WEEKLY ECONOMIC COMMENTARY

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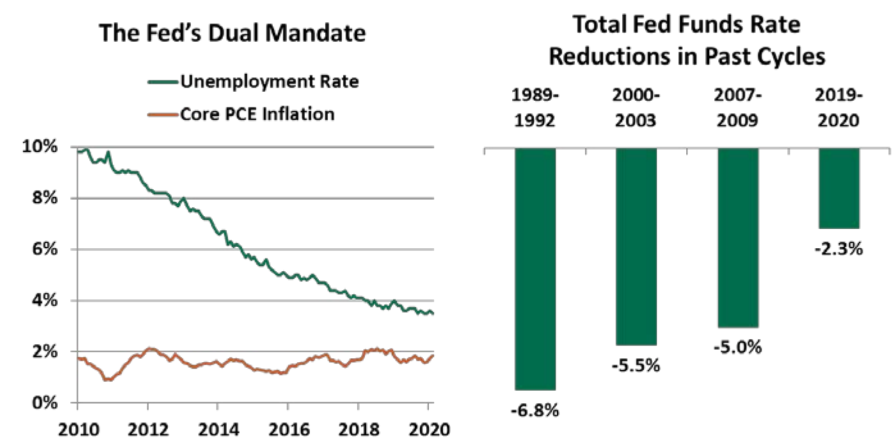
The Kansas City Fed's annual Monetary Policy Symposium at Jackson Hole is a signature event for those of us who follow central banks. The conference typically doesn't generate much front-page news: the subject matter is usually more technical and conceptual than a broad audience would appreciate. But 2020 is not a typical year.

The symposium began with a substantial announcement by Federal Reserve Chair Jerome Powell that detailed a new approach to inflation targeting, which we analyzed last week. His announcement was accompanied by the release of a dozen Federal Reserve discussion papers, which were written in the course of the Fed's policy review. The comprehensive body of research reflects a thorough reevaluation of monetary policy.



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Federal Reserve, Haver Analytics

Well before last week's announcement, Powell had been describing 2% inflation as a "symmetric" target, suggesting it could be allowed to run high to make up for intervals where the price level had been lower than desired. Research found these make-up strategies to yield economic gains by permitting rates to stay lower for longer. However, this approach will likely create communication challenges when the time comes to temper inflation back down to its target.

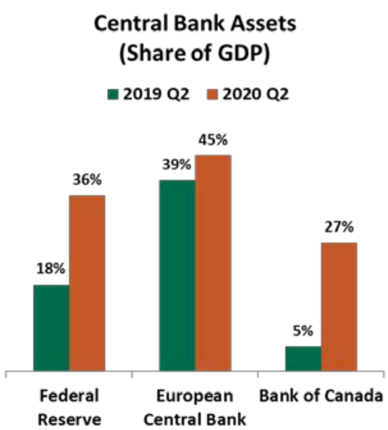
It certainly appears that the Federal Open Market Committee will give more priority to employment gains going forward. Researchers explored the disconnect between the expected long-term unemployment rate and the unemployment rate that does not increase inflation. They can be different numbers, and neither can be measured in advance. In

2018 and 2019, actual unemployment was below most expectations of the long-run rate, but inflation remained well-behaved. Most predictions for the long-run rate of unemployment were too high, prompting policy makers to reconsider their reliance on concepts like the Philips Curve.

In the near term, the Fed is managing a crisis. Rates have reached their lower bound, and the Fed must rely on its balance sheet to implement its policies. Asset purchases can be varied in their size, structure and goals, tailored to specific outcomes as demanded by the situation at hand. Purchases can target specific sectors, such as buying mortgage-backed securities to support housing markets. The assortment of funding facilities launched in the COVID-19 crisis reflects an intention to support a wide cross-section of the debt market.

Clear communication will be vital for central banks as their strategies evolve.

The Fed is not blind to the risks created by aggressive policy. Researchers investigated how to prevent low rates from increasing financial system vulnerabilities through higher leverage and inflated asset prices. Smart use of macroprudential policies like capital buffers and sector-specific guidance can help manage these risks. And in order to avoid surprising financial markets, the Fed will have to set expectations properly by carefully considering its forward guidance.



Sources: Bureau of Economic Analysis, Haver Analytics

Powell's speech set a tone echoed by all other Jackson Hole participants: We are at a turning point in the global economy, and now is the time to reassess our expectations. Research papers hinged on several important questions:

Why is growth slowing? Despite continued technological advancements and greater educational attainment, economic growth in developed markets is slowing. Research presented this year explained a loss of business dynamism by exploring the greater market share and power of large firms. Giants within a sector can attract the most talent and amass the most intellectual property, warding off innovation by small competitors. As barriers to entry rise, entrepreneurism and growth fall off, impairing growth and limiting productivity gains. The winning firms' gains come at a cost to the broader economy.

