



# Monetary Policy and Labor Market Recovery in the wake of COVID

**MAY 27, 2020**

**Christopher Erceg**

Monetary and Capital Markets Department,  
IMF

Any views expressed in this presentation are those of the author and do not necessarily represent the views of the IMF or its Executive Board.

# Presentation Overview

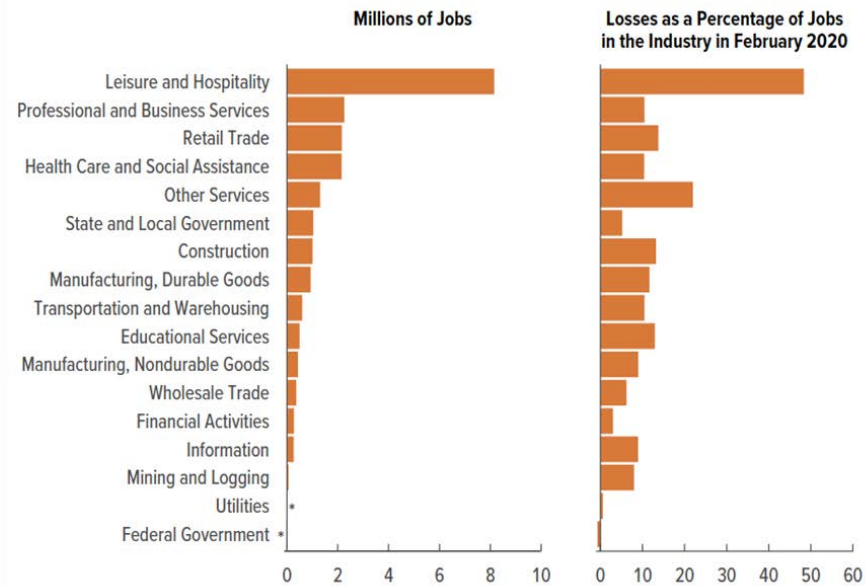
- Brief overview of labor market since COVID
- Headwinds likely to affect pace of recovery
- Challenges facing monetary policy

# Labor market since COVID

- High unemployment likely to persist
  
- Large effects on service sector
  - contrasts with past recessions
  - big effects on SMEs that are major employers of low-skill labor
  
- Large differences across geographic regions
  
- Falling labor force participation

Figure 1.

**Job Losses by Industry During March and April 2020**



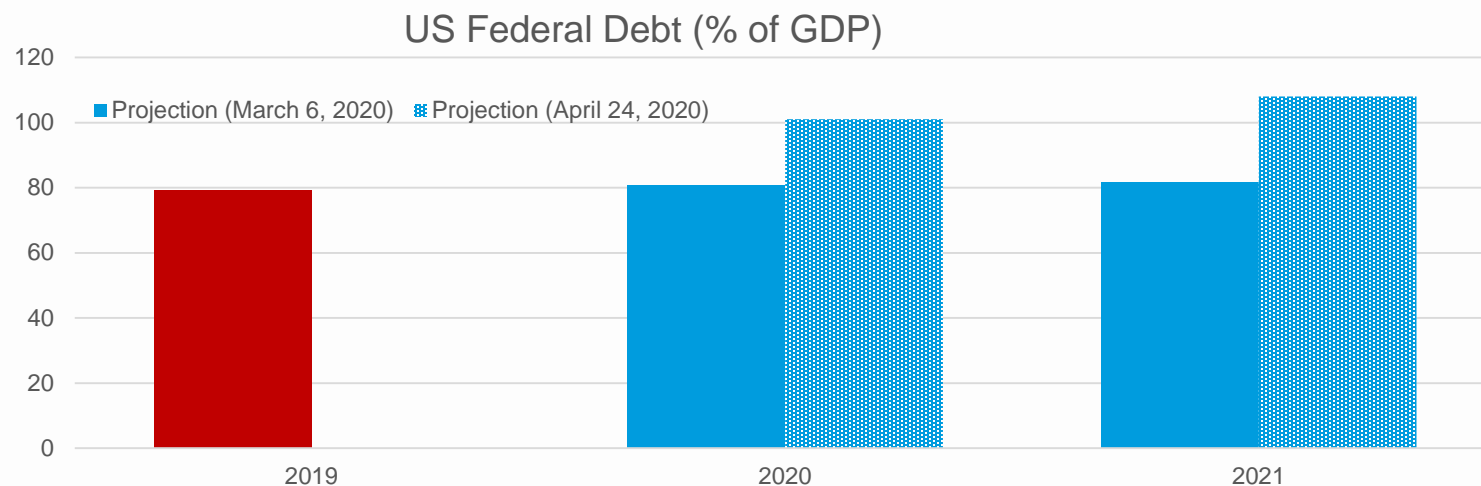
The more than 20 million nonfarm payroll jobs lost during March and April were concentrated in industries that rely on a high degree of in-person interactions, including leisure and hospitality, retail trade, and educational services. The leisure and hospitality industry was hit particularly hard, losing more than 8 million of its 17 million jobs.

