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Federal Reserve Bank of Boston®

"The Economy's Outlook, Challenges, and Way Forward"

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Remarks to the Boston Economic Club

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Good afternoon and thank you for the opportunity to meet with the members of the Boston Economic Club, albeit virtually.

As we approach the fall, the recent data for the national economy have been better than expected. The reason is quite clear; many states opened up from pandemic shutdowns relatively quickly, and economic activity has reflected the benefits of increased personal mobility. Unfortunately, we are also seeing the *costs* of higher mobility on public health outcomes, as infections and deaths from COVID-19 remain elevated.

In Massachusetts, until recently, we had the highest state unemployment rate in the country, at 16.2 percent in July. However, the unemployment rate in Massachusetts fell to 11.3 percent in August as more businesses have reopened. Notably, over the summer both infection and mortality rates have been much lower than in many other parts of the country.[1]

Our higher unemployment and lower infection rate have several causes. One is the laudable focus of Massachusetts policymakers on public health, and their unwillingness to trade off higher levels of economic activity in the short-term for higher rates of COVID-19 infection. However, the type of work that is conducted in the state also affects the employment situation. A large swath of Greater Boston's workforce hold white-collar jobs – many of which can be done remotely – so downtown Boston has yet to see most workers return to its office towers. With more workers remaining at home, activity in the downtown area has fallen off significantly. The large support system that developed around these white-collar jobs, consisting of many downtown businesses and their employees, have suffered greatly.

Looking beyond employment, the consequent sharp reduction in revenues of these businesses has impaired their ability to make timely rent payments, producing adverse effects on landlords, and eventually their mortgage lenders. The changed working environment and its "multiplier effects," as they emanate through other stakeholders, exemplify some of the headwinds the economy still faces.

The Federal Reserve's response to the initial and ongoing effects of the pandemic has been swift and multifaceted. As an example, the statement after last week's meeting of the Fed's policymaking body, the Federal Open Market Committee (FOMC), included new guidance regarding interest rate policy.[2]

The statement highlighted that the federal funds rate range is expected to remain at the currently low level until three conditions are met. First, that the economy reaches maximum sustainable employment. Second, that inflation has risen to 2 percent. Third, that inflation is on track to moderately exceed 2 percent for some time. These three conditions come with a caveat that no risks emerge that could impede the Fed achieving its dual mandate – such as increased financial instability. In essence, the Committee is committing to waiting until inflation is above its long-run target before normalizing the federal funds rate, unless other important risks become significant. The lethargy of the inflation rate below the 2 percent target essentially since 2008 has made the FOMC willing to overshoot the 2 percent target before normalizing rates, accepting the added risk to financial stability from holding interest rates near zero for an extended period of time.

Last week FOMC meeting participants also provided their updated forecasts for the economy, in the form of the Summary of Economic Projections – often referred to as the SEP.[3] The median forecast of the FOMC participants has the unemployment rate dropping to 7.6 percent by the end of this year, and to 5.5 percent at the end of 2021, along with a gradual return of inflation to 2 percent. This outlook constitutes a rapid return to full employment, considering the extent of the downturn from the pandemic this spring.

Unfortunately, my own forecast is less optimistic.

While I expect the economy to recover in time, my own expectation is that it will be more gradual than the median forecast of FOMC participants. The reason for my differing outlook hinges on several challenges that, I believe, the economy could face in the coming months. First, I am concerned that a second wave of COVID-19 infections this fall and winter is likely, which could cause some states to impose new restrictions on mobility and face-to-face interactions. Even without added restrictions, the added risk of infection from a second wave could sap some of the willingness of consumers and businesses to spend and invest. Second, additional support from fiscal policy, which I believe is very much needed, seems increasingly unlikely to materialize anytime soon. The occurrence of a second wave could result in more fiscal actions, but their impact on the economy would probably not be realized until early next year. Third, I expect that financial spillovers from businesses impacted by the virus will become a more significant headwind going forward. Finally, my forecast reflects my concern that workers displaced by the pandemic may find it difficult to quickly transition to new jobs, with more furloughs turning into permanent layoffs as many businesses remain troubled.

