The Coronavirus Shock: Implications for the Economy and Monetary Policy

Remarks by

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June 25, 2020
Delivered Virtually to the Economic Club of Kansas City
Kansas City, Mo.

The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers, or representatives.

I would like to thank the Economic Club of Kansas City for the opportunity to meet with you today. In my discussion, I will review the tremendous hit to the economy inflicted by the coronavirus, before highlighting some recent indicators that suggest a recovery is underway, including across the seven states of the Tenth Federal Reserve District that is served by the Kansas City Fed. This is a region that spans much of the central plains from western Missouri through Colorado, Wyoming and northern New Mexico. I will then discuss the extraordinary policy response, both fiscal and monetary, that is underlying this recovery, closing with a discussion of the economic outlook, and the implications of that outlook for monetary policy.

The past few months have been a challenging time for our economy and our nation. The coronavirus pandemic has led to a public health emergency unlike any in modern times. Measures taken to control the virus have delivered an unprecedented shock to economic activity, both nationally and in the Tenth District.

The economy entered recession in February, with real output falling 5 percent in the first quarter of the year, the most significant decline since late 2008, and a widespread expectation that activity will decline at a record pace in the second quarter. A tremendous number of Americans have lost their jobs since March, pushing the unemployment rate up from one of its lowest levels in half a century to the highest readings in the post-war era in just a matter of months.

The coronavirus recession has some unique elements. Modern recessions have typically resulted from imbalances within the economy that become unstable over time, either as economic demand exceeds supply leading to a buildup in inflation or as financial imbalances unwind after an unsustainable build up. However, the coronavirus shock came from outside the economy. An otherwise healthy economy was more or less put into a medically induced coma to

protect the public's health with policies that allowed only businesses deemed essential to remain open.

The nature of the measures taken to combat the coronavirus also have differentiated the current recession from past recessions. The need for social distancing has taken a particularly heavy toll on the consumption of services. The services sector is often relatively stable in a downturn; this time services are leading the decline.

LABOR MARKET DEVELOPMENTS

One consequence of the services-led downturn has been that certain parts of the labor market have been hit harder than others. Almost two-thirds of the 22 million jobs lost in March and April were concentrated in three broad industries: leisure and hospitality, education and health services, and retail trade. The vast majority of the 8 million layoffs in leisure and hospitality was concentrated in highly socially interactive sectors, including accommodations, restaurants and bars. Within education and health services, dentist and physician offices cut many workers, as did daycare providers. While we saw strong job gains in these industries in May, with employment increasing by 2 million jobs, a full recovery is still far off.

It is notable that, partly as a consequence of the sectoral distribution of layoffs, different demographic groups, though all suffering large declines in employment, have been affected to varying degrees. The increase in the unemployment rate has been particularly pronounced for Hispanic workers, increasing from 4.4 percent in February to 17.6 percent in May. African-American workers have also seen a large increase in unemployment, from 5.8 percent in February to 16.8 percent in May. It is also concerning that, unlike most demographic groups, the unemployment rate for African-Americans showed no improvement in May relative to April

even as the overall economy added millions of jobs. Similar to previous recessions, younger workers also have been especially hard hit by job losses.

A particular feature of the current recession is that women have suffered disproportionate job losses, in contrast to their relative performance in the typical recession.[1] Women held more jobs in the hardest-hit industries and a majority of these women did not have a college degree. Consequently, the unemployment rate of non-college-educated women rose more than fourfold from 4.5 percent in February to almost 21 percent in April, a far larger increase than experienced by men with similar educational background. A similar imbalance was also observed for college-educated men and women, though to a slightly lessor degree. Overall, women went from having an unemployment rate below their male counterparts in February to a far higher rate after the coronavirus shock.

ECONOMIC DEVELOPMENTS

Although every part of the United States experienced dramatic decreases in activity, states in the Tenth District have fared slightly better, likely due to the lower case counts experienced in the region.[2] All the same, more than 21 percent of the Tenth District labor force has filed for unemployment benefits since mid-March, with employment in the leisure and hospitality sector recording a dramatic 44 percent decline in the region.

More recently, as stay-at-home orders and other restrictions on activity have been lifted we have started to see signs of recovery, both in the Tenth District and nationally. Because there

[1] Didem Tuzemen and Thao Tran. 2020. "Women Take a Bigger Hit in the First Wave of Job Losses due to COVID-19." Federal Reserve Bank of Kansas City, *Economic Bulletin*, April 16.
[2] For further detail on the economic effects of the pandemic, see Jason Brown and Alison Felix. 2020. "COVID-19 Stuns U.S. and Tenth District Economies, but Both Show Signs of Stabilization." Federal Reserve Bank of Kansas City, *Economic Bulletin*, June 17.

is a lag in the official data, economists at the Kansas City Fed and elsewhere have been monitoring more timely, but less traditional, indicators of activity. One of these measures is foot traffic to businesses. Foot traffic in mid-April was down 60 percent relative to early March in both the U.S. and the Tenth District. Traffic began to improve by late April, and has picked up slightly faster in the Tenth District, where stay-at-home orders were lifted earlier. As of early June, foot traffic relative to the first week in March was down about 25 percent in the District versus 35 percent for the nation as a whole, still depressed but a considerable improvement relative to where we were in April.

