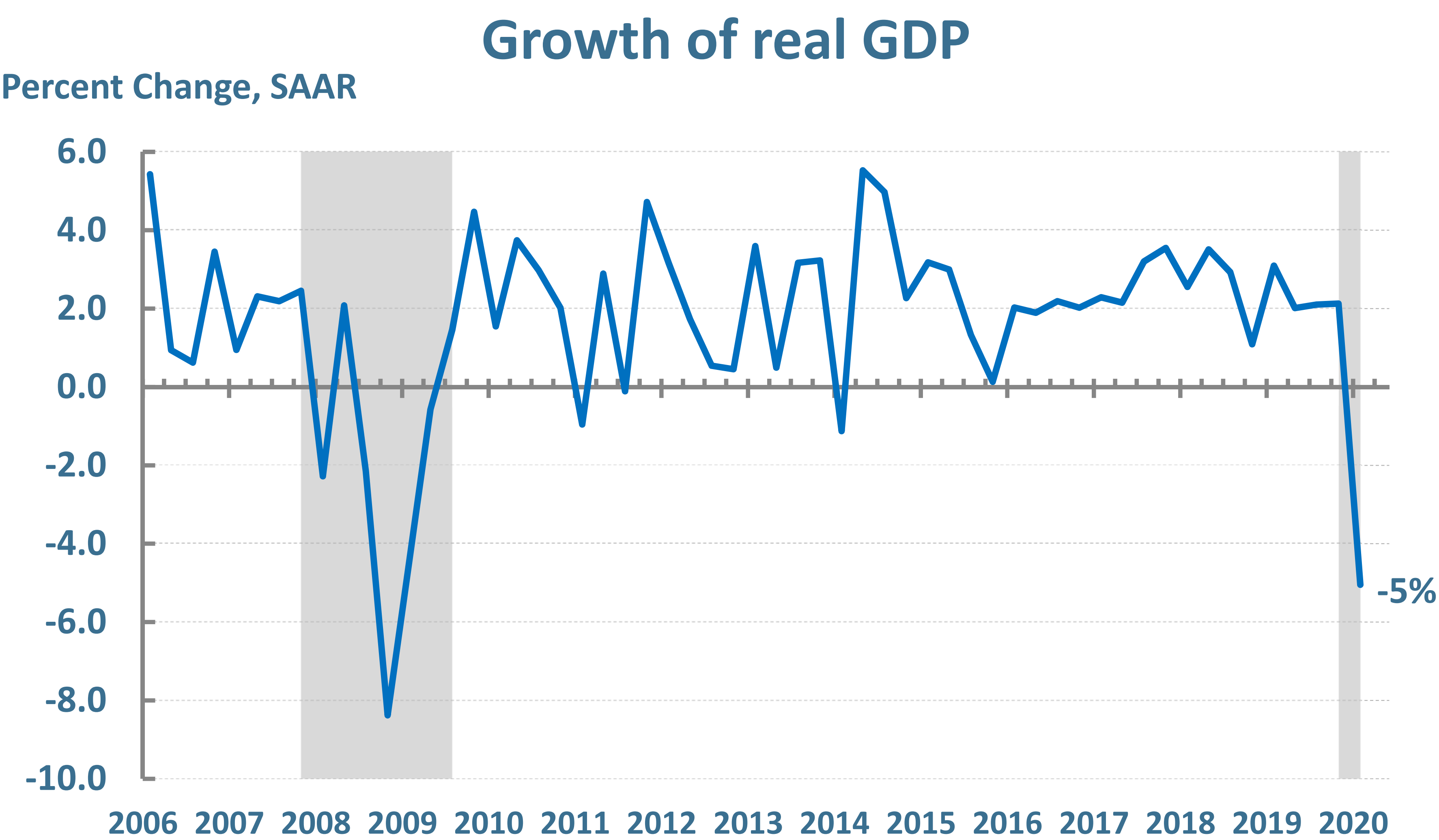
Loretta J. Mester*
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Economists on the Economy
Council for Economic Education
June 17, 2020