I certainly hope that this less optimistic outlook turns out to be wrong. But the likelihood that this view is right is why I believe additional fiscal stimulus, and continued monetary stimulus, remain necessary – despite some of the encouraging economic data received over the summer. In particular, as concerns monetary policy, it continues to be very important that the Federal Reserve's emergency lending facilities provide support to the economy.[4] In my remarks today, I will briefly discuss the progress on one such facility, the Federal Reserve's Main Street Lending Program – including some recent expansions to include multi-borrower loan structures (loans made to multiple co-borrowers) and loans to nonprofits, and a recent announcement emphasizing that lenders should focus on borrowers' financial positions before and after the pandemic as they make their underwriting decisions.[5]

Before I turn to the Main Street Lending Program, however, I'd like to begin with a brief summary of recent economic data and the forecast provided by the FOMC, while highlighting some of the risks and challenges I see in the economic outlook. To preview my conclusion, my views are that the economy remains fragile, that fiscal- and monetary-policy stimulus are essential to the recovery, and that policymakers should continue to explore how to reduce economic scarring from this severe pandemic.

Examining the Recent Data

Figure 1 shows the unemployment rate for the nation since the beginning of the year. The dark blue line shows the standard, widely reported "U-3" measure. The lighter blue line shows the unemployment rate corrected for one of the misclassification errors that have been documented this year.[6] In particular, many respondents — especially early on in the pandemic — answered the household labor survey by saying they were employed but not at work because of the pandemic, when they should actually have stated that they were unemployed on temporary layoff. Even without this adjustment, the U-3 unemployment rate is currently at 8.4 percent, which is still consistent with a severe recession. This misclassification has become less severe with better reporting efforts and some of the workers being recalled or, unfortunately, transitioning to being permanently unemployed.

In addition, other indicators suggest that the headline unemployment rate, even if measured correctly, may understate the amount of slack in the labor market. Indeed, the labor force participation rate is still almost 2 percentage points lower than it was at the beginning of the year, and the number of individuals reporting that they are working part-time for economic reasons remains elevated. While the improvement in the unemployment rate since April is encouraging, I believe further progress will be more difficult to achieve until disruptions from the virus become less acute.

Figure 2 highlights the industries with the most pronounced employment growth since May. These industries are the ones that were most disrupted by the pandemic – such as Retail Trade, and Accommodation and Food Services – and are sectors of the economy still impacted by consumers' reticence to engage in activities where they are less confident of being protected from the virus.

Despite the recent hiring, **Figure 3** shows that employment in these industries remains dramatically below levels from the beginning of the year – especially in Arts, Entertainment, and Recreation, which is impacted by the lack of group events; and in Accommodation and Food Services (hotels and restaurants), which relies on consumers leaving home to make expenditures. Among even those industries that have recovered more significantly, employment still remains below where it was earlier this year. As a result, while labor markets have improved, the path for further reemployment will not be easy – particularly if a second wave of infections occurs and consumers remain reluctant to participate in activities where social distancing is difficult.

As a result, the most likely labor market outcome seems to me to be continued improvement, but with slower gains in employment than we have experienced since April.

The Economic Outlook

As I mentioned, following last week's FOMC meeting, the Federal Reserve released the Summary of Economic Projections (SEP), which involves asking each FOMC participant to provide their forecast for key economic variables. **Figure 4** shows the median SEP forecast, and the central tendency, for the unemployment rate. The median of the participants' forecasts has unemployment ending the year at 7.6 percent, falling to 5.5 percent by the end of 2021, and then dropping down to 4.6 percent by the end of 2022.

Although some of this improvement has already occurred, the expected decline would represent a rapid recovery from the pandemic's severe employment effects. Despite this projected pattern of a swift improvement in labor markets, **Figure 5** shows that FOMC participants forecast only a gradual return to the Federal Reserve's 2 percent inflation goal. The median of the SEP projections has inflation still at 1.8 percent at the end of 2022, despite the accompanying forecast of tightening labor markets.