What if inflation rises above target? While Powell made a case for inflation to run hot, some effort may be required to change the perception of that goal. In general parlance, higher inflation is understood to be a bad outcome (such as for people living on fixed incomes). If central banks fail to make a clear case that higher inflation is not a risk, consumers expecting higher inflation may reduce spending, and firms may slow investment and hiring.

What will the long-term damage of COVID-19 be? Perhaps the hardest task for policymakers, and all of us, will be restoring confidence. The pandemic is a life-changing event that will skew perceptions of risk: survivors will begin to consider improbable events to be more likely than they are. While no policy can prevent people from believing that future pandemics are more likely than they originally thought, policies can help mitigate some economic costs. For example, interventions to prevent bankruptcies can limit the long-run damage done and fear caused by the crisis.

The framework review was thorough, but monetary policy still faces significant limitations.

Jackson Hole is also important for its global perspective, with central bankers from around the world joining the meeting. Speeches from the leadership of the Bank of England, the European Central Bank, the Bank of Canada and the Organization for Economic Cooperation and Development (OECD) all struck on the theme of comprehensive crisis mitigation. With no further willingness to cut rates, research concluded that alternative central bank policies have worked, but a complete response requires elected leaders to also support their economies.

None of the updates from outside the U.S. had quite the same import as Powell's speech; the Fed has been a first mover in its change to policy after the pandemic. The ECB is currently undergoing a strategic review of its own, while Andrew Bailey of the BoE reassured listeners that "we are not out of firepower" if more intervention is needed.

Taken as a whole, the body of research shows central bankers understand how their policies must evolve in the years ahead. But for now, they must manage through a crisis. With rates already at their bottom and asset purchases continuing at a high volume, monetary policy may be at its limit, requiring a greater expansion of fiscal policy to support the recovery.

Off a Cliff

A few months ago, India was among the first countries to impose a stringent lockdown in a bid to contain the spread of COVID-19. Awkwardly, today, the country has the third-largest number of cases and is soon to surpass Brazil to take second place.

Similarly, a few quarters ago, the country was known to be one of the fastest growing major economies; but during the second quarter of 2020, it endured the worst slump economic slump among major nations. India's real gross domestic product (GDP) collapsed to -23.9% year-over-year in the second quarter, its first quarterly decline since records were first kept in 1996.

India's growth story had been faltering before the virus hit, with GDP decelerating for four consecutive years. This was partly due to the twin shocks of demonetization and a rather hasty implementation of the goods and services tax. This year's lockdowns have hammered nearly all sections of the economy, bringing business activity to a near standstill. Construction and manufacturing output tumbled by 50% and 40% year-over-year respectively in the second quarter. Consumption, which accounts for 60% of India's GDP, was decimated.

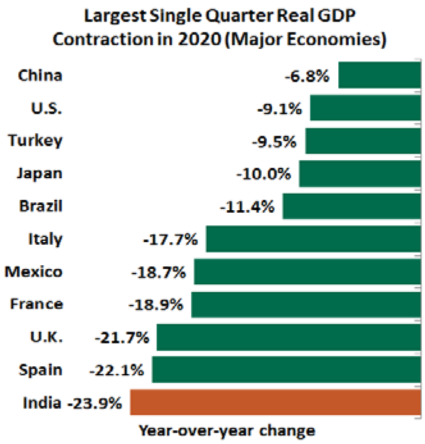
The downturn is putting government finances under pressure as revenues have declined and states are struggling to pay their bills. The government's $265 billion package, equivalent to 10% of GDP, is further denting public finances. Moody's has already downgraded the country's sovereign rating. And the promised money may not have much impact. The package included direct spending of less than 2% of GDP, a portion of which were previously announced expenditures.

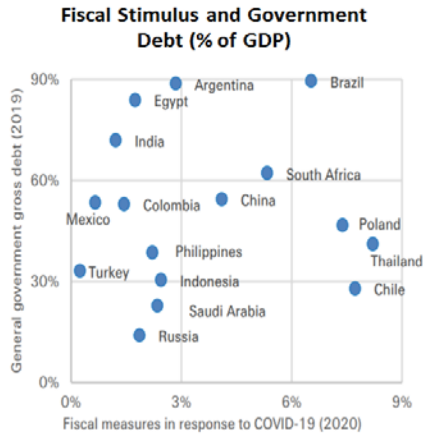
The remaining fiscal support has come in the form of credit guarantees. Official loan backstops are not generally very effective in countries like India, which has a large informal economy and a substantial small-and-medium sized enterprise (SME) sector. Only about 5% of bank credit goes to small businesses, and only 16% of micro-SMEs are financed by the formal banking system. Stimulus is not reaching areas that account for a substantial amount of economic activity.