*** The views expressed here are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.**

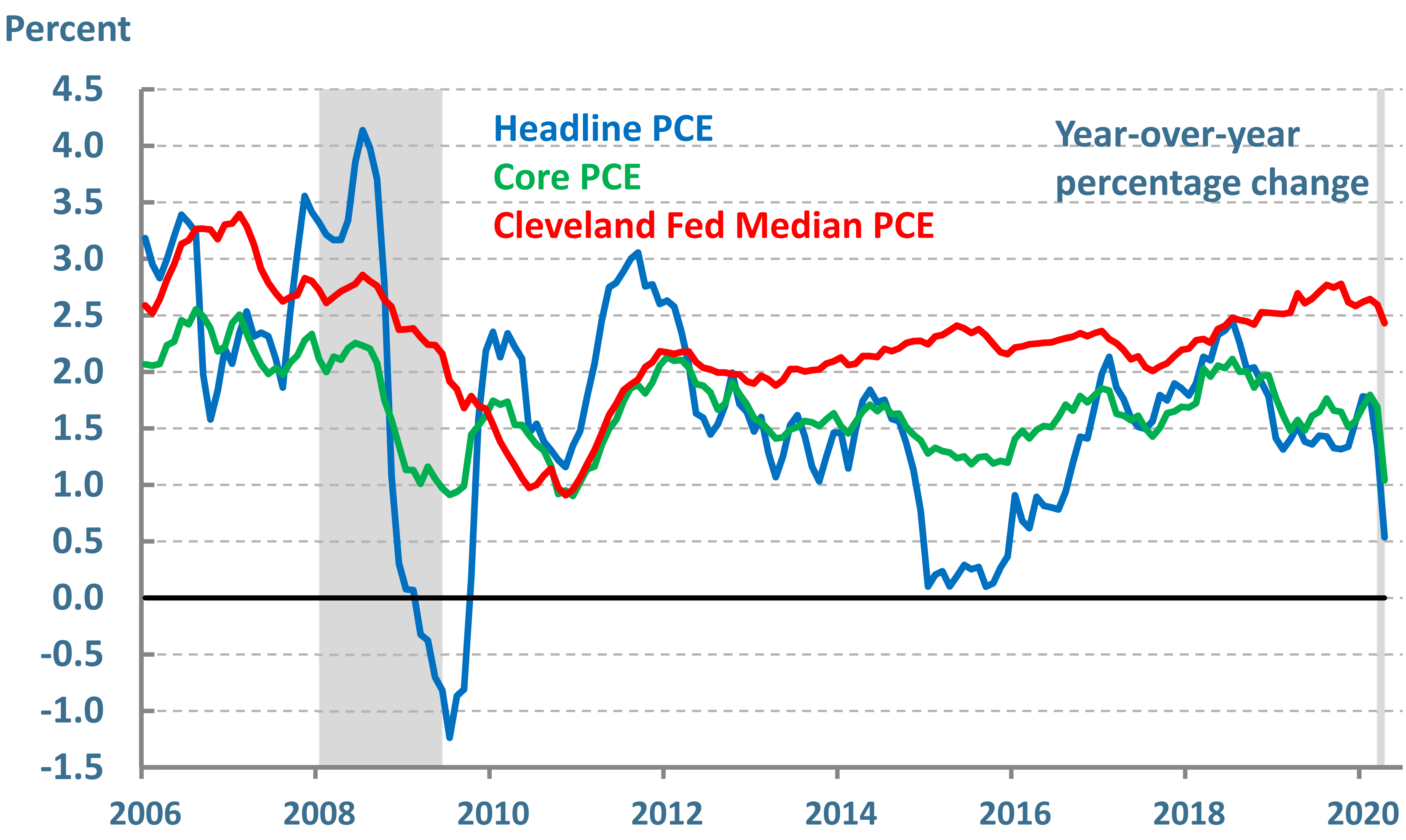
FEDERAL RESERVE BANK
of CLEVELAND

