

**An Update on the Economy
and the Federal Reserve's Policy Response**



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Introduction

I thank the CFA Society Chicago and the CFA's Women's Network for inviting me to speak today. In preparing my remarks, I noticed that the last formal speech I gave on the economy was on March 3, which seems like a lifetime ago, and it was in London, which seems like a world away. A lot has happened since then. So before the question and answer portion of today's session, I'd like to start with a brief update on the economy and 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 coronavirus pandemic is a global public health crisis that has inflicted pain and hardship on people all over the world. I want to express my deepest sympathies to those who have been affected by the virus. This is an unprecedented situation. In the interests of public health, the country has taken aggressive social distancing measures to limit the spread of the virus, resulting in a shutdown of much of the economy. This investment in public health is buying 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 develop tests and treatments. This investment is beginning to pay off in terms of fewer new hospitalizations in some locations. We owe a great deal of thanks to the healthcare workers, public health officials, scientists, and all those who support them as they battle the virus, and to all the people working in essential activities, including grocery stores, delivery companies, and municipal services, whose dedication allows many of us to stay safely at home.

While the shutdown has yielded public health benefits, its effects on the economy have been swift and severe. In the first quarter, real output declined at a nearly 5 percent annual rate, with real consumption down over 7-1/2 percent and nonresidential business fixed investment down nearly 9 percent. And these sharp declines reflect mainly what occurred in just one month, March. In April, the unemployment rate surged to 14.7 percent, its highest level since the Great Depression. Remember, it was only this past

February when the unemployment rate was a low 3.5 percent. Over the past two months, payrolls declined by more than 21 million jobs; that is nearly the same the number of jobs added over the entire 10-plus-year expansion. There were losses across all major sectors. The deterioration in the labor market is even sharper than these numbers indicate. A large number of people left the workforce last month and they do not show up in the unemployment rate, and many workers had their hours cut. Certainly, this is the worst and speediest deterioration in the labor market many of us have ever seen.

Both headline and core inflation readings moved down in March, reflecting the drop in oil prices due to both supply and demand conditions in global markets, and the start of the shutdown in activity. I expect inflation will move down further this year because the sharp pullback in demand will outweigh any upward pressure due to limited supply in certain goods and services.

Our outreach at the Cleveland Fed is painting a very painful picture. Since mid-March, we have watched confidence among regional businesses and households drop from week to week as the negative effects of the virus have risen. Regional firms are taking defensive positions, pulling back from risk taking, conserving cash, putting capital expenditures on hold, and drawing on their credit lines. At the start of the shutdown, many told us that they intended to keep their employees on their payrolls, but over time, an increasing number have felt the need to lay off or furlough workers. The Cleveland Fed's national survey of consumers indicates that most respondents initially thought the virus outbreak would last less than six months. More now believe it will last one year, and a growing number think it could last two years.¹

In some sense, the sharp contraction we are seeing should not come as a surprise: it is a direct result of the necessary actions taken to shut down activity to try to limit the spread of the virus. Nevertheless, the numbers are eye-popping. And it is worth noting that much of the sacrifice is being borne by the most

¹ 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>.

vulnerable in our economy: lower-income workers and communities and small businesses. In fact, the job losses in April fell disproportionately on lower-wage workers. This resulted in a sharp rise in average hourly earnings in the report, which was not indicative of the state of the job market. Our outreach paints a more accurate picture. Over three-quarters of the regional community development organizations recently surveyed by the Cleveland Fed said that the low- and moderate-income areas they serve are experiencing significant disruptions that will hamper recovery.

I anticipate that the second quarter will show the most severe effects on the economy. Given the unprecedented nature of the shutdown, private-sector forecasters are offering a wide range of estimates for second quarter real GDP growth, with most falling in the range of minus 25 to minus 40 percent. My own estimate is in the middle of this range, but with numbers so bad, the precision seems less relevant. I anticipate that the reported unemployment rate is likely to go up further, perhaps to 20 percent or even more.

Looking ahead, parts of the country are beginning to relax some of the stay-at-home orders, and economic activity will likely begin to pick up in the second half of the year. But these are still early days, and there is considerable uncertainty around what the recovery will look like. It will depend on the evolution of the virus and the success of our methods to control its spread while it is still among us. It will also depend on how successful policy actions are in ensuring that the temporary disruption in activity does not cause more persistent damage to the economy and that the economy is well staged for a recovery. Let me discuss some of these policy actions and then talk about the outlook.