Sources: Congressional Budget Office; Bureau of Labor Statistics.

\* = between -0.05 million and 0.05 million.

# Headwinds impeding labor market recovery

- Even after medical crisis subsidies, many forces restrain demand (lower  $r^*$ )
- **Massive deterioration of public and private sector balance sheets**
  - ◆ Public sector debt/GDP will rise substantially, increasing risk that fiscal policy may turn contractionary
  - ◆ Many corporates highly leveraged even pre-crisis

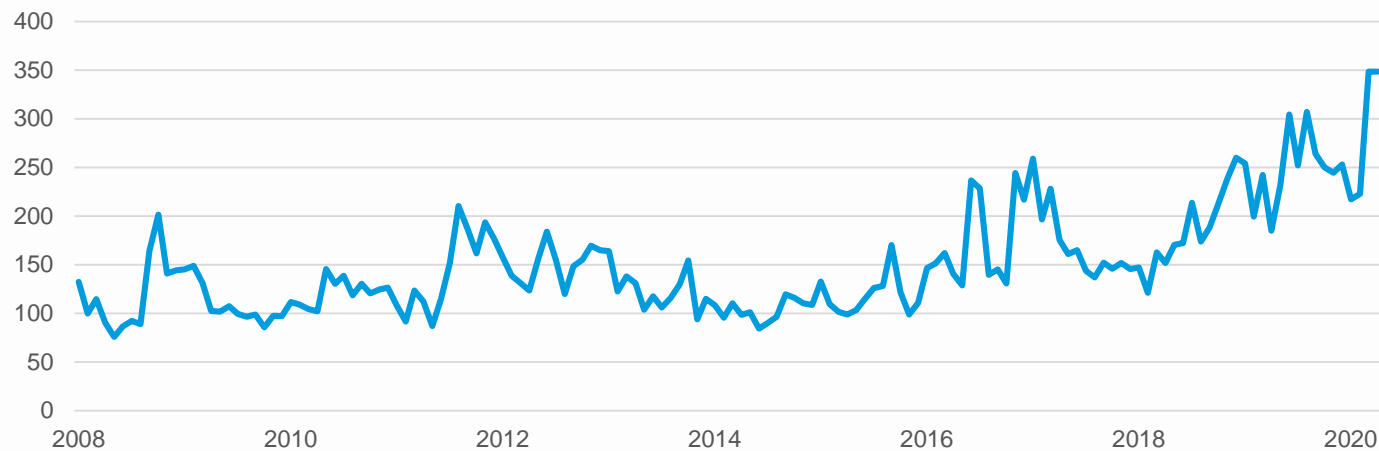


Source: Congressional Budget Office (red: actual; blue: projection).

# Headwinds impeding labor market recovery (con't)

- **High level uncertainty facing firms and households**
  - ◆ Uncertainty facing firms will weigh on business investment
    - EMEs/LICs may be especially affected by more uncertainty about global supply chains
  - ◆ Weaker job market prospects induces precautionary savings
- **Tighter financial conditions for SMES and low income households**

**Heightened Global Economic Policy Uncertainty**



Source: Davis, Steven J., 2016. "An Index of Global Economic Policy Uncertainty," *Macroeconomic Review*, October.

