Economic Fragility: Implications for Recovery from the Pandemic

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Marburg Memorial Lecture – Focus on Social Dimensions of Economic Issues

▶ Economists discuss social dimensions all too rarely

▶ Worldwide pandemic is a stark reminder
  ▶ More than 210,000 have died in the United States
  ▶ Minorities disproportionately impacted
    ▶ More likely to live in dense urban areas
    ▶ Employed as front-line and essential workers – often at modest pay

▶ Uneven effects of recessions are not unique to the pandemic
  ▶ Recessionary dynamics
    ▶ Businesses close
    ▶ Permanent loss of jobs

▶ However, policy can impact severity of recession
Recession Dynamics are Impacted by the Health of the Financial System

- Is the United States, as currently configured, particularly vulnerable to economic disruptions?
- Pandemics cannot be predicted precisely – but vulnerabilities to disruptions make the downturns, when they occur, more severe
- Concentration of risk in commercial real estate and levered firms is making the effects of the downturn more severe
- Financial vulnerabilities impact more than shareholders
  - Bankruptcies result in permanent job losses and significant scarring of labor markets
  - Bankruptcies result in losses to creditors
Bankruptcies often Reflect Accumulation of Risks

- Ernest Hemingway – The Sun Also Rises
  “How did you go bankrupt? … Two ways, gradually and then suddenly.”
- Unfortunately too many are facing the “suddenly” part now
- Increase in risk-taking – gradually accumulates in low-interest environment
  - Households and firms reach for yield
  - Take on more debt that can be difficult to pay in downturns
  - Leverage magnifies returns in good times; magnifies losses in bad
- Increases in risk-taking – one way that monetary policy works
  - In depths of recession – borrowers may be too risk-averse
  - But low rates persisting in recovery – can result in excessive risk-taking
Outline of My Remarks

- Tightening of credit terms and credit availability
- Impact magnified by low interest rate environment in preceding economic expansion
- Accumulated risk-taking in real estate and reliance on debt are making this downturn more severe
- Significant implications for labor market conditions
- Policy implications
  - Supervisory policies – to address build-up of risks
  - Financial stability needs more emphasis – to make downturns less severe
Figure 1: Bank Lending Standards for Commercial and Industrial Loans
2000:Q1 - 2020:Q3

Net Percent Tightening Standards

- Standards for C&I Loans to Large and Medium-Sized Borrowers
- Standards for C&I Loans to Small Borrowers

Note: Large and medium-sized borrowers have annual sales of over $50 million.
Source: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, NBER, Haver Analytics
Note: For capital ratios, U.S. banks include commercial and savings banks throughout the period and the former OTS-regulated thrifts beginning in 2012. Bank failures include all U.S. bank failures throughout the period.

Source: Quarterly Bank Call Reports, FDIC, NBER, Haver Analytics
Nonperforming loans are loans 90 or more days past due plus loans in nonaccrual status by loan type. Nonperforming loans are displayed as a share of all loans of that particular loan type. U.S. banks include commercial and savings banks throughout the period and the former OTS-regulated thrifts beginning in 2012.

Source: Quarterly Bank Call Reports, NBER, Haver Analytics
Figure 4: Performance of Bank Stocks and the S&P 500
January 2, 2020 - October 6, 2020

Source: Bloomberg Finance L.P., Haver Analytics
Credit Tightening Increases Recessionary Dynamics

- Credit tightening can occur even when banks are expected to remain solvent despite a depletion of capital
- Bank data responds with significant lags
- Forbearance for customers – while helpful – distorts data
- Declines in bank stocks, and bankruptcies, reflect significant economic uncertainty going forward
Figure 5: Commercial Real Estate Loans as a Share of Assets at U.S. Banks by Asset Size as of June 30, 2020

Note: U.S. banks include commercial and savings banks and the former OTS-regulated thrifts.
Source: Quarterly Bank Call Reports, Haver Analytics
Figure 6: Performance of REIT Equity Indices by Sector and the S&P 500
January 2, 2020 - October 6, 2020

Source: Bloomberg Finance L.P., The S&P Supercomposite 1500 REIT Indices by Sector
Risk in Commercial Real Estate