Figure 1. The economic expansion ended in February



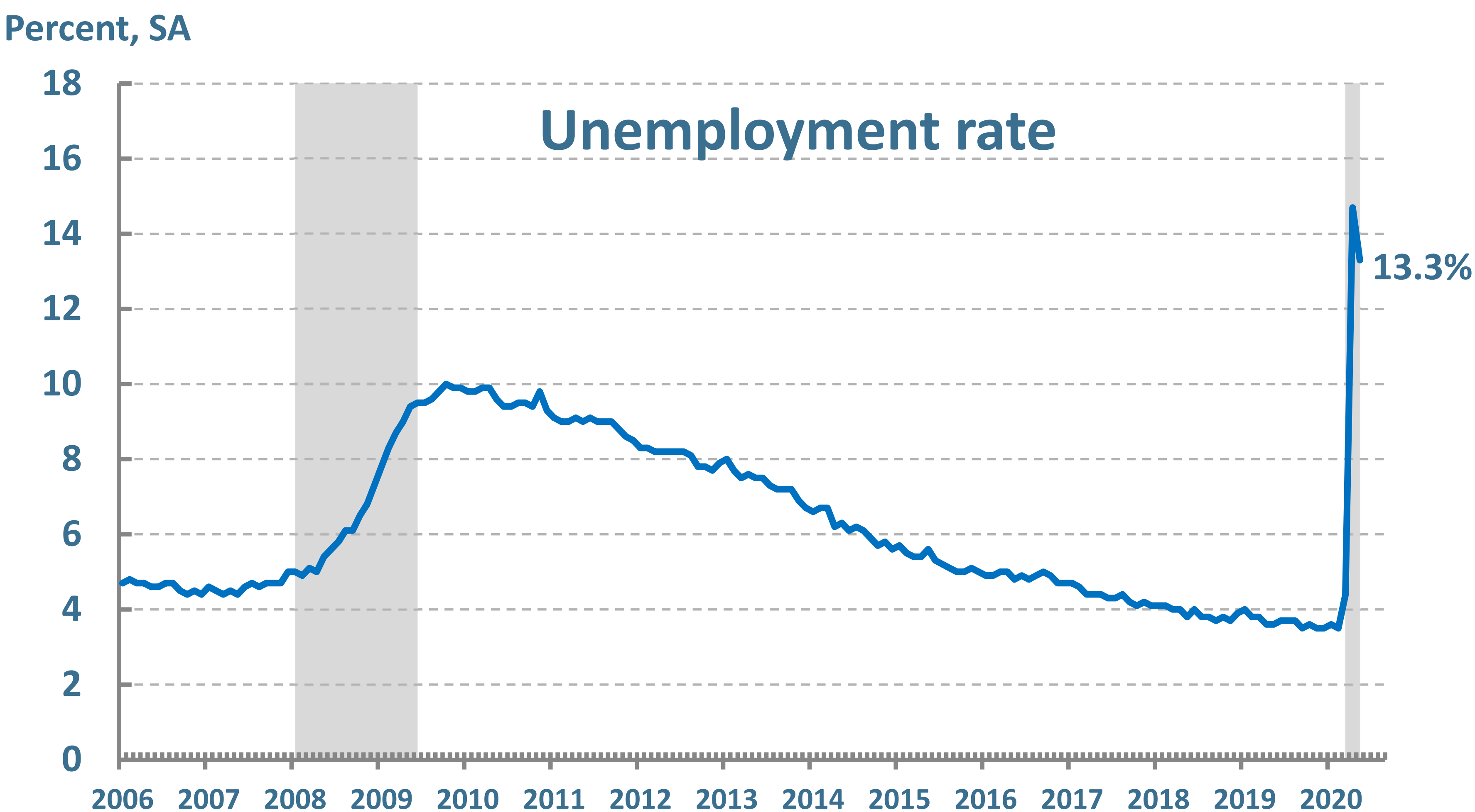
Source: Bureau of Economic Analysis via Haver Analytics
Quarterly data: Last obs. 2020Q1