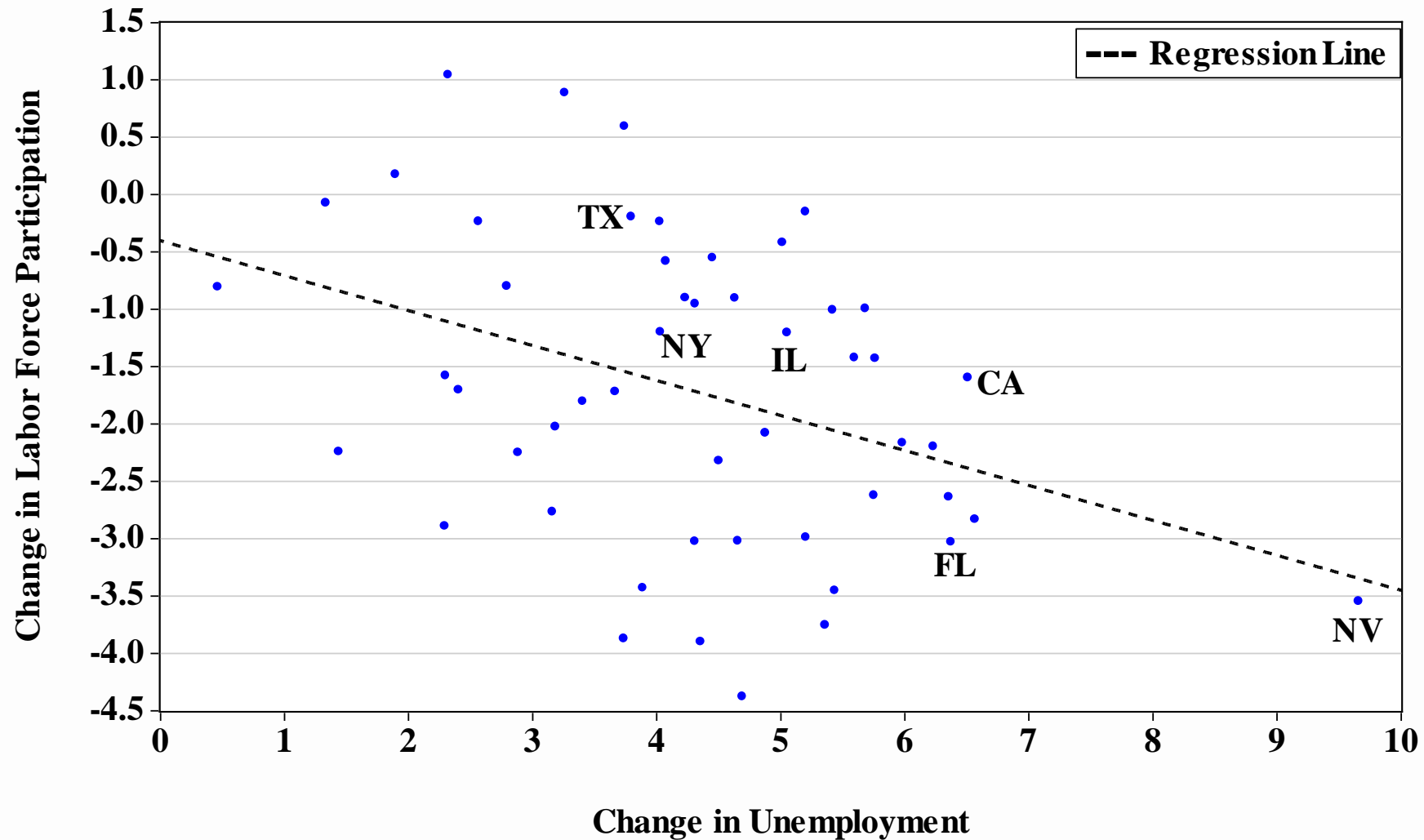
# Will workers return to the same jobs?

- Expectations have shifted from V-shaped to much slower recovery
  - ◆ Many jobs may be destroyed due to bankruptcy and firm downsizing
  - ◆ COVID-related shifts in demand from key sectors as well as intra-industry shifts
  - ◆ Recent research by Berrero, Bloom, and Davis (2020) suggests that 40 percent of U.S. layoffs may be permanent
- Reallocating labor to new firms likely to be time-consuming and costly

# Implications for monetary policy

- Persistently high unemployment can fuel labor market scarring
  - ◆ In U.S. case, not very evident before GFC: recessions were fairly short-lived, with little increase in long-term unemployment
- During GFC, prolonged rise in unemployment induced a sizeable drop in labor force participation
  - ◆ U.S states with large runups in unemployment in 2008-2010 had large labor force participation declines (Erceg and Levin, 2014)

