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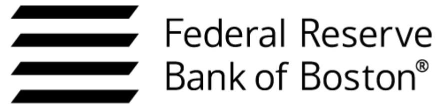

"The Economic Outlook – Optimism Despite the Challenges Ahead"

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The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Good afternoon, and a very happy new year to all. It has been a long and unprecedented nine months since the COVID-19 pandemic forced Greater Boston to all but shut down last March. Through December and into early January, the pandemic continues to significantly alter our normal ways of living and working. However, we come now to a time of considerable promise: as the new year dawns, it seems likely that the public health crisis that has inflicted so much damage – on individuals, families, businesses, and the economy generally – will dissipate over the course of this year. With two highly effective vaccines already starting to be distributed in the United States and more in the pipeline – and with medical staff and those most at risk now being vaccinated – we should see much needed relief for hospitals as we move into the spring. Although it seems likely to me that the economy will, at best, continue to grow modestly until there is widespread vaccination, I believe a more robust economic recovery – supported by expansionary monetary and fiscal policy – is likely to follow.

Near-term economic performance is likely to continue to be substantially affected by pandemic-related challenges. The labor market has stalled as infections have climbed and simple self-preservation has forced many people to continue to restrict their activities. Many firms in the service sector remain quite stressed; with restaurants, hotels, and entertainment venues likely to continue to be materially impacted by the virus, particularly with a new more infectious strain reportedly becoming more pervasive.

In my view, targeted fiscal policy actions are an appropriate way to support those businesses that have been disproportionately impacted by the pandemic – and the Consolidated Appropriations Act, recently signed into law, will provide support to many businesses and

individuals that have experienced significant distress. Unfortunately, some states have had to cut back on essential services (given their sharp drop in revenue and their balanced-budget rules); and the limited financial flexibility of state and local governments is likely to restrain the speed of the recovery, similar to what was experienced after the financial crisis of 2007 and ensuing "Great Recession."

In addition, it is sobering to note that many of the economic problems caused by the pandemic have actually been deferred, to date – for example, problems in commercial real estate and the bank loans tied to such property are likely to only be fully revealed later this year. These factors, along with the speed of inoculations, will impact how quickly the U.S. economy returns to full employment.

However, I am relatively optimistic about the economic outlook for the second half of 2021. Domestic stock market indices are near all-time highs, suggesting investor confidence in a recovery.[1] With very low interest rates, even some financially strapped individuals may be able to make payments on debt until incomes are restored (although low interest rates do not solve the challenge of ongoing expenses when there has been an interruption of income).[2] The housing sector has been helped by low mortgage rates, and the eagerness of many households to transact real estate despite the challenges of the pandemic (and in some cases, because of the pandemic and the lifestyle changes it has ushered in). While consumer services remain depressed, the consumer goods sector has recovered nicely and continues to benefit from the broad and expedited movement to online purchasing. Many firms have increased their capital investments, as they rely more on technology to conduct business and refit offices to accommodate more remote work. For those lucky enough to have the option to work at home, there may be more

opportunities to do so going forward, which may be a long-term positive for some, including working parents.

As a result, despite the near-term challenges brought on by COVID-19, I am optimistic that we will see significant employment gains over the next two years. However, I do not expect the U.S. economy to reach a sustained 2 percent inflation rate over the same time frame, which according to the guidance the interest-rate-setting Federal Open Market Committee (FOMC) has provided in its policy statements, implies that policymakers will continue to maintain very accommodative short-term rates.

Yet, as I often note, a "low for long" environment does present other important challenges. For example, it encourages firms and individuals to take on more leverage and financial risk. In addition, many of the financial shocks in March 2020 could have been ameliorated by proactively addressing problems with money market mutual funds and financial infrastructure *before* the pandemic hit. If we are to avoid similar problems in the future, my view is more needs to be done to make the financial infrastructure of our economy more resilient.[3]

Finally, and importantly, the disparate economic outcomes we have seen during the pandemic have further highlighted the problems of income inequality that remain a significant challenge for a strong economy. As I have discussed in recent speeches, policymakers must be mindful of the deep pain still occurring in many segments of the economy – particularly for personal-service-related businesses (restaurants, hotels, retail stores, and tourism – for example) which employ large numbers of workers, many of whom have little savings to cushion against a disruption in wages that lasts for many months. Frequently, these workers are people of color,

young, or individuals with less educational attainment. Not surprisingly, the unemployment rate has risen the most for these groups.[4]