Unprecedented times require unprecedented actions. Both the federal government and the Federal Reserve took action quickly. These relief efforts can be viewed as building a bridge to get households and businesses from the generally good economy we had in February to the other side of the pandemic shutdown period. The shutdown period has lengthened over time, driven by the course of the disease. So

the bridge has to be longer than first assumed, and it also has to be wider, as more households and firms are in need of some kind of help.

Fiscal policymakers have taken significant actions, including making 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 depth of the economic downturn. In my view, further direct fiscal support will be needed if we are to avoid the longer-lasting damage to the economy that would happen if job losses become persistent and a large share of otherwise viable businesses fail.

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. The actions fall into three general categories. First, some of the Fed's actions focus on ensuring that financial markets have enough liquidity to continue to function well. Well-functioning financial markets allow credit to flow to households and businesses and monetary policy to effectively transmit to broader financial conditions. The Fed aggressively responded to stresses in the U.S. Treasury market by purchasing Treasury securities and agency mortgage-backed securities and by conducting operations in the repo market. With the approval and financial backing of the U.S. Treasury, the Fed is also setting up emergency lending facilities to serve as a backstop to other key credit markets, including money market mutual funds and the commercial paper market. And the Fed is ensuring that primary dealers have access to liquidity and 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.

A second set of Fed actions focuses more directly on supporting the flow of credit to households, to businesses of all sizes, and to state and local governments. These programs include the Paycheck Protection Program Liquidity Facility, the Main Street Lending Program, the Primary and Secondary Market Corporate Credit Facilities, the Term Asset-Backed Securities Loan Facility, and the Municipal Liquidity Facility.² Based on consultations with both lenders and potential borrowers, the Fed 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.

The third category of Fed actions focuses on banks 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 Board of Governors has temporarily relaxed some of the regulatory requirements and supervisory oversight so that banks have greater capacity to lend in a safe and sound manner through the downturn. Our current situation highlights the value of a resilient banking system, one that builds up sufficient capital and liquidity buffers in good economic times in preparation for bad ones.

While this is a long list of actions, the Fed continues to look for gaps where our tools can be used to benefit the economy. For example, the Board of Governors is evaluating an approach to meet the needs of nonprofits, including institutions of higher education, because they play an important role in the economy. And I shouldn't conclude this list of policy actions without discussing our usual tool of monetary policy, the federal funds rate. The FOMC has reduced its target range for the fed funds rate to 0 to 1/4 percent, and we have said 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

² 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>.

stability goals. Low rates cannot stop the sharp drop in activity caused by the pandemic shutdown, but once the economy begins to reopen, accommodative monetary policy will be needed for some time to support the recovery.

So what might that recovery look like? A reasonable baseline outlook is that as some of the stay-at-home restrictions are lifted, the economy will begin to grow again in the second half of this year and unemployment will begin to move down, with continued recovery in 2021. I would expect this improvement to start off slowly, with variation 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. Under this baseline, by the end of this year, output would still be below its level at the end of last year, by 5 percent or even somewhat more, and the unemployment rate would still be in the high single digits or low double digits. I expect inflation to remain low for the remainder of this year and for some time to come.

Achieving this outcome depends on a number of things falling into place. It depends on there being a solid enough bridge of economic relief and support. It depends on the relaxation of stay-at-home restrictions being based on public health criteria and being done in a careful and responsible way, respecting guidelines on social distancing, mask-wearing, and hygiene. It depends on more progress being made on testing and treatments so that the virus can be better controlled and people feel safe re-engaging in activity. And it depends on the medical system being prepared to handle the periodic increases in cases that epidemiologists tell us to expect. These are a lot of conditions, which is another way of saying there is considerable risk around this outcome. It isn't difficult to imagine more pessimistic scenarios, especially if an upsurge in virus cases necessitates shutting down activity again or if there is considerably more harm in terms of business and personal bankruptcies or if instabilities in the

banking system arise. At this point, I think some of the more pessimistic outcomes are almost as likely as the reasonable baseline I just described.

So I think it makes sense for policymakers to continue to monitor the economy, continue to support the flow of credit to households and businesses and the smooth functioning of financial markets, evaluate several scenarios rather than focusing only on a modal forecast, and stand ready to address the challenges that will arise as the country incrementally re-engages in economic activity as the year progresses.