Figure 2. Inflation has moved down



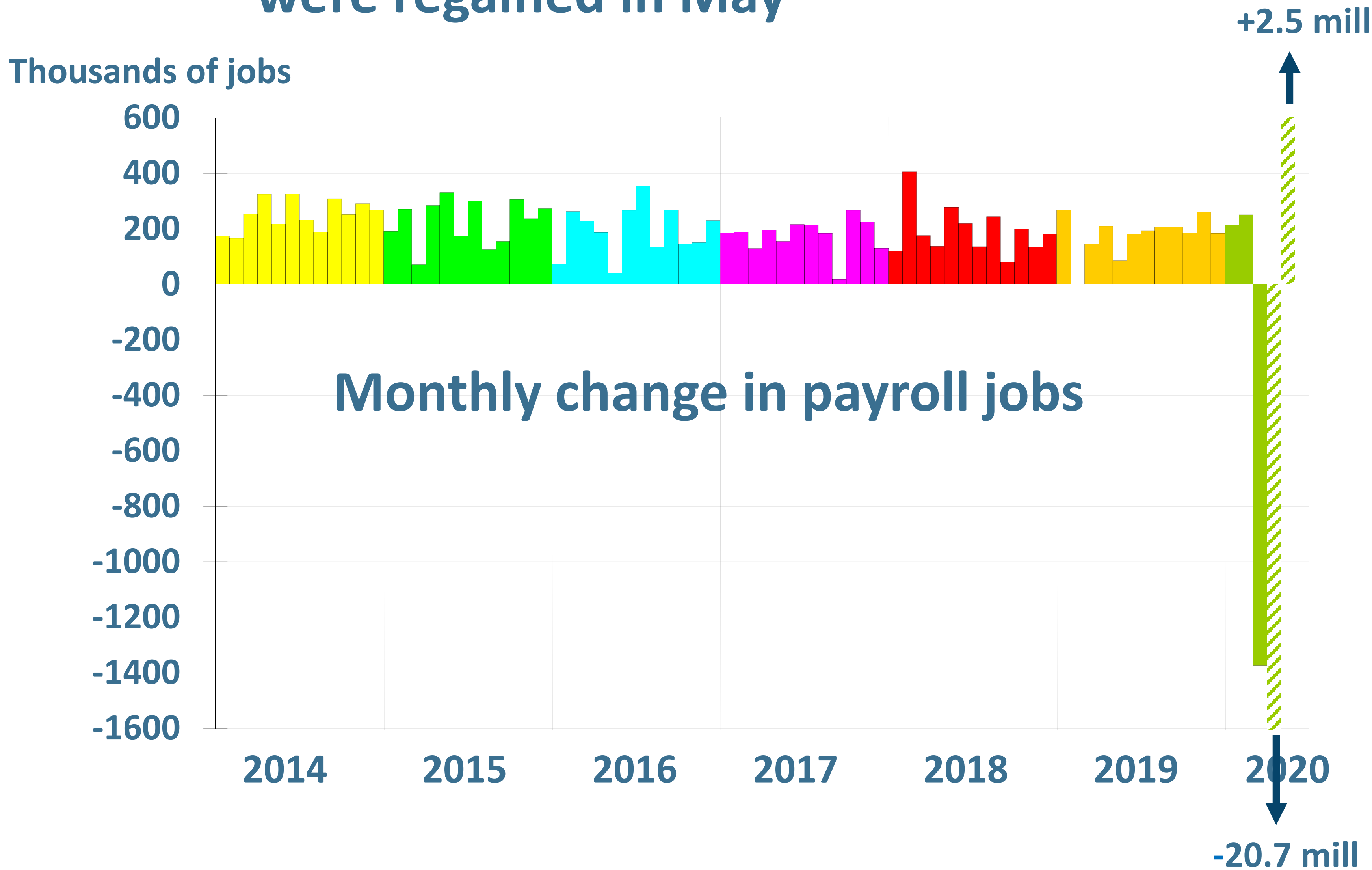
Source: Bureau of Economic Analysis via Haver Analytics and
Federal Reserve Bank of Cleveland
Monthly data: Last obs. April 2020