The rapid improvement in the unemployment rate is facilitated by unusually low interest rates. The median of the SEP forecasts for the interest rate through 2023 is unchanged at its current target range, as shown in **Figure 6**. This is consistent with the forward guidance that I discussed at the outset of my remarks, where Fed policymakers stated their intention to wait to raise rates until the economy has reached maximum sustainable employment, and inflation is on track to moderately exceed 2 percent for some time.

All told, the median SEP projection is a relatively optimistic forecast. The unemployment rate falls to 4.6 percent by 2022, and inflation reaches 2 percent in 2023. As I noted earlier, my own view is less optimistic, because I believe that the path of the pandemic will continue to present challenges that represent significant headwinds to economic growth.

Challenges to the Economy and the Forecast

The biggest challenge to the economy, and the risk to a more optimistic forecast, continues to be our inability in the United States to achieve the public health progress on the virus seen in many other developed countries. **Figure 7** shows new infection rates for the United States in dark blue, new infections for Massachusetts in light blue, and new infections for G7 countries (excluding the U.S.) in green. Starting with Massachusetts, the infections per million population peaked in April, and then declined significantly as the state imposed strong restrictions to reduce the infection rate. To date, we have been able to avoid a large resurgence of the virus in Massachusetts, with infections rising only a bit higher than the lows reached in June. In contrast, national infections were much more subdued in March and April, but increased significantly as many states re-opened very quickly, with few restrictions, causing a surge in infections. Thankfully, those infections have moderated nationally, but remain well above the levels in Massachusetts. The G7 countries, excluding the U.S., show a dramatically different situation, with their new cases per million population peaking in late March at a much lower level than either Massachusetts or the U.S. as a whole went on to achieve – and remaining low throughout the summer.

Despite the overall progress nationally since the July peak, the virus has tended to surge in areas that previously had relatively low infection rates. **Figure 8** shows three states in the Northern Midwest that have recently experienced a surge – possibly triggered by less restrictions on, or higher aversions to, wearing masks and social distancing, despite a number of large group events. These patterns of infections emphasize the need to be vigilant, particularly as more activities move inside this fall and winter.

Figure 9 shows the forecasted effect of the virus over the remainder of this year, based on the Institute for Health Metrics and Evaluation (IHME) model that is maintained at the University of Washington.[7] While this is only one model-based projection, it broadly reflects the consensus of many experts and the experiences of past pandemics, that the fall and winter are likely to result in a resurgence of the virus. Because community spread is not contained, and regional flare-ups are still occurring, one has to be concerned about reductions in restrictions on mobility at a time when schools are back in session and colder weather is returning.

Of course, the outlook from the IHME model could likely be improved by more careful personal behaviors, such as social distancing and wearing masks, or by states clamping down on mobility in the face of rising infection rates. Still, the model highlights that a second wave is certainly possible if we do not take sufficient precautions. Due to projections such as this one, my economic forecast is predicated on individuals and firms still being constrained significantly by community spread of the virus this fall and winter.

If increased infection rates occur during the fall, as I expect, it will exacerbate other economic and financial headwinds that I anticipate will be more apparent in the last four months of this year. **Figure 10** shows the delinquency rates associated with different real estate asset classes so far this year, based on data reported on collateralized mortgage-backed securities or CMBS. Moving forward, even conservatively underwritten properties will likely face challenges if consumers are afraid to shop in stores and stay in hotels through the fall and winter. So far, these fears have more clearly manifested themselves in the data from CMBS markets; already over 25 percent of hotel properties are delinquent, and close to 20 percent of retail properties are in arrears. Moreover, the CMBS market data may actually be underestimating the problems in these sectors, as it disproportionately accounts for larger properties. Smaller hotels and retail strip malls, which are more likely to be financed by small and medium-sized banks, are likely to be even more severely impacted – although data on delinquencies from the summer are not yet available.

In contrast, office and multifamily commercial real estate loans currently have low delinquencies. However, an important issue for both of these sectors is rollover risk. Given that most multifamily properties have one-year leases, the costs arising from a wave of non-renewing tenants become clear only at lease renewal times. An inability to fill the resulting vacancies could lead to an increase in mortgage delinquencies for these properties.

