Giving the Economy Time to Catch Its Breath

Mortgage Bankers Association Annual Convention and Expo
Pennsylvania Convention Center
Philadelphia, PA

October 16, 2023

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Federal Reserve Bank of Philadelphia

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Good morning.

My thanks to the Mortgage Bankers Association for the opportunity to be part of your annual convention and to Chair-elect Laura Escobar for that introduction.

And, with that, welcome to the City of Philadelphia and the Third Federal Reserve District.

I am honored to share this podium with my fellow speakers and to provide my outlook for economic conditions moving forward.

But before I do that, there is one piece of business to which I must attend, and that is the usual Federal Reserve disclaimer: The views I express are my own and do not necessarily reflect those of anyone else on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

Or, if I may give the Cliffs Notes version: When recounting my remarks, please just say, "Pat said," *not* "The Fed said."

Let me put it plainly: I stand here this morning fully aware of the mood in this room. And I am also fully aware of the way the actions we on the FOMC have taken over the past 18 months in our efforts to tame inflation and get it back down to our 2 percent annual target have, in their own way, contributed to the current mortgage climate.

As you know, one of the pillars of the Federal Reserve's dual mandate is price stability — getting inflation back to that 2 percent annual target. And while I am sensitive to the impacts higher policy rates have had, that goal remains job one.

Throughout the summer, I traveled with my team throughout the Third District — as we do every year — to meet with community bankers and other contacts in their home communities, to talk about conditions on the ground, to hear their perspectives and concerns, and to see firsthand the impacts of monetary policy on the local level.

Suffice it to say, the impact of rising mortgage rates was something that took front and center in nearly every conversation. In fact, the climate could be crystalized in seven words, which one of those contacts said to me recently: "There are no first-time home buyers."

That's a stark assessment. And it is one I take without further parsing. The housing market is key for our economy overall, not to mention its greater importance for our society as a whole in ensuring that every family has access to a safe and affordable place to call home.

The rise in interest rates not only raised borrowing costs on those looking to purchase a home, but it also contributed to the contraction of inventory. It is completely understandable that current homeowners won't put their houses on the market and step away from their current low-rate mortgages.

And it is just simple market dynamics that a lack of inventory would elevate prices overall, further lessening the depth of the pool of potential buyers.

Of course, the other side of this coin is new home sales, which both the hard data show and our contacts relay are trending upward throughout this period. This, too, makes sense from the view of market dynamics — the way around contracting inventory in existing homes is to purchase a home that didn't exist before. And we know these homes often come with attractive amenities and features an existing home may not, including being more energy efficient and decreasing the cost of keeping that home comfortable.

But, again, these sales cannot fully make up for the overall slowdown in one of the economy's most impactful sectors.

Now, I'm not going to stand here and provide a lecture on things you all know. And I am not going to minimize the work we've done to get inflation moving back toward target. What I want to provide you with this morning is where I see things moving forward.

To start, I remain in the place where I have found myself for the past several months: Absent a stark turn in what I see in the data and hear from contacts, and audiences like you, I believe that we are at the point where we can hold rates where they are.

After our last policy rate hike in July, I went on the record with my view that, if economic and financial conditions evolve roughly as I expect, we can hold rates where they are. And, so far, economic and financial conditions are evolving as I expected, perhaps even a tad better.

Disinflation *is* under way, labor markets *are* coming into better balance, and economic activity *continues* to be resilient.

Looking back, we did a lot, and we did it very fast. In fact, I heard that summation from some of your peers throughout the summer. In barely more than a year, we increased the policy rate by more than 5 percentage points and to its highest level in more than two decades. We also turned around our balance sheet policy, and we turned it around fast.

The workings of the economy cannot be rushed, and it will take some time for the full impact of the higher rates to be fully absorbed. What I have heard this summer is an appeal to give you and your customers the thing you wanted most: time to catch your breath.

But my argument is that by doing nothing, we *are* doing something. And I think we are doing quite a lot. Look where we are — headline PCE inflation remained elevated in August at 3.5 percent year over year, but it is down 3 percentage points from this time last year.

About half of that drop is due to the volatile components of energy and food, so despite both of these being basic necessities of life, economists typically exclude them in the so-called core inflation rate, which gives a more accurate assessment of the pace of disinflation and its likely path forward.

But even that core measure of PCE inflation has also shown clear signs of progress, and the August monthly reading was its smallest month-over-month increase since 2020.

And again, I'm telling you something you already know, the rate of inflation in housing prices is similarly down from its peak levels.

I do see a steady disinflation under way, and I expect it to continue, with inflation dropping below 3 percent in 2024 and leveling out at our 2 percent target thereafter.

However, there can be challenges in assessing the trends in disinflation. For example, September's CPI report came out modestly on the upside, driven by energy and housing.

Let me be clear about two things. First, I will not tolerate a reacceleration in prices. But second, I do not want to overreact to the normal month-to-month variability of prices.