Figure 3. The unemployment rate is well over its previous peak



Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. May 2020

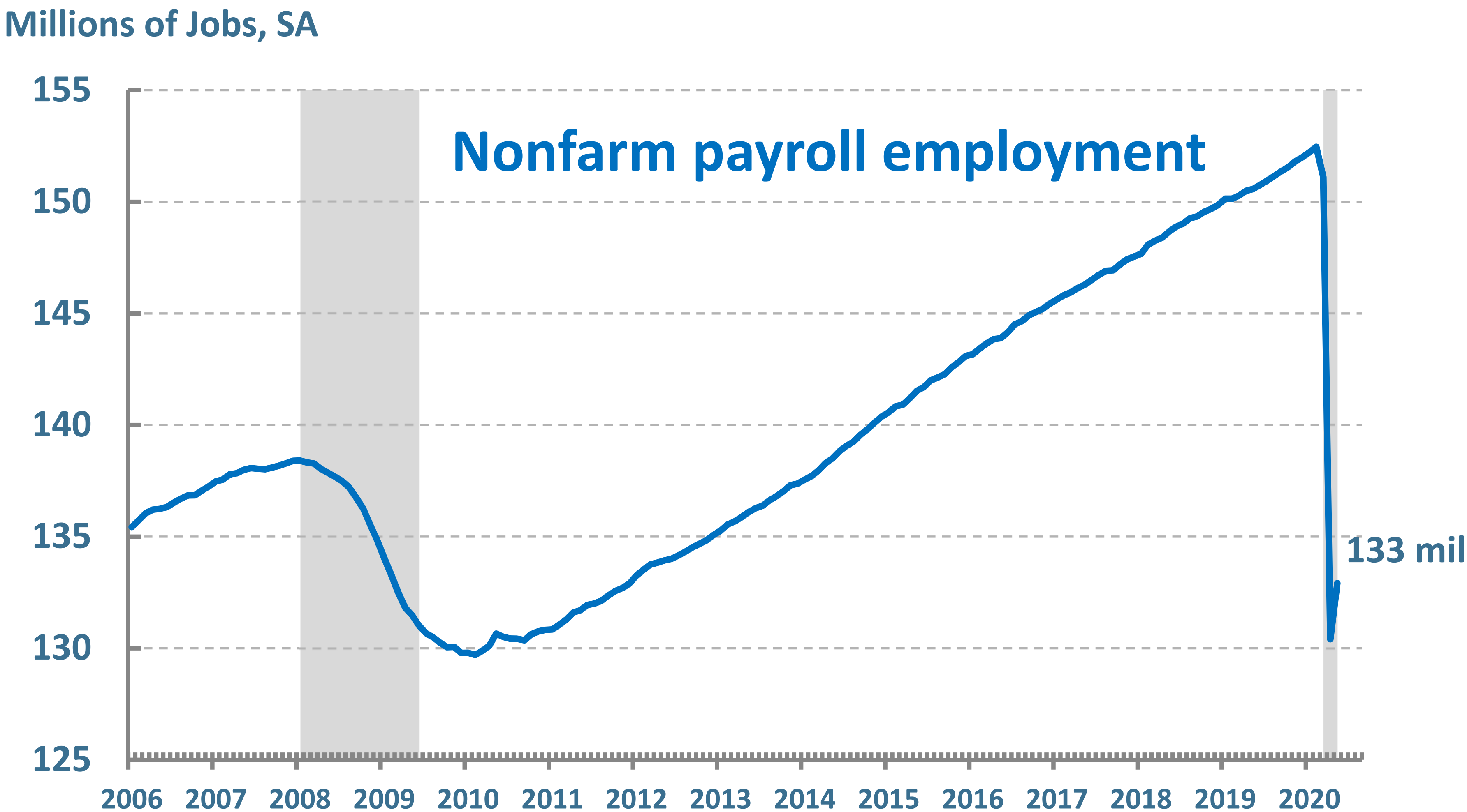
Figure 4. Only 11% of job losses in March and April were regained in May



Source: Bureau of Labor Statistics via Haver Analytics
Quarterly data: Last obs. May 2020