The Near-Term Economic Outlook

I am looking forward to the time when the outlook for the economy is no longer intertwined with that of COVID-19; but unfortunately, that is not yet the case. We continue to face an unusually complex employment situation due, in large part, to the uneven response in the United States to this public health crisis. As I have said in prior talks, I firmly believe that the path to stabilizing the economy hinges on first getting the virus under control, and without effective public health policy, the virus will remain the major source of economic challenges.[5]

Figure 1 shows the rate of COVID infection, scaled by population – for the United States, the European Union, and G-7 countries excluding the U.S. Unfortunately, the figure shows that the public health response in this country has been problematic. The U.S. has tended to have higher per capita COVID infection rates for much of the past nine months and, relative to many European countries that have managed to gain some control over infection rates through limits on social mobility, the United States now has significantly more infections. This is all the more tragic because these infections are occurring only months before vaccinations will significantly reduce individuals' chances of becoming infected.

While infection rates have been high in the U.S., **Figure 2** shows that although death rates from COVID are quite high, they are roughly similar with that of Europe. For Europe, the United States, and the G-7 countries excluding the U.S., the death rates among those with

COVID are now higher than at any time during the pandemic. The fact that Europe has more substantially restricted economic activity in response to virus resurgence – and still is seeing very high death rates – suggests the potential for high economic costs to preventing COVID spread in the near term.

Given the high infection and death rates currently seen in the U.S., it is not surprising that we are also observing a softening of economic conditions, in the data. **Figure 3** provides the four-week moving average of initial claims for unemployment. Over the last three months, as the pandemic has worsened, the earlier progress reducing the flow of workers into unemployment has suffered a setback, with these initial claims for unemployment insurance rising somewhat from the end of November and remaining at a very elevated level of 800,000 claims. This is consistent with the employment report covering the month of December, released last week, which had unemployment leveling off at 6.7 percent and payroll employment declining by 140,000.

However, the unemployment rate can be misleading when many people are dropping out of the labor force, because it takes into account only those currently seeking work. With many people dropping out of the labor force, data on actual employment can provide a more accurate snapshot of labor market conditions. **Figure 4** shows the employment-to-population ratio for the past year. When the pandemic first hit, many people were placed on temporary layoff, or furloughed. However, the employment-to-population ratio still shows a large gap relative to pre-pandemic conditions, reflecting continued elevated numbers of people out of work and also out of the labor force.[6]

Figure 5 shows the variety of outcomes for payroll employment across industries during the pandemic. Overall, payroll employment is more than 6 percent below the level seen a year earlier. Industries such as entertainment, which relies on group gatherings, and personal services, like restaurants, have declined much more than the average for all nonfarm industries. The number of industries that have higher employment than a year ago is limited, but it involves work such as couriers and messengers, and warehousing and storage, as well as building material and general merchandise stores – which saw a rise in employment as people worked from, and stayed at, home.

As shown in **Figure 6,** some goods that can be consumed at home saw significant increases; including, for example, games and computers. It is important to note that many of these goods are not domestically produced, limiting the employment benefits in the U.S. Meanwhile, goods that have been consumed less during the pandemic, when people were largely confined to their homes, include gasoline and cars.

Consumer services have been more depressed than goods. **Figure 7** shows some increases in certain services, such as streaming services and medical laboratories, but there were big declines in many service areas related to travel and entertainment. Many of these depressed consumer services are unlikely to fully recover until widespread vaccination of the population has been achieved.

Overall, recent indicators suggest near-term problems stemming from elevated infections and persistent public health concerns. So clearly, the near-term recovery is highly dependent on rapid, widespread vaccination. Unfortunately, to date, the inoculation rate has been disappointing, which likely will impact public health and the economy in the near term.

A Positive Medium-term Outlook

Amidst the near-term challenges we face, I will also point out several reasons for optimism concerning the economy's medium-term outlook.

One reason to be optimistic is that household saving remains elevated and accommodative fiscal policy is likely to further support individuals and firms. **Figure 8** shows that the personal saving rate remains quite high, even before the recently enacted additional federal stimulus. Prior to the COVID-19 pandemic, the saving rate was roughly 7.5 percent, and more recently it has been over 12 percent. This suggests that for those whose incomes were not interrupted (for example, those whose jobs were conducive to working from home, and whose industries were not stalled by the pandemic), there is significant capacity to make expenditures once the pandemic is over. Because consumption is such a large part of the economy, in the second half of the year if vaccinations are widespread, we are likely to see a significant pick up in consumption – particularly in the kind of services that consumers have missed during the pandemic, such as dining in restaurants, traveling, and attending in-person entertainment events.