# Labor Force Participation and Unemployment for Prime-Aged Adults (2008-2010)





# ELB and labor market scarring

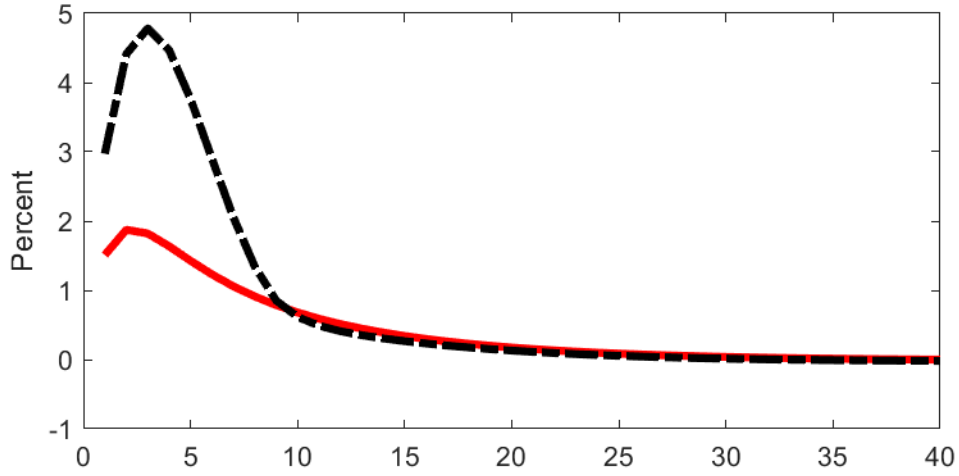
- Consider ELB constraint in DSGE model with endogenous labor force participation
- Aggregate demand shock drives up unemployment substantially
- ELB constraint induces:
  - Much bigger rise in unemployment
  - Prolonged period of low labor force participation (hysteresis)

# ELB and labor market scarring

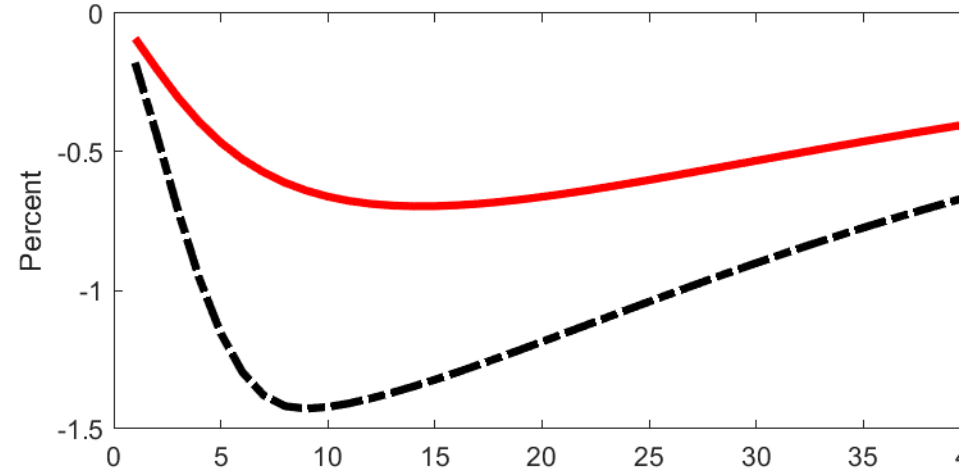
- Consider ELB constraint in DSGE model with endogenous labor force participation
- Aggregate demand shock drives up unemployment substantially
- ELB constraint induces:
  - Much bigger rise in unemployment
  - Prolonged period of low labor force participation (hysteresis)