And for all the fancy techniques, the best way to separate a signal from noise remains to average data over several months. Of course, to do so, you need several months of data to start with, which, in turn, demands that, yes, we remain data dependent but patient and cautious with the data.

As long as policy rates are restrictive, we will keep steadily pressing down on inflation and bringing markets into better balance.

And the policy rate has outside factors that are working in parallel to further push down on inflation. For example, while we are now six months past the spring banking turmoil, the tighter credit conditions that have existed since then are having the impact of higher interest rates without requiring them to be so.

Additionally, the current turmoil in labor markets is likely to similarly exert downward pressure on the economy — not just in the loss of overall economic activity but in the immediate impact on consumer spending as striking auto workers, for example, are forgoing their usual wages.

On top of this, we can also add the resumption of student loan payments. Again, we do not yet know what impact this will have on consumer spending and savings, but I do expect it to be impactful, if not significant.

So, it is against this backdrop that I believe the prudent position to be in is one in which the policy rate can remain steady. Alas, you may have noticed that I didn't tell you how long rates will need to stay high.

Unfortunately, I simply cannot tell you at this moment. My forecasts are based on what I know as of 10:30 a.m. on Monday, October 16, 2023.

As time goes by, as adjustments are completed, and as we have more data and insights on the underlying trends, I may need to adjust my forecasts, and with them my time frames. But, as for future policy, I can tell you I do subscribe to the moniker, "higher for longer." I didn't coin the phrase, but my expectation is that rates will need to stay high for a while.

It is not just the data that will signal to me when the time comes to adjust policy *either way*, but what I also hear from contacts and through outreach.

After all, my discussions over the summer helped lead me to my current position. And while I really do not expect it, if inflation were to rebound, I know I would not hesitate to support further rate increases as our objective to return inflation to target is, simply, not negotiable.

Meanwhile, I continue to see strong underpinnings for our economy overall. This economy is proving to be nothing if not resilient. I expect this to continue.

GDP growth is outperforming estimates from earlier this year. I do expect GDP gains to continue through the end of 2023, before pulling back slightly in 2024. But do not conflate a more moderate rate of GDP growth as a contraction. Put simply: I do not anticipate a recession.

Of course, to afford a home, a family needs a job to provide the means through which to purchase it. I continue to anticipate unemployment to end the year at about 4 percent — just slightly above where we are now — and to increase slowly over the next year to peak around 4.5 percent before heading back toward 4 percent in 2025.

This path would put the unemployment figure in line with the *natural rate of unemployment,* or that theoretical level where labor market conditions support stable 2 percent inflation.

Now, let me be clear about one thing: This does not mean that I expect mass layoffs.

There are many factors that play into the calculation of the unemployment rate itself. For instance, we've had recent months in which, even as the economy added more jobs, the unemployment rate increased because more workers moved off the sidelines and back into the labor force.

I also have to balance the soft data. For example, I have heard from employers — both directly and through contacts — that given how hard they've worked to find the workers they currently have, they are doing all they can to hold onto them.

Then there are also factors that have a very persistent impact on the underlying dynamics of the economy and the labor market — technological change, immigration, child care all can shape or reshape labor markets. And some or all of these factors can be at play simultaneously.

The amount of upheaval we've felt in our economy in a relatively short period of time may lead some to believe that there are fundamental changes taking place. I would argue that's only natural, given what we've all been through since March 2020.

The pandemic was such a large health and economic crisis that it marks a "before" and an "after" in our minds and lives, not the least of which was the tremendous loss of life that touched so many of us very closely. I cannot blame anyone who says that the *new normal* still does not feel *normal*.

But let me conclude by posing the following rhetorical question: What in the economy has fundamentally changed from, say, 2018 or 2019? In 2018, inflation averaged 2 percent almost to the decimal point and was actually below target in 2019. Unemployment averaged below 4 percent for both years and was as low as 3.5 percent, while policy rates peaked below 2.5 percent.

Now, I'm not saying that we're going to be able to exactly replicate prepandemic economic conditions. But the resilience of this economy is making me rethink some of the classic models.

I have been wrong before, and this economy is challenging us with its willingness to do what the models say it should not and cannot be able to do. But, as they say, every challenge comes with *opportunity*.

Opportunity to look at the data in different ways. And opportunity to get out and to speak with contacts for the all-important soft data, which, so often, captures nuances that the hard data cannot.

All of this — the hard data and the soft data — must be viewed together. And when it is, I believe my position on holding the policy rate steady is the prudent one to take.

I believe such a resolute, but patient, stance of monetary policy will allow us to achieve the *so t landing* that we all wish for our economy. And with that landing, we'll be able to see our economy take off again, but this time on a clear and stable path forward.

I thank you all for the opportunity to be with you today. I wish you the very best for a productive convention.

Thank you.