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"Current Risks in the Economy from Headwinds of Household Income Loss and Inadequate State and Local Expenditures"

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Thank you, Chair Mark Crapo and Ranking member Sherrod Brown, for this invitation to give testimony before your committee today on the issue of where the economy stands with the status of the Federal Reserve's emergency lending facilities. I am happy to offer this testimony on behalf of the AFL-CIO, America's house of labor, representing the working people of the United States, and based on my expertise as a professor in Howard University's Department of Economics.

We began this year with the world facing a novel virus for which we lacked adequate cures and that proved more deadly than most flus we had encountered. The lethal potency of the virus and its easy spread required a new set of responses. Given the lack of a cure and its costly nature of care on people and health systems, the world adopted a policy of social distancing and isolation to prevent its spread. This policy proved very effective in reducing deaths, and for the nations that took aggressive measures, like New Zealand, proved highly effective in ending the virus' threat.

But, despite the huge economic benefits of these policies, slowing the economy to carry out social distancing had huge costs, too. By all measures, the benefits of saved lives alone, far outweighed the cost of slowing the economy. It is important to note, that in the United States where our implementation of social distancing policies was very uneven, it is also clear that the uncertainty of COVID itself, slowed economic activity. The United States policy variation has clearly documented that social distancing policies are not the driver of the economic slowdown, but the spread of the disease is the cause of the economic slowdown. The difference is in the efficacy of the policy in slowing down the virus spread.

This virus has caused the greatest decline in global economic activity since World War II. It has affected the Gross Domestic Product of every advanced economy according to the Organization for Economic Cooperation and Development. In response to this tremendous and unprecedented slowdown, economic policy makers everywhere have responded with swift, large and bold actions. The United States Congress took early action to sustain the economy this Spring. Two quick acts of Congress, the Family First and the Cares Acts, bought time for policies to contain the virus to take hold. Unfortunately, while the economic policies were effective, the policies to contain the virus in the United States have lagged those of other countries, so our economy now enters a new phase of high uncertainty because of COVID without the aid of those earlier bold actions.

In March, the uncertainty of COVID slowed certain economic activity in the U.S. that led to the first month of job loss, ending its record string of growth. But April brought the most dramatic loss of jobs in U.S. economic history. In that one month, we lost more than twice the jobs lost over the course of the Great Recession. While other advanced economies planned for social distancing by massively subsidizing payroll, America chose to dump workers into our unemployment insurance system. Rather than subsidize payroll, we chose to try and subsidize workers within the unemployment insurance system. To approximate pre-existing payroll, an additional $600 was added to weekly unemployment benefits. This policy choice might have worked the same as with other advanced countries if COVID were put under control, and sufficient economic certainty were restored for households to resume normal consumption.

However, there were many challenges to using the U.S. unemployment insurance system. The greatest job losses in April, almost 8 million, were in the leisure and hospitality industry. Our nation's unemployment insurance laws were not well designed for these workers, and in normal economic times, workers in those industries are the least likely to receive unemployment benefits when they become unemployed—fewer than 8 percent in 2018. And, at its peak during the Great Recession the system handled a little over 3 million in May 2009, but received over 6 million at the end of March 2020, and had a four-week average above 3 million for seven weeks from April to May. This overwhelmed the system and created backlogs, delays and confusion for American households that had lost labor income.

Congress also granted the Federal Reserve funds and unprecedented latitude to devise policies to maintain liquidity in the capital markets. This let the Fed take steps to ease blockages in public finance and corporate borrowing that had frozen markets for those needed lines of liquidity. In periods of heightened uncertainty, a primary function of the Fed is to reduce uncertainty so the financial markets can function. But this case was different because the uncertainty from COVID were high and affected a broad range of economic actors, many that do not rely on Wall Street, but need access to liquidity from the commercial banking sector. Here the Fed was met with restrictions from the U.S. Treasury on how to devise plans to help those firms that live on Main Street. As with the Payroll Protection Plan loans overseen by the U.S. Treasury, banks were the primary financial intermediary. And, as with the PPP program, the banking sector proved both inadequate to the task and a reluctant participant. The banking sector also showed the problems of discrimination that plague banking, and access to minority-owned firms was greatly limited. Further, rather than let the Fed take advantage of the funds from Congress to assume room for risk in making loans, the U.S. Treasury limited this possibility, resulting in the program under the Fed's control as far more limited than would have been desirable given the uncertainty we faced.

However, at this point, it is not clear whether the primary concern should rest with the Fed. The economic scarring of the downturn is taking hold on the economy. The initial plans of the Family First and Cares Acts to bide the economy over the COVID fight, now confront unemployment levels looking like the Great Recession. It is no longer the case that the best set of policies are in deepening the debt position of companies or households. Increased debt burdens in those sectors would lead to a weakened recovery as both the household and business sectors would engage in balance sheet consolidation during the early stages of a recovery, slowing down the economic rebound. In fact, most companies have already leaned toward increasing their cash balances, given the uncertainty that COVID has created. And, initially, those households with the greatest discretion used their Economic Impact Payments to consolidate their balance sheets as well, paying off debts or increasing their cash balances, too.