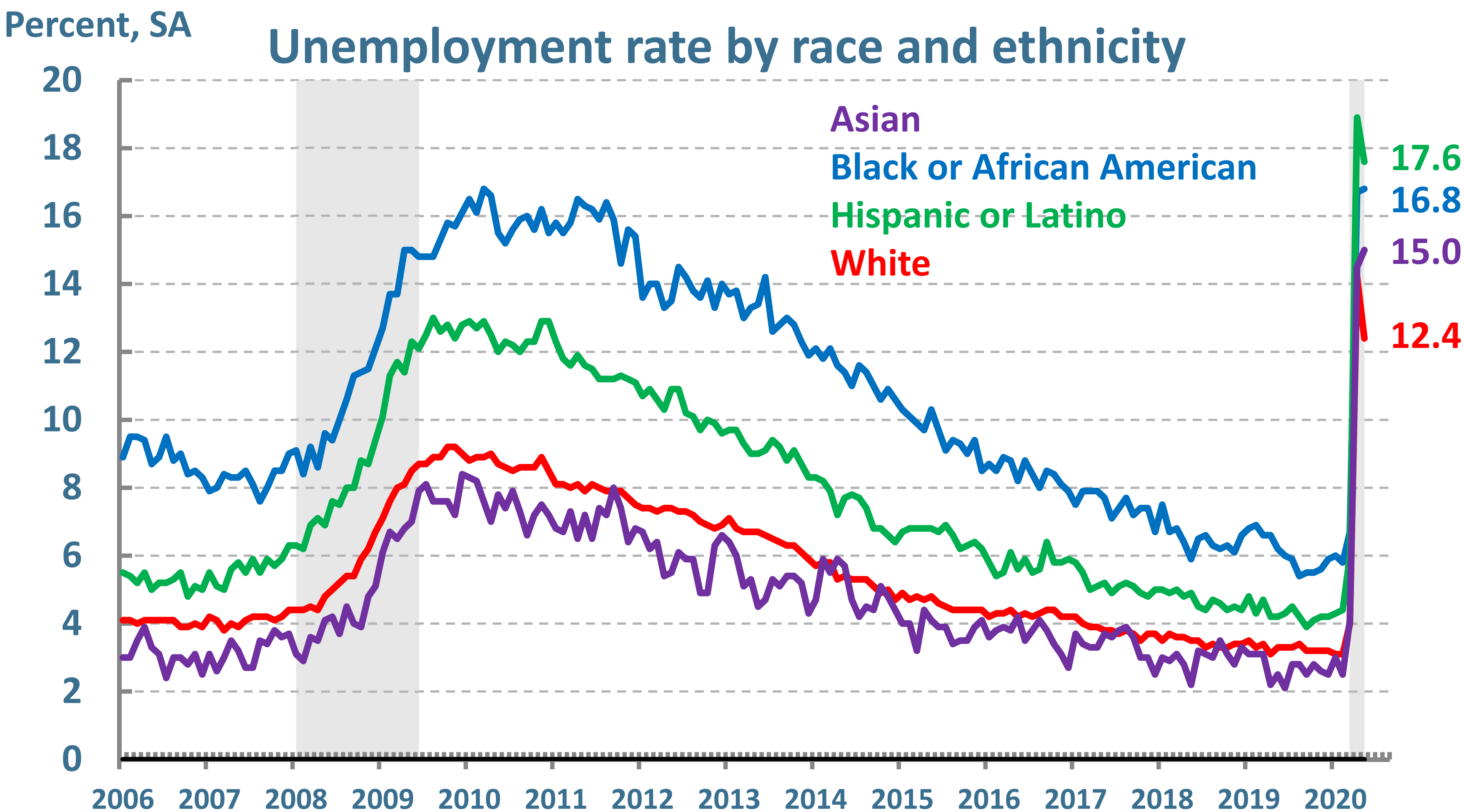
FEDERAL RESERVE BANK of CLEVELAND

Figure 5. The economy has shed almost all of the jobs it added over the past expansion