**Figure 2: Adverse Demand Shock: Role of ELB**

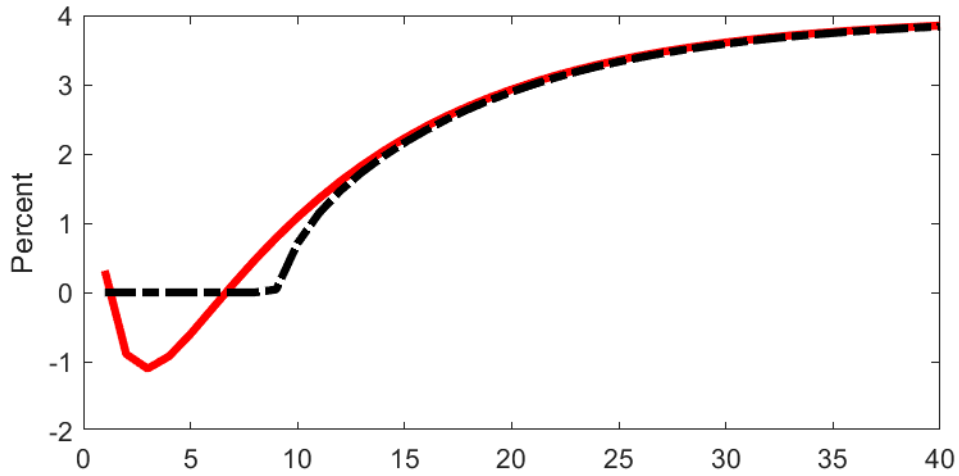
**Unemployment Gap**



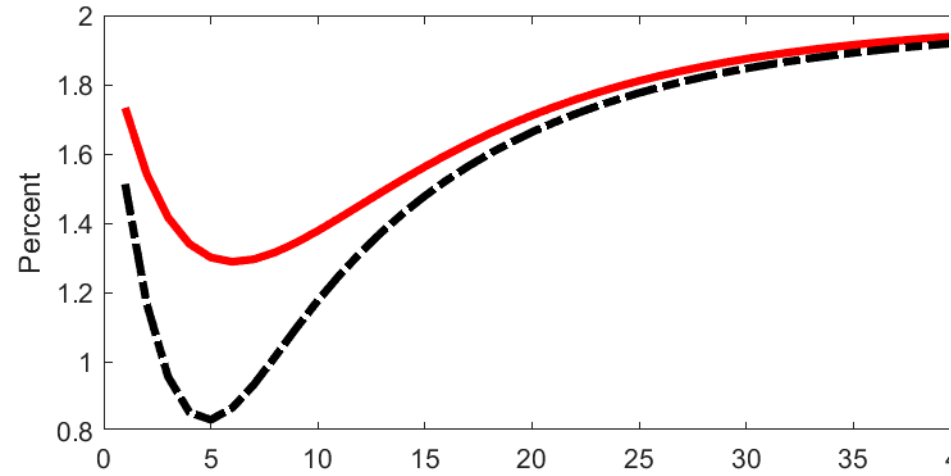
**Participation Gap**



**Nominal Interest Rate (APR)**



**Inflation**



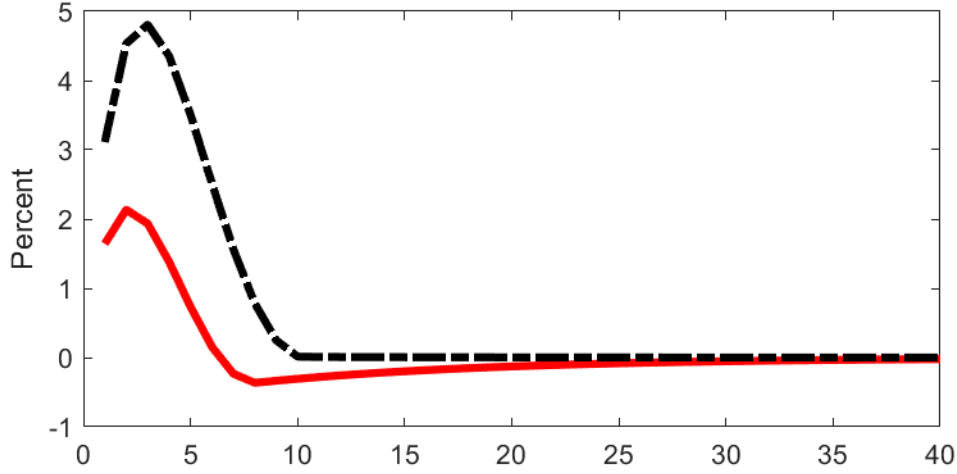
— No ELB constraint  
- - - ELB Binds

# Policy strategies to promote faster recovery

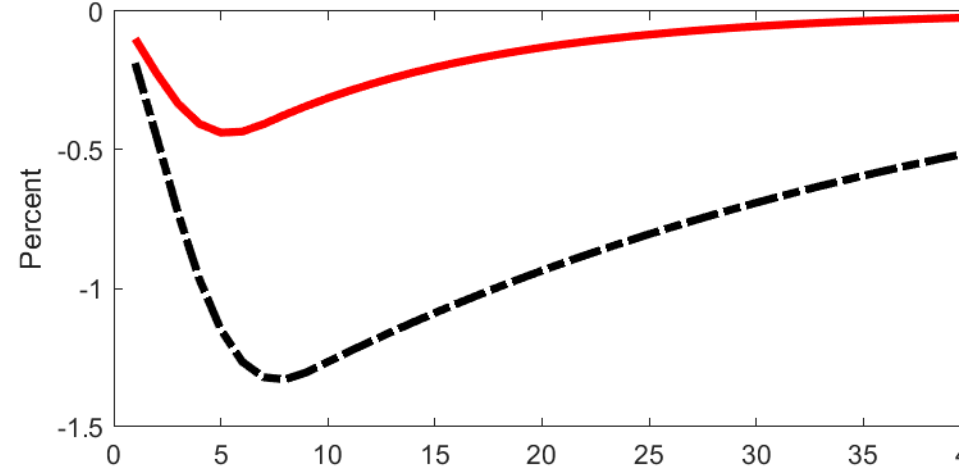
- **Aim broad** Monetary policy should focus on broader measure of slack that includes labor force participation (Erceg and Levin, 2014)
  - Drive unemployment below  $U^*$
  - Hot labor market causes faster rebound in participation (see simulation next page)
- **Aim high on inflation to reduce downside risks** Calibrate policy stimulus so modal distribution of inflation is well above target
  - ◆ Benefits of insurance higher as risks of f long-lived scarring are more material (as in very low  $r^*$  environment)