Figure 11 shows that such stresses are already showing up in major cities, in terms of vacancy and rental rates. Data from Costar, which calculates daily vacancy rates and rental prices for apartments in major cities, show rapidly rising vacancy rates and fairly sharp declines in rents in several major cities. Particularly challenged are expensive cities like Boston and San

Francisco, shown in the figure, and Los Angeles. The decline in rents is more abrupt than we would normally see in a more traditional (non-pandemic) economic downturn, and may be indicative of more substantial problems on the horizon. Similarly, office properties have longer-term leases, so the stresses in that market will likely become apparent only over time. However, an open question remains – whether there will be structural changes in downtown office space as a result of a prolonged period with many employees working from home.

The reason to focus so much attention on commercial real estate is because real estate prices were inflated by reaching-for-yield behavior as low interest rates persisted during the recovery from the Great Recession. A structural shock, like the pandemic, can result in a significant increase in the number of nonperforming loans, eventually impinging the ability of banks and insurance companies to continue to make credit available to borrowers. Hence, I am especially worried about a "second shoe dropping" that will particularly affect small and medium-sized banks, which provide a large share of commercial real estate loans and small business loans. A curtailment of credit resulting from such problems has caused serious headwinds to recoveries in the past, and may be a serious problem going forward.

Figure 12 shows that, unfortunately, challenges from the pandemic are likely to extend to the labor market. If many hotels, restaurants, and retail firms declare bankruptcy, workers in these sectors will have to search for new employers, and possibly new industries for employment. The industries most impacted by the pandemic tend to be large employers of women, minorities, and young people, as the figure illustrates. The ability to retrain for jobs with different employers or in different industries can take time, and I worry that these employer-employee matching challenges will result in a slower labor market recovery than what is implied by the median unemployment-rate outlook in the SEP. However, fiscal policy actions, like the creation of Paycheck Protection Program (PPP) or emergency Federal Reserve programs, like the Main Street Lending Program, could help moderate the numbers of firms that close.

The Federal Reserve's Main Street Lending Program

The Main Street Lending Program, the MSLP, was designed to provide support to firms that had been profitable before the pandemic, expect to be profitable after the pandemic disruptions abate, but have been severely impacted during the pandemic. This "bridging" concept is entirely appropriate and beneficial given the presumably temporary disruptions in activity and revenue while the pandemic is present. These kinds of bridge loans also tend to be scarce during crises, particularly for small and medium-sized firms.[8]

The MSLP involves the Federal Reserve purchasing 95 percent participations in loans to for-profit companies or nonprofit entities – loans that have been underwritten by a bank, which retains 5 percent of the loan. The program is attractive to borrowers because the interest rate is 3 percentage points over LIBOR – and requires no payment of interest until year two, and no payment of principal until year three. Also, principal payments are back-loaded, at 15 percent in years three and four, and 70 percent in year five – allowing time for the pandemic to pass and business activity and revenue streams to revive. The program should be attractive to banks, both because of the fees collected and because it reduces the risk to the bank of a borrower that was impacted by the pandemic, given that the Federal Reserve holds 95 percent of the loan. Hence, the MSLP allows banks to help maintain vital credit flows in their local market, which avoids spreading bankruptcies and permanent layoffs, and preserves the economic fabric in communities.

Throughout my career as a researcher and policymaker, I have studied the ways that credit interruptions and problems in essential financial flows have pernicious and snowballing effects on the businesses and organizations that are essential actors in local economies, and the people that work for those entities. The Main Street program brings a solution – a backstop to that problem – given the Federal Reserve's ability to take on 95 percent of the loans. I continue to urge the nation's financial institutions to work with the Federal Reserve to help provide a bridge for pandemic-affected businesses and nonprofits to better times, avoiding more lasting economic damage to communities and workers.[9]

Importantly, I would note that there has been some confusion about the appropriate underwriting standards that a bank should apply to the loans in the program. The Federal Reserve recently provided new clarifying FAQs encouraging banks to focus on borrower status both before and after the pandemic when considering whether a borrower is appropriate for the program. We also published an FAQ that clarifies how the loan should be treated by bank supervisors, with all three federal regulators agreeing on the clarification. Hopefully, these developments will encourage some banks to more actively engage with borrowers impacted by the pandemic, using the Main Street program.