The jobs report we got from the U.S. Bureau of Labor statistics for August was very revealing in respect to where the economic challenges now stand. First, the report was the first since the end of the $600 weekly Federal Pandemic Unemployment Compensation payments to the unemployed. This gave a final test of whether those payments had distorted labor market participation by encouraging lower wage workers to stop seeking employment opportunities. Several studies looking at the effect of the FPUC showed there was no effect on labor force participation, with some showing it had a positive effective, mostly because the additional benefit encouraged many low wage workers to apply for unemployment benefits and thus get and remain engaged in the labor market. In normal economic times, low wage workers are the least likely to apply for unemployment benefits. And, research has shown unemployment insurance benefits help workers remain in the labor market, rather than become discouraged and drop out of the labor force. Clearly in August, there was no spike, or break in trend with labor force participation, putting to final rest the payments were a disincentive to returning to work.

This new information we have on the performance of the FPUC is key because it showed clearly in the data from the U.S. Bureau of Economic Analysis the role the FPUC had in offsetting the significant drop in aggregate payroll for personal income. Without that money channeled to households, the economy will have a hole it cannot make up. Available evidence on spending patterns, clearly showed that the FPUC and the EIP payments kept consumption smooth for the bottom 75 percent of American households. Absent that support, to offset lost payroll income, we are heading into the final quarters of this year facing a huge headwind.

Second, the report showed a slowing down in the job bounce back from April's decline. In May, with some key hotspots under better control, like New York city, employment was able to return quickly. Spikes in COVID activity around the country after Memorial Day, however have slowed the employment rebound. We remain down over 11 million jobs from our peak in February of this year. That is greater than the depths of the Great Recession. The number of workers losing jobs permanently is rising in step with the pattern of the Great Recession, as is the number of workers unemployed over 26 weeks. The rate of net job creation is too slow to get those numbers down, and those losses mount on personal household balance sheets. A feedback loop can set in to slow the recovery in aggregate demand and slow the recovery in jobs. So, this adds to the affect of the missing $600 FPUC payments in unemployment checks.

The share of unemployed workers who are from households with little wealth and no liquidity is rising. The initial recovery for jobs has been far more rapid for white households than for Black and Hispanic families. Black and Hispanic families have significantly less wealth and liquidity than white households. The result is that a $1 drop in labor income leads those households to experience a greater than drop in consumption than for white households. The extra $600 the FPUC provided to unemployment benefits is needed for these households to maintain spending and keep aggregate demand at levels to sustain the macroeconomy. And, because Black and Asian American workers face discrimination in the labor market, they have the longest duration of unemployment spells. The loss of job for them has far greater financial risks. Consequently, the $600 FPUC does not carry the same work disincentive, as they face much lower probabilities of an unemployment spell ending with a job; meaning, their prospective loss of income from refusing a job offer is much higher. This dimension of racial equity underscores another important element of the FPUC.

Other advanced economies that chose to subsidize payrolls, have much lower levels of unemployment than the U.S. They will enter the final quarters of the year with healthier household balance sheets and they have managed to do a far better job of containing the virus. For the U.S. to enter the final quarters in a similar position will require maintaining personal income as best possible. Having chosen the path of using our unemployment system as the avenue of maintaining payroll employment levels, we have little choice but to continue down that path by keeping the FPUC up.

The Fed cannot maintain personal consumption, or solve the COVID mystery. So, it must rely on the Congress to take actions to maintain household incomes. That can only be done through fiscal actions.

Similarly, state and local governments are constrained by state constitutions in borrowing money to balance their fiscal issues. They are essentially, public actors under a single currency. As such, state and local governments must look to the federal government and Congress to act to provide stability in the face of macroeconomic uncertainty. In this economic situation, state and local government austerity will be counter-productive to an economic recovery, and further complicate the situation because they are playing a vital role as partners in getting COVID under control. At this point we need state and local governments to increase their investment in the safe return of workers to employment, and students to their schooling; while maintaining state and local government investments in the rest of our nation's infrastructure. The great lesson of the Great Recession was the drag that state and local government austerity can play on economic recovery. As we enter the final quarters of this year, we will be facing the new fiscal years for state and local government. An additional headwind of drag from public investment austerity will make recovery even more difficult.

We are heading into the final quarters of this year with a more severe labor market than the depths of the Great Recession while facing headwinds from the household and public sector. This is dangerous. We rely on households to pay rents, make mortgage payments and to buy the goods that let small businesses pay their rents and workers. Ultimately, the health of our financial sector rests on the real economy, and households making the payments that repay the loans the financial sector has made. Currently, the Fed has taken the actions it must to reassure the financial markets there is sufficient liquidity for businesses to borrow to keep up business. But the Fed cannot pay off the loans that banks make.

What we are risking at this point is a failure of the real economy that increases uncertainty that loans will be repaid. That is something that Congress alone can address. It can keep to its course of maintaining payroll through adequate unemployment insurance payments, and keep the household sector afloat until the uncertainty of COVID is reduced and households return to normal consumption patterns, or it can watch personal consumption collapse and try and deal with the fall out that may contaminate the solvency of the financial sector. Congress can maintain the state and local government sector, its vital partner in getting COVID under control, or face disappoint in deploying a vaccine when, and if, one becomes available and the needed steps for safe opening of more workplaces.

Congress should hope the Fed can maintain the economy while it waits to act. The Congress can ask the Fed to be as aggressive as possible in making lending available to restart the economy. Congress can direct the U.S. Treasury to loosen the reigns and let the Fed be more creative in getting funding to Main Street, recognizing this is a period of higher risk but also where more risk must be taken to ensure that when the recovery takes hold we have the greatest competitive balance our economy can maintain.

But, in conclusion, Congress must act. It cannot pretend that jobs will magically appear and the labor market will heal itself before the loss of payroll income collapses demand. It cannot wish the job crises away, anymore than it can wish COVID away. Actions are needed on both fronts, and a full economic recovery is not possible without actions on both fronts.