- Real estate risks are important in recession dynamics
- Exposure is concentrated in smaller banks – still a financial stability concern
- Low bank and REIT prices reflect market concerns
Figure 7: Nonfinancial Corporate Business Debt Relative to GDP
2000:Q1 - 2020:Q2

Note: Series is the four-quarter moving average of the ratio of nonfinancial corporate business debt to GDP.
Source: Federal Reserve Board, NBER, Haver Analytics
**Figure 8: Leverage Ratios of Retailers with a Default During 2020**

<table>
<thead>
<tr>
<th>Default Date</th>
<th>Firm Name</th>
<th>Debt/EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>05/27/2020</td>
<td>Tuesday Morning Corporation</td>
<td>2.25</td>
</tr>
<tr>
<td>03/09/2020</td>
<td>Bluestem Brands, Inc.*</td>
<td>4.39</td>
</tr>
<tr>
<td>06/23/2020</td>
<td>GNC Holdings, Inc.</td>
<td>7.12</td>
</tr>
<tr>
<td>07/23/2020</td>
<td>Ascena Retail Group, Inc.</td>
<td>7.31</td>
</tr>
<tr>
<td>08/02/2020</td>
<td>Tailored Brands, Inc.</td>
<td>8.08</td>
</tr>
<tr>
<td>05/15/2020</td>
<td>J.C. Penney Company, Inc.</td>
<td>8.61</td>
</tr>
<tr>
<td>07/24/2020</td>
<td>Party City Holdco Inc.</td>
<td>10.14</td>
</tr>
<tr>
<td>05/07/2020</td>
<td>Neiman Marcus Group, Inc.*</td>
<td>12.02</td>
</tr>
<tr>
<td>08/12/2020</td>
<td>Stein Mart Inc.</td>
<td>19.59</td>
</tr>
<tr>
<td>05/04/2020</td>
<td>Chinos Holdings, Inc.*</td>
<td>33.72</td>
</tr>
<tr>
<td>02/17/2020</td>
<td>Pier 1 Imports, Inc.*</td>
<td>NA</td>
</tr>
<tr>
<td>07/13/2020</td>
<td>RTW Retailwinds, Inc.</td>
<td>NA</td>
</tr>
<tr>
<td>05/11/2020</td>
<td>Stage Stores Inc.*</td>
<td>NA</td>
</tr>
</tbody>
</table>

Note: *Most recent FYE financial data available prior to FYE 2019. EBITDA is earnings before interest, taxes, depreciation, and amortization. Total debt includes operating and capital leases. Default is defined as a missed or delayed disbursement of interest or principal payment, bankruptcy filing or receivership, or a distressed debt exchange. NA depicts firms with negative Debt/EBITDA. As the ratio is a measure of earnings capacity to pay debt, negative EBITDA firms have no such capacity to pay debt by this measure, on balance. Does not include defaulted private companies whose financials are not publicly available.

Source: Bloomberg Finance L.P.; Capital IQ, S&P Global Market Intelligence; Compustat, S&P Global Market Intelligence; Moodys
Build-up in Leverage

- Corporate sector became more leveraged during the economic recovery over the last decade
- In a downturn, high debt loads can result in more bankruptcies – for example in retail
- Leverage at many retail firms exceeded what is permissible in a program designed for troubled borrowers
Figure 9: Permanent Job Loss
January 2020 - September 2020
Figure 10: Duration of Unemployment
January 2020 - September 2020

Source: BLS, Haver Analytics
Figure 11: Change in the Labor Force Participation Rate Since January for Prime Working Age Men and Women
January 2020 - September 2020

Source: BLS, Haver Analytics
Figure 12: New COVID-19 Cases Per Million Population
March 1, 2020 - October 6, 2020

New Cases Per Million Population

Note: New cases are seven-day moving averages.
Source: Johns Hopkins University
Concluding Observations

- Addressing public health crisis is prerequisite for solving economic crisis
- Build-up of risk – makes economic recovery more difficult
- Policy – need to avoid these build-ups of financial stability risk
  - Need cohesive regulatory and supervisory tools
  - Current tools are quite limited – compared to other countries
  - Need to use tools we have – bank supervision
- Need research into risk-taking behavior that makes the economy more susceptible to protracted downturns
- Urgency underlined by the fact that the impact of these downturns is disproportionately borne by those who can least afford it