As shown in **Figure 13**, the Main Street Program as of Monday night has $2 billion in loans that have been accepted and $2.4 billion in loans that have been completed or are actively being considered in the portal. We have seen an increased flow of loans as banks and borrowers become more familiar with the program. The Main Street Lending Program has recently been made available to nonprofit borrowers, and the portal now accepts loans with multiple co-borrowers. The program will continue to evolve as the Board of Governors and Treasury evaluate needs for any additional changes to the program.

Figure 14 shows the top states where Main Street program loans have been completed or are under review. The states are generally areas that were impacted more severely by the pandemic over the summer, and some of the larger states by population.

However, an important component has been banks' willingness to participate in the program. **Figure 15** shows that relatively few banks have made more than 10 loans (shown as a square) and the banks making at least six loans in the Main Street Program have been banks with assets under $20 billion. None of the nation's largest banks, by this metric, are currently active in the program.

Concluding Observations

Recent economic data have been encouraging, but I believe the most difficult part of the recovery is still ahead of us. A full recovery probably requires the availability of vaccines and more effective treatments for the virus because until then, many businesses and households are unlikely to return to more normal spending habits. While I anticipate a slowly improving economy, economic activity still faces serious headwinds. Potential financial impediments and challenges in the labor market make the recovery process more gradual than any of us would prefer.

Improvement in the economy will depend importantly on the progress we make in mitigating and treating the virus. Until a vaccine is widely available, it is appropriate to have highly accommodative monetary and fiscal policy. Monetary policy is pursuing new and imaginative ways to deal with the effects of this pandemic. However, my view is that additional fiscal policy is probably the more effective tool at this time, since it can directly allocate money to firms and businesses most impacted by COVID-19 without requiring them to take on additional debt that must be repaid.

Thank you for having me to speak with you today. I hope you all stay well, and I look forward to our next gathering – hopefully – being in person.

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[1] Massachusetts had the highest unemployment rate in July at 16.2 percent. In August, it saw the most improvement among states, falling 4.9 percentage points to 11.3 percent. The highest unemployment rate in August was Nevada, at 13.2 percent.

[2] See September 16, 2020 statement of the Federal Open Market Committee: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200916a.htm

[3] See, Federal Reserve Board and Federal Open Market Committee release economic projections from the September 15-16 FOMC meeting: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200916b.htm

[4] The Federal Reserve's Main Street Lending Program, for example, is a facility authorized by the Board of Governors of the Federal Reserve System under section 13(3) of the Federal Reserve Act, with approval of the Secretary of the Treasury. More here: https://www.federalreserve.gov/funding-credit-liquidity-and-loan-facilities.htm

[5] As of Monday, September 21, the Main Street lender portal includes the additional functionality to support multi-borrower loan structures, meaning the program now permits the submission of multi-borrower loans – loans made to multiple co-borrowers. For more on this and other recent updates on the Main Street Lending Program, see: https://www.bostonfed.org/supervision-and-regulation/supervision/special-facilities/main-street-lending-program.aspx

[6] There are other types of misclassifications not accounted for here. Some workers who are categorized as not in the labor force are workers who want a job but are not looking for work as a result of the pandemic. If they were looking for a job they would be classified as unemployed, resulting in yet a higher unemployment rate.

[7] For more about the IHME model, see:
https://covid19.healthdata.org/global?view=total-deaths&tab=trend

[8] Banks tend to cut back sharply on new loans, both because they are risky and because lenders tend to be short on capital to support an expansion of assets, or even to maintain their previous level of assets.

[9] For additional discussion, see: https://www.bostonfed.org/news-and-events/speeches/2020/the-covid-19-pandemic-the-economic-outlook-and-the-main-street-lending-program.aspx