THE FISCAL POLICY RESPONSE

The pick-up that we have seen has been importantly supported by some of the swiftest and most aggressive fiscal policy actions on record. In March and April, Congress enacted four bills related to the current pandemic and economic crisis, providing an estimated $2.9 trillion of fiscal support to the economy, including one-time direct payments to households, an expansion of unemployment benefits, forgivable loans to small businesses, and support for new Federal Reserve lending facilities.[3] These fiscal measures are unprecedented not only in terms of their size, but also in terms of how rapidly they were enacted. As a comparison, following the 2008 financial crisis, Congress provided a total of $2.5 trillion of fiscal support to the economy, enacted over a two-year span from 2008 to 2010.

So far, increased transfer payments from the government, including importantly both direct payments and increased unemployment benefits, have covered the loss of income for many

[3] The CARES Act allows employers and self-employed people to defer Social Security taxes from March 2020 through December 2021. The CBO estimates that the federal government will reduce revenues over 2020-21, but increase revenues over 2022-23. Including this deferral, while excluding the estimated revenue increases over 2022-23, brings the total fiscal package to $3.6 trillion.

households. As a result, economy-wide disposable income actually increased in April despite a sharp fall in wage income. However, the coronavirus is affecting household economic prospects differently, often depending on how easily jobs can be transitioned to a remote work environment. Relatively secure and highly paid jobs are most often the easiest jobs to make remote, while relatively low-paying jobs are overwhelmingly less amenable to remote delivery.

THE FEDERAL RESERVE'S POLICY RESPONSE

The Federal Reserve has also responded quickly and aggressively to the developing coronavirus crisis. Credit conditions tightened at an unprecedented pace as the pandemic spread and states and local jurisdictions began to issue shelter-in-place and quarantine orders. Economic strains apparent in early March developed into a fully-realized financial panic weeks later when investors fled risky assets resulting in sharp asset price declines, increased debt spreads, and notable deterioration in market liquidity. Commercial banks experienced draws on existing lines of credit, shadow banks saw funding runs, and short-term corporate debt issuance stalled as investors flocked to the safety and liquidity of cash and shorter maturity government securities. Even conditions in markets typically considered safe-havens, such as longer-dated Treasuries and agency guaranteed mortgage-backed securities, became strained.[4]

The severity of the liquidity crisis threatened to exacerbate the economic contraction from the pandemic, prompting a forceful response from the Federal Open Market Committee (FOMC). On March 3, the FOMC reduced its benchmark rate 50 basis points in response to burgeoning economic stress before ultimately cutting the target rate to zero a few weeks later due to rising financial strains. Credit conditions finally began to ease around March 23 after the

[4] Karlye Dilts Steadman, 2020. "Measuring Liquidity Risk in Treasury Markets: The G-Spread" Economic Bulletin, Federal Reserve Bank of Kansas City, forthcoming.

FOMC announced purchases of Treasury securities and agency mortgage-backed securities in the amounts needed to facilitate orderly market functioning, and established new credit facilities to promote the flow of credit.

In addition to FOMC actions, liquidity facilities administered by the Federal Reserve have helped to further ease financial conditions and improve market functioning. Commercial banks, for example, have been encouraged to borrow from the Federal Reserve's discount window to maintain the flow of credit in the face of increased demand by businesses. At the same time, the Federal Reserve has established a number of temporary liquidity facilities that make short-term loans against safe collateral to address illiquidity at nonbanks.[5] These temporary facilities are largely guided by the Federal Reserve's 2007-09 crisis-era experience, though their scope has been expanded to include a wider variety of accepted collateral and a larger number of eligible participants. Domestically, these facilities aim to ensure credit remains available to U.S. businesses and local governments. For example, the Federal Reserve has intervened directly in the commercial paper market to facilitate the flow of short-term credit to corporations. Globally, the Federal Reserve has established swap lines with other central banks so that U.S. dollar funding is widely available abroad.

The sudden nature of the coronavirus shock, however, presents unique and unprecedented financial challenges for businesses and local governments. While the Federal Reserve's initial responses eased short-term funding stresses, additional actions were required to address longer-term concerns. In a significant departure from the 2007-09 crisis-era policy, the Federal Reserve joined the U.S. Treasury, as authorized under the CARES Act, to provide temporary relief to localities and businesses to offset revenue losses. Examples include programs that lend directly

[5] Rajdeep Sengupta & Fei Xue, 2020. "The Global Pandemic and Run on Shadow Banks," Economic Bulletin, Federal Reserve Bank of Kansas City, issue May 11, 2, pages 1-5, May.

to smaller businesses with limited access to external capital markets, programs that provide liquidity to financial institutions participating in the Treasury's Paycheck Protection Program, and direct intervention in corporate bond, corporate loan, and local government bond markets.[6] These longer-term interventions require the Federal Reserve to take on more credit risk than that assumed by short-term liquidity facilities, and, as such, are backed by an equity stake from the U.S. Treasury, which will absorb any losses. To the extent that these funds can assist businesses and local governments in maintaining their operations, however, they help lay the foundation for a quicker recovery once the pandemic abates.

So far, Federal Reserve actions appear successful. Markets are largely functioning in an orderly fashion and debt spreads are near pre-pandemic levels for highly rated borrowers. Moreover, utilization rates at some liquidity facilities and the discount window have declined, while market activity has resumed, suggesting that liquidity conditions have improved.

THE ECONOMIC OUTLOOK

The improvement in financial conditions should further support a rebound in economic activity backed by fiscal support and a further relaxation of virus-related restrictions, however, there are a number of risks that could hold up the recovery.

Most important is the course of the virus itself. A renewed upsurge in infections and resumed social distancing, either mandatory or voluntary, is likely to be a persistent risk, at least until a vaccine has been developed or treatment options sufficiently improve.

Putting aside the direct effects of the virus, there are other elements of the health crisis that are likely to prolong the recovery. One risk is that consumers and businesses react to the new

[6] Huixin Bi & Jacob Dice & Chaitri Gulati & W. Blake Marsh, 2020. "Understanding the Recent Rise in Municipal Bond Yields," Economic Bulletin, Federal Reserve Bank of Kansas City, May 27.

uncertainty introduced by the virus by pulling back on consumption and investment with the goal of building precautionary buffers against future disruptions. While rational at the individual level, such a pullback can hamper growth across the wider economy.

Another risk comes from the global economy. Foreign demand for U.S. exports had already been weak for some time before the crisis. Now, with the virus rolling across foreign economies at varying times and intensities, it seems unlikely that we should expect much support from overseas as our economy picks back up.

Finally, while fiscal policy is currently providing substantial support for growth, there is a risk that the impetus from fiscal policy will turn negative before the recovery has been fully realized. The coronavirus pandemic has created serious financial consequences for state and local governments, which unlike the federal government, must balance their budgets. In the near term, governments are facing liquidity challenges, as many tax deadlines have been postponed, leading to massive drops in income tax collections this spring. Also, shelter-in-place orders have sharply reduced consumer spending, thereby lowering sales tax collections. At the same time that state revenues are under pressure, the demand for state services, including spending on medical supplies and temporary health facilities, is growing. Although funding from the CARES Act, which allocated $150 billion in direct aid to state and local governments, including over $11 billion for states in the Tenth District, will help states cover some of the costs associated with Covid-19 and partially fill budget gaps in the short term, strains are likely to intensify. Indeed, many states are already making difficult decisions about spending cuts as they finalize budgets for the next fiscal year.

In the longer term, governments will experience large revenue declines that are likely to lead to significant budget cuts for years to come. Likewise, the current crisis is likely to further

stress the funding of government pension plans, as contributions will likely come under pressure and investment returns decline sharply. Even as some economic indicators are starting to improve, evidence from previous recessions suggests that the economic effects of the coronavirus shock on state and local governments may take some time to fully materialize and may persist even as health risks dissipate.[7]

OUTLOOK FOR POLICY

How does this economic outlook shape my views on the appropriate stance of monetary policy? One thing to note is that determining the correct path for policy is likely to be even more difficult than usual given what I expect to be the continued volatility of the incoming data. Indicators are expected to improve in the third quarter even as the level of activity remains depressed. Overall, it might be awhile before the dust settles and we gain insight on whether further accommodation is necessary or not.

As the economy's reopening progresses, we should get more clarity about the impact of the actions we've taken, as well as the impact of fiscal stimulus. I am also realistic that the extraordinary uncertainty about the path of the pandemic over the second half of the year and the economic outlook will require a fair amount of patience and wisdom as we navigate the likely long-lasting implications of the coronavirus shock.

[7] See Alison Felix, 2020. "COVID-19 Challenges State and Local Government Finances." Economic Bulletin, Federal Reserve Bank of Kansas City, May 13.