A second reason to be optimistic in the medium term is that financial conditions remain favorable, and asset prices have risen significantly since last spring. **Figure 9** shows that, despite the substantial decline in stock prices last March as the pandemic took hold, the S&P 500 ended the year roughly 15 percent higher than it was at the beginning of 2020. My view is that highly accommodative fiscal and monetary policy will provide a significant tailwind for risky assets this year.

A third reason to be optimistic is that the housing market has remained quite resilient (in contrast to the last crisis and recession). New and existing single-family home sales plummeted

during the initial COVID lockdown, but recovered over the summer and were more than 20 percent higher at the end of November than a year prior (**Figure 10**). While the resurgence in the pandemic has caused a pause in sales, I expect that low interest rates, higher asset prices, and more savings will support continued home purchases in the coming year.

Figure 11 shows the forecast from the Federal Reserve policymakers' Summary of Economic Projections, which asks each participant to provide their outlook for the unemployment rate over the next three years. My own forecast is somewhat more pessimistic than the consensus in the near term, as a result of the second wave of the pandemic – but does anticipate a decline in the unemployment rate once a significant proportion of the population has been vaccinated.

It is important to note that despite my optimism for 2021, there are risks to this outlook. The pandemic is likely to economically scar many individuals and firms. A large number of households have experienced a loss of wealth and employment during the pandemic, and many firms experienced a substantial drop in revenues when they had to shut down. Many businesses closed permanently.

In addition, some economic consequences of the pandemic are likely to be revealed only with a lag. A good example is commercial real estate. **Figure 12** shows the delinquency of loans in commercial mortgage-backed securities (CMBS holdings of commercial real estate). Several sectors, particularly hotels and retail, are showing delinquencies much higher than even during the severe financial crisis that began in 2007. Most CMBS structures limit the ability to work directly with troubled borrowers, so the problems tend to appear relatively quickly. Similar assets held in bank and insurance portfolios have benefited from financial institutions working

with many of their borrowers. However, as that forbearance ends, rising nonperforming loans are likely to appear by the second half of 2021. This example illustrates that despite the generally positive outlook for 2021, there are still lingering problems from the pandemic that will likely need to be addressed.

Central Bank Emergency Support

A major factor in the resilience of the economy through the pandemic has been the presence of significant fiscal and monetary support. Fiscal stimulus from elected officials has provided needed support to businesses and individuals badly impacted by the pandemic. Monetary policy has been very supportive as well, as interest rates were immediately reduced to their lower limit once the pandemic began, in order to enable individuals and businesses to borrow very cheaply.[7]

Other significant supports came in the variety of emergency lending facilities established by the Federal Reserve with the approval of the U.S. Department of the Treasury. The New York Reserve Bank operated a number of facilities focused on market functioning, and the Boston Reserve Bank operated a facility supporting money market mutual funds. Together, these facilities were important reasons why the financial instability and sharply declining output in the spring did not persist through the year.

In addition, the Boston Fed administered, on behalf of the Federal Reserve System, a new type of facility during the crisis – the Main Street Lending Program. The program was designed to help small- and medium-sized businesses and nonprofit organizations bridge the pandemic

downturn.[8] The program aimed to assist organizations that might otherwise be in a challenging spot – not large enough to have marketable debt that might benefit from the emergency facilities focused on market functioning, but larger than many of the companies utilizing the federal government's Paycheck Protection Program.[9]

The Main Street program is now closed. I am pleased to be able to share some initial summary information on the program with you. This information complements the disclosures the Fed makes on a weekly basis in the H.4.1 statistical release, which includes the net portfolio holdings,[10] and at 30-day increments per the CARES Act (providing details on Main Street Program loans, last published yesterday, January 11).

Over 2020, the program extended more than $16.5 billion in lending to over 1,800 companies. As **Figures 13 and 14** show, the value and number of loans processed increased significantly in December. This surge in demand for the program followed the November 19 announcement of the decision by the Treasury to not extend CARES Act facilities. It also no doubt reflects the stresses many medium-sized businesses were experiencing at the end of 2020 as a result of the resurgence of COVID infections.

I'll share some summary information and then draw a few conclusions from the data.

- While Figure 14 shows consistent loan growth from July, it really underlines the surge in demand in December. The program settled just under 650 loans in the months from July to November, then over 1,150 loans in December alone. Lender participation also surged in December, with 45 percent of the eventual total pool of lenders participating for the first time .