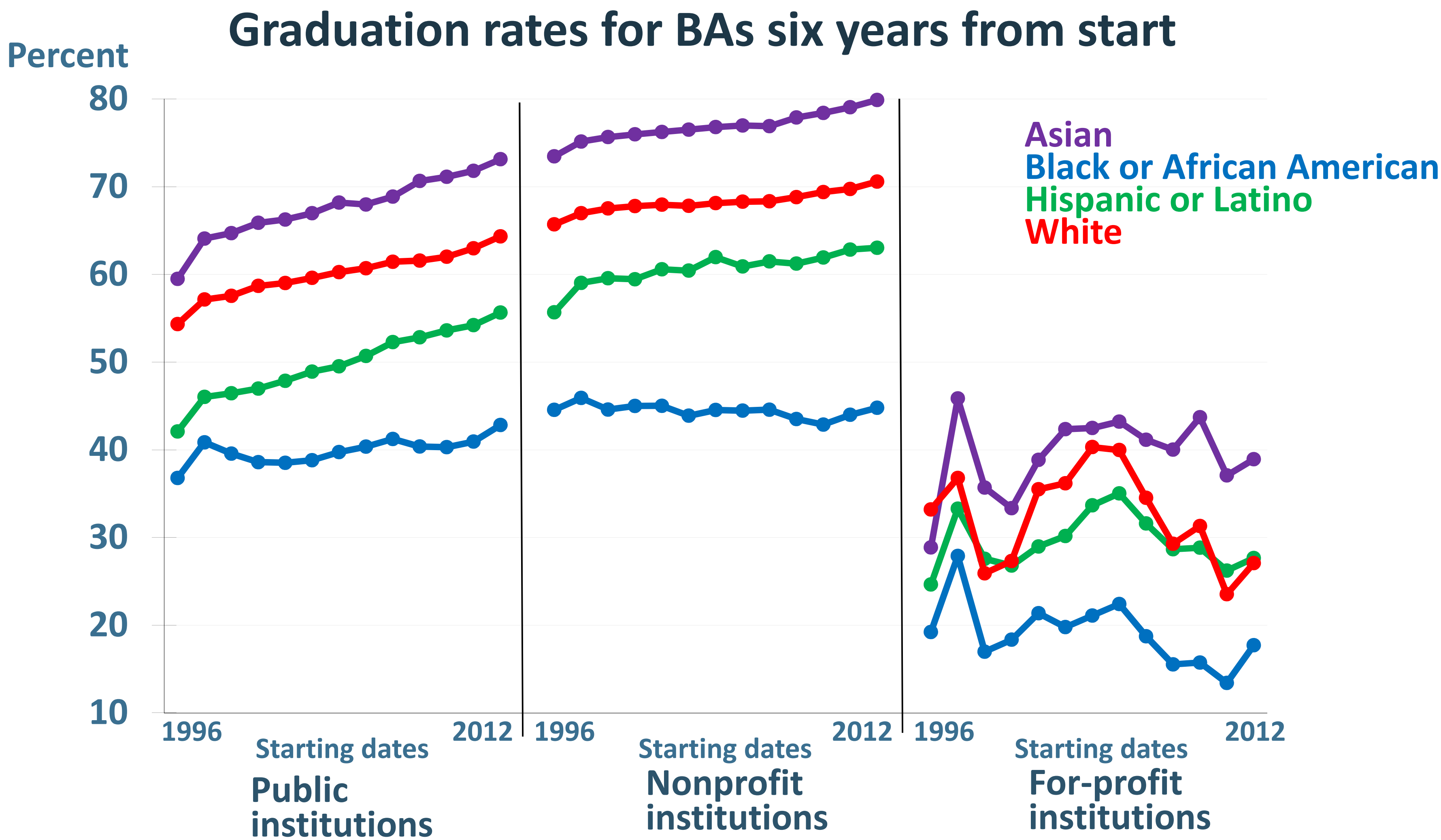
Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. May 2020

Figure 6. May's decline in the unemployment rate was not shared by blacks or Asians



Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. May 2020

Figure 7. Graduation rates for blacks are lower than for other groups and have not improved over time



Source: U.S. Department of Education, National Center for Education Statistics, Integrated Postsecondary Education Data System (IPEDS), Table 326.10

FEDERAL RESERVE BANK *of* CLEVELAND

Charts for “The Outlook for the Economy and Federal Reserve Policy”

Loretta J. Mester*
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Economists on the Economy
Council for Economic Education
June 17, 2020

*** The views expressed here are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.**