**Figure 3: Adverse Demand Shock under Different Rules**

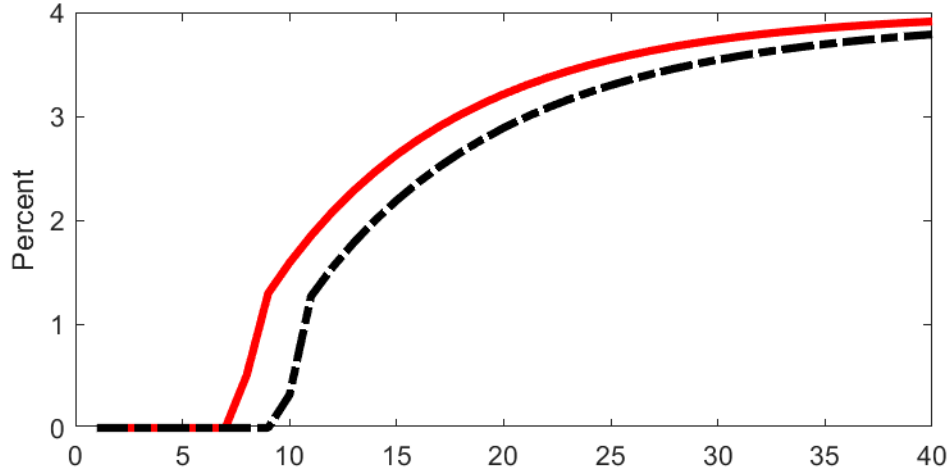
**Unemployment Gap**



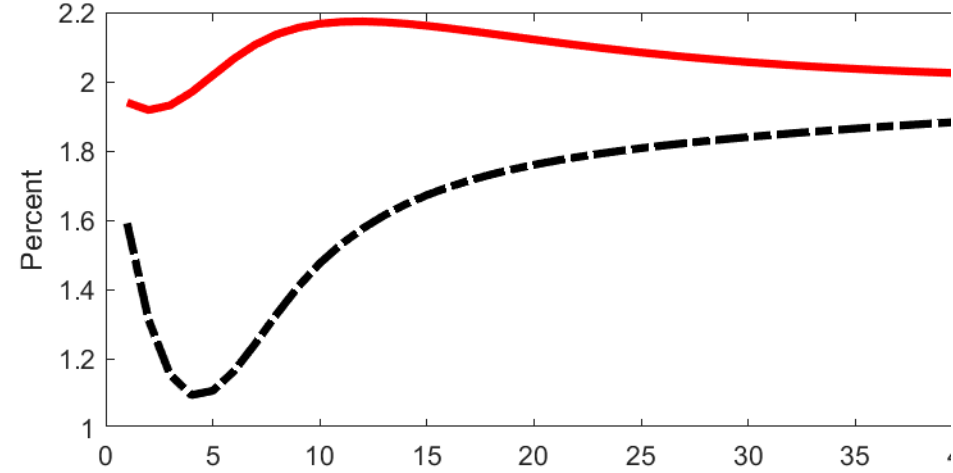
**Participation Gap**



**Nominal Interest Rate (APR)**



**Inflation**



— Respond to Broad Measure of Slack  
- - - Respond to Unemployment (Narrow)

# Policy Tools and Challenges

- With sovereign bond yields very low, central banks must aim to reduce borrowing spreads
  - ◆ Entails moving more deeply into private assets, including through targeted lending
  - ◆ Can be instrumental in easing strains on EMEs and boosting employment
  - ◆ Could raise policy economy challenges