- Again, this was quite a surge in demand for Main Street borrowing. On a related side note, I would like to commend everyone at the Fed for their dedication to public service, exhibited by working tirelessly through the month of December to support the increased yearend demand, in an intense effort to meet the needs of program participants before closure.
- The program's geographic reach was ultimately broad, with settled loans across 49 states and two U.S. territories (See **Figure 15**).
- Looking at the industries utilizing the program's loans suggests some unsurprising areas of need, given the pandemic's toll on certain industries where social distancing is challenging (**See Figure 16**). Industrial categories that include food services; scientific and technical services; and arts, entertainment, and recreation are the most prominent in the Main Street portfolio. Many of these industries reflect what one would expect to be industries disproportionately impacted by the pandemic.

The Main Street program proved to be a challenging undertaking for all involved, and unfortunately did not meet the needs of everyone who expressed interest; however, my personal preference would have been to continue the program through the first half of 2021. The program filled a hole often left unaddressed – support for *medium-sized* businesses. In my view, there are significant implications for productivity and industrial organization if only small and large companies can receive fiscal and lending support during crises.

At the same time, while the Main Street lending program provided very helpful financing, I believe that were certain tweaks permitted, it could have been more impactful. I will

offer a few preliminary observations. First, with less focus on mitigation of potential loss to the Treasury, much more credit would have been made available. Second, designing the program to have less legal and operational complexity, and structuring the banks' role[11] differently – for example, as an opportunity to earn fees as long as the loan performed, rather than a 5 percent participation – may have increased the attractiveness of the program for banks. Finally, longer terms and greater ability to refinance would have provided support to medium-sized businesses more akin to what was available to larger companies.

The Main Street program was unprecedented, and very challenging, given the fact that business loans are not homogeneous and loan participations are difficult to streamline. Still, we must keep in mind the vital importance of credit access, especially to small and medium-sized companies and nonprofit organizations. If a future crisis compels lawmakers and policymakers to want to extend emergency lending to small and medium-sized businesses, through the Fed or another entity, I hope such a program can incorporate the lessons of the Main Street effort and address challenges where possible, so that it is better structured to meet even more firms' needs.

Despite the potential for improvements, and its many challenges, the Main Street Lending Program showed the feasibility of marshalling lenders and the public sector to assist hard-to-reach businesses – businesses that *can* survive with the support of a bridge to better times, post-downturn.

Concluding Observations

In summary and conclusion, we enter 2021 with some optimism. The pandemic is likely to continue to be a problem for public health and the economy until widespread vaccinations take hold. Nonetheless, with substantial fiscal and monetary support, I expect a robust recovery starting in the second half of this year. I also expect that short-term interest rates near zero will be appropriate throughout this year, and that the Federal Reserve will continue to purchase long-term assets until the economy is on a stronger economic footing.

Despite this generally upbeat outlook, my own view is that policymakers must continue to find ways to support those individuals and firms that have been disproportionately and severely impacted by the pandemic.

Thank you for having me speak today, and I wish you continued good health in the new year.

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[1] And, potentially, accumulating wealth to complement pent-up demand.

[2] It is worth noting, many low-income individuals lack savings they can rely on, even in good economic times. For example, in 2013, the Federal Reserve Board of Governors introduced an annual survey of the economic well-being of U.S. households, which, among other findings, highlighted the so-called '$400 problem' – almost half of respondents at the time could not cover a $400 emergency expense without selling something or borrowing money. (For more, see, *Attacking the $400 problem on many fronts*, Jay Lindsay, Jan. 30, 2019, www.bostonfed.org.) According to the Board's most recent survey data, however, *Current Report - Update on the Economic Well-Being of U.S. Households: July 2020 Results*, 70 percent of adult respondents would pay a $400 emergency expense using cash or its equivalent, up from 64 percent in April and 63 percent in October 2019.

[3] For more discussion, see Oct. 8, 2020 remarks by Eric S. Rosengren, entitled *Economic Fragility: Implications for Recovery from the Pandemic*.

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[4] For more discussion, see June 19, 2020 remarks by Eric S. Rosengren, entitled *An Update on the Economy and the Main Street Lending Program*.

[5] For more discussion, see Nov. 10, 2020 remarks by Eric S. Rosengren, entitled *Financial Stability Factors and the Severity of the Current Recession*.

[6] It is worth noting that the dropout rate of women from the labor force is greater than the typical recession, likely because of the unequal burden sharing between husbands and wives of taking care of children who are schooling at home.

[7] For more discussion of fiscal and monetary support, see May 19, 2020 remarks by Eric S. Rosengren, entitled: *The Main Street Lending Program and Other Federal Reserve Actions*.

[8] For more on the Federal Reserve's Main Street Lending Program, see https://www.bostonfed.org/mslp.

[9] Some companies utilized both programs.

[10] Of MS Facilities LLC (Main Street Lending Program)

[11] Their "skin in the game," as some would say.