While the government's fiscal response has been tepid, the central bank has acted more decisively by lowering interest rates, declaring a loan repayment moratorium and injecting additional liquidity into the financial system.

While the most restrictive quarantine measures are in the past for India, its problems are far from over. An uneven recovery is underway, but is unlikely to hold. In July, aggregate demand was estimated at around 67% of pre-COVID levels. Fiscal vulnerabilities are lingering, whether in the banking system due to weak asset quality, low capital adequacy or high corporate debt. Risks will be compounded by a prolonged period of subdued economic activity. And according to Moody's, India is likely to have the highest debt burden among the large emerging markets (EMs) by 2021.

India has done very little to stimulate demand.





Sources: Haver Analytics, Swiss Re

While India is the worst affected it isn't an outlier among EMs outside of China. Almost all EMs first appeared to have mild outbreaks of COVID-19, but infection rates were held artificially low by limited testing. Infection rates are rising, and EM nations now account for 70% of the world's total new cases. They share the maladies of weak public health infrastructure and a lack of political resilience.

This crisis has economic policy lessons for all EMs. Though difficult to implement, a universal basic income or direct cash transfer would have not only have helped stimulate demand but may have prevented millions from falling back to poverty. Domestic policies will need to allow for more durable and inclusive growth: India has the highest income inequality among major economies.

India and other EMs need to continue to deploy more measures in order to support their economies to avoid greater hardships. With the virus spreading at a worrying rate, financial conditions still fragile, and policy room diminishing, it is going to be an uphill battle from here.

Hard to Gauge

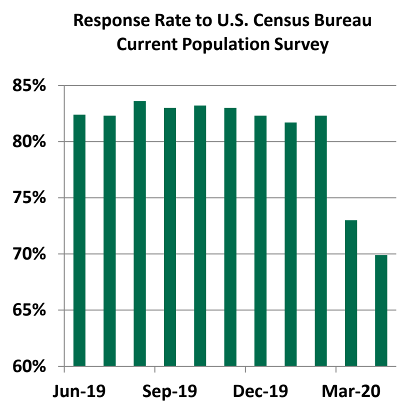
It's not the primary concern created by the pandemic, but COVID-19 has wrought havoc with the collection of economic information. This has complicated the setting of policy at a critical time.

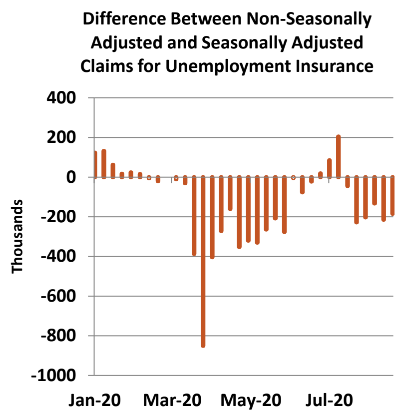
Reports on output and prices are compiled from sources around the economy. Some of those sources have been scattered to the four winds during the last six months, as businesses face temporary closures and professionals work from home. Those working for statistical agencies are also working remotely, and may not have access to the measurement methods needed to complete their work. For example, measuring inflation in many countries still requires tabulating physical trips to retail outlets, which have been discouraged or prohibited at times during COVID-19.

The timing couldn't have been worse for statisticians in the United States, which is conducting its decennial census. The census is the basis for apportioning legislative representation and federal funding, so an accurate count is terribly important. The last legs of the count are done by compilers on foot; doing so during a pandemic is a complicated endeavor.

It is hard to steer the economic ship of state without a good compass.

The U.S. Census Bureau also conducts the monthly Current Population Survey (CPS), which is the basis for calculating the unemployment rate. As COVID-19 hit, response rates to the CPS dropped sharply, diminishing the reliability of the results.





Sources: U.S. Census Bureau, Bloomberg

Many economic series are adjusted to account for normal seasonal variation. Needless to say, the pandemic has disrupted normal patterns, causing large fluctuations in the data. In some cases, analysts are relying more on unadjusted figures as they try to discern trends.

Challenges faced by economic statisticians have resulted in some positive steps. As we wrote in our essay on life after COVID-19, the pandemic promises to accelerate technological trends already underway. The use of online pricing sources to gauge inflation is getting a needed boost. And promising alternative measures of economic activity have arisen, which will serve as a nice complement to more traditional indicators.

With some key economic decisions upcoming in a number of world capitals, having reliable data will be essential to making good choices. Unfortunately, the pandemic has made securing reliable